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Report of the Comptroller and Auditor General of India

Union Government (Commercial)
No. 3 of 2011-12
(Compliance Audit Observations)

Report of the Comptroller and Auditor General of India

for the year ended March 2010

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Laid on the table of Lok Sabha and Rajya Sabha on ....

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PREFACE

1. The accounts of Government Companies set up under the provisions of the Companies Act (including Companies deemed to be Government Companies as per the provisions of the Companies Act) are audited by the Comptroller and Auditor General of India (CAG) under the provisions of Section 619 of the Companies Act, 1956. The accounts certified by the Statutory Auditors (Chartered Accountants) appointed by the CAG under the Companies Act are subject to supplementary audit by officers of the CAG and the CAG gives his comments or supplements the report of the Statutory Auditors. In addition, these companies are also subject to test audit by the CAG.

2. The statutes governing some Corporations and Authorities require their accounts to be audited by the CAG and reports to be given by him. In respect of five such Corporations *viz.* Airports Authority of India, National Highways Authority of India, Inland Waterways Authority of India, Food Corporation of India and Damodar Valley Corporation, the relevant statutes designate the CAG as their sole auditor. In respect of one Corporation *viz.* Central Warehousing Corporation, the CAG has the right to conduct a supplementary or test audit after audit has been conducted by the Chartered Accountants appointed under the statute governing the Corporation.

3. Reports in relation to the accounts of a Government Company or Corporation are submitted to the Government by the CAG under the provisions of Section 19-A of the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971, as amended in 1984.

4. The Audit Board mechanism was restructured during 2005-06 under the supervision and control of the CAG. The Board, which is permanent in nature, is chaired by the Deputy Comptroller and Auditor General (Commercial) and consists of senior officers of the CAG. Two technical experts are inducted as special invitees, if necessary. The Director General (Commercial) of the CAG's Office is the Member Secretary to the Board. The Board approves the topics recommended for performance audit. It also approves the guidelines, audit objectives, criteria and methodology for conducting major performance audits. The Board finalises the stand alone performance audit reports after discussions with the representatives of the Ministry and Management.

5. Annual Reports on the accounts of the Central Government Companies and Corporations are issued by the CAG to the Government. For the year 2010-11, these are:

Compliance Audit Reports

Report No. 2 of 2010-11 - Financial Reporting by Public Sector Undertakings (PSUs): This gives an overall picture of the quality of financial reporting by PSUs and an appraisal of the performance of the Companies and Corporations as revealed by their accounts.

Report No. 3 of 2011-12 - Compliance Audit Observations: This contains observations as a result of theme based audit and on individual topics of interest noticed in the course of audit of the Companies and Corporations.

Performance Audit Reports

Report No. 22 of 2010-11: This contains the results of performance audit on Capacity addition programme project management of NTPC Limited.

Report No. 27 of 2010-11: This contains the results of performance audit on Corporate Social Responsibility of Steel Authority of India Limited and Rashtriya Ispat Nigam Limited.

Report No. 28 of 2010-11: This contains the results of performance audit on Joint Venture Operations of ONGC Videsh Limited.

6. The cases mentioned in this Report are among those which came to notice in the course of audit during 2009-10 as well as those which came to notice in earlier years but could not be reported. Similarly, results of audit of transactions subsequent to March 2010 in a few cases have also been mentioned, wherever available and relevant.

7. All references to 'Government Companies/ Corporations or PSUs' in this Report may be construed to refer to 'Central Government Companies/ Corporations' unless the context suggests otherwise.

EXECUTIVE SUMMARY

I Introduction

1. This Report includes important audit findings noticed as a result of test check of accounts and records of Central Government Companies and Corporations conducted by the officers of the Comptroller and Auditor General of India under Section 619(3) (b) of the Companies Act, 1956 or the statutes governing the particular Corporations.

2. The concept of thematic study was introduced during the year to shift to system based quality audit reporting using risk based audit approach. The Report contains 34 theme based audit/IT audits and 37 individual observations relating to 50 PSUs[1] under 17 Ministries/Departments. The draft observations were forwarded to the Secretaries of the concerned Ministries/Departments under whose administrative control the PSUs are working to give them an opportunity to furnish their replies/comments in each case within a period of six weeks. Replies to 51 observations were not received even as this report was being finalised in March 2011. Earlier, the draft observations were sent to the Managements of the PSUs concerned. In respect of six paragraphs[2], the Managements did not respond.

3. The paragraphs included in this Report relate to the PSUs under the administrative control of the following Ministries/Departments of the Government of India:

Ministry/Department (Total number of PSUs/ **PSUs involved here)**	**Number of paragraphs**	**Number of thematic studies/IT audits**	**Number of paragraphs/ thematic studies/IT audits in respect of which Ministry reply was awaited**
1. Atomic Energy (5/**1**)	1	-	1
2. Civil Aviation (10/**1**)	3	3	6
3. Coal (12/**3**)	2	1	1
4. Commerce and Industry (11/**1**)	-	1	-
5. Communications and Information Technology (7/**1**)	3	4	6
6. Consumer Affairs, Food and Public Distribution (3/**1**)	2	3	5

[1] ***This includes 14 PSUs whose paras have been shown under the Department of Public Enterprises as consolidated paras.***

[2] ***AAI in respect of para number 2.1 and 2.3; BSNL in respect of para number 5.1, 5.2 and 5.3 and FCI in respect of para number 6.2.***

7. Defence (10/3)	3	2	5
8. Fertiliser (12/2)	-	2	2
9. Finance (22/5)	3	3	3
10. Heavy Industries (52/1)	1	2	3
11. Housing and Urban Poverty Alleviation (2/1)	-	1	1
12. Petroleum and Natural Gas (23/7)	7	2	2
13. Power (39/3)	1	4	1
14. Public Enterprises ([1]/[2])	4	1	3
15. Road Transport and Highways (2/1)	1	-	1
16. Shipping (9/1)	1	1	2
17. Steel (15/4)	5	4	9
Total (234/50)	37	34	51

4. Total financial implication of audit observations included in 34 thematic studies/ IT Audits was ₹ 5353.74 crore.

5. Individual Audit observations in this Report are broadly of the following nature:

- Non-compliance with rules, directives, procedures, terms and conditions of the contract etc. involving ₹ 1022.39 crore in 13 paras.
- Non-safeguarding of financial interest of organisations involving ₹ 505.36 crore in 11 paras.
- Defective/deficient planning involving ₹ 868.96 crore in eight paras.
- Inadequate/deficient monitoring involving ₹ 28.77 crore in two paras.
- Non-realisation/ partial realisation of objectives involving ₹ 21.16 crore in one para.
- Recovery at the instance of Audit involving ₹ 7.21 crore in one para.
- Corrections/rectifications at the instance of audit in one para.

[1] All the PSUs are under the Department of Public Enterprises
[2] 14 PSUs covered in the para are not appearing in the respective Ministry/Department

transported through road to three rail-fed depots under Gujarat Region during the year 2006-07 and 2007-08 by incurring extra expenditure of ₹12.57 crore. Though the grab was to be provided by the sellers at their cost or by SCH&T contractors, ₹ 21 crore was paid as grab charges to SCH&T contractors for discharge. FCI suffered a loss of 32523.315 MT above standard allowance, amounting to ₹17.27 crore on account of Rail Transit Losses, which could not be recovered from the contractors as there was no provision in the contract. Similarly, the claims towards losses/shortages/damaged gunnies to the extent of ₹ 6.19 crore were pending settlement as the contractors had disputed the amount.

(Para 6.2)

6. Steel Authority of India Limited decided to set up Steel Processing Units (SPUs) in different parts of the country especially in states where there was no steel plant to meet customer demand for sized and finished steel near the point of consumption, to increase consumption of steel in rural areas and to expand market base. The Company accorded 'in principle' approval for installation of 10 SPUs in six states where no integrated steel plant was located at an investment of ₹ 1259.67 crore during October 2007 to February 2009.

However, it was observed that in six sites necessary facilities like loading and un-loading arrangement, power, water, and approach road were not available or the land was not suitable. As per feasibility reports viability of the project was dependent on availability of certain concessions/relief from State Governments; in seven cases the Company's request for the concessions was either refused, conditionally agreed to or had not been granted so far. The Company could not get the intended benefits of setting up of SPUs as final approval of only two units was accorded after lapse of 8-33 months of 'in-principle' approval and actual work of construction/erection had started at one site only.

(Para 17.6)

7. Pratt & Whitney, Canada (P&WC), the manufacturer of Aero-Engines, expressed their interest (February 2006) for outsourcing critical rotating components to Koraput Division of Hindustan Aeronautics Limited. The Division set up dedicated facilities for undertaking export orders without firm commitment or equity participation with P&WC. During July 2009, that is, after 27 months from the date of signing agreement, P&WC cancelled the orders on the pretext that their personnel were not comfortable with regard to manufacturing of critical rotating parts outside their direct supervision and the sustained concerns of their Senior Management regarding their personnel security. This resulted in blocking up of funds of ₹ 53.57 crore as well as infructuous expenditure of ₹ 46.97 crore.

(Para 7.5)

8. To fill in the deficit of its large scale operation in rural areas, Bharat Sanchar Nigam Limited levied Access Deficit Charge (ADC) on all private telecom service providers (PSPs) using WLL(M) viz. 'Wireless in local loop Mobile' for their all outgoing calls and incoming international calls. 'Unlimited Cordless' and 'Walky' services of Reliance Communications Limited, Tata Teleservices Limited and Tata Teleservices (Maharashtra) Limited were found to be the services from WLL (M) and, hence, ADC was levied on them for the period November 2004 to February 2006. Contention of the PSPs that their services were not WLL (M) services was dismissed by Telecom Dispute Settlement and Appellate Authority and the Hon'able Supreme Court in

April 2008. Accordingly, the PSPs paid 75 *per cent* of the claim that was raised by the Company during the period October 2005 to June 2008.

Test check in four telecom circles revealed that dues for ₹ 50.51 crore for the balance ADC for the period from November 2004 to February 2006 (with interest upto May/June 2008) had not been paid by the PSPs, despite the above judgement of the Court. All the four circles had also not raised interest claims on these PSPs for subsequent periods for the delayed payments.

The bills for the interest claim of ₹ 12.98 crore upto May 2010 were raised on PSPs by the circles on being pointed out by Audit. Thus, all the four telecom circles of the Company test checked in Audit failed to realise Access Deficit Charge and interest thereon for ₹ 63.49 crore from the PSPs.

(Para 5.5)

9. As a part of diversification activity, BEML Limited decided to form a Joint Venture Company (JVC) for entering into the contract mining business. Adequate publicity was not given in press for calling for Expression of Interest from prospective partners. Selection of M/s Midwest Granite Private Limited, Hyderabad (MGPL) as a JV partner was justified by the Company by adopting incorrect data of turnover, staff strength and experience of MGPL. The Ministry of Defense had drawn attention of the Company to the need for proper credit rating to ensure financial soundness. Even then, the Company's Board approved formation of the JVC with MGPL. The Chairman of the Company was the Chairman of the JVC.

To help MGPL gain contract mining experience before incorporation of the JVC, the Company obtained work relating to contract mining from MOIL Limited and subcontracted to MGPL. MGPL could execute a small fraction of the work. The JVC undertook the balance work and sustained a loss of ₹ 1.41 crore.

With no further orders on contract mining, the Company persuaded the JVC into trading of iron ore which was neither one of the objectives of its formation, nor an activity for which it had any previous experience. BEML funded the activity by providing an advance of ₹ 112.61 crore. In addition, BEML provided a Corporate Guarantee of ₹ 19.15 crore to the JVC against credit facilities from bank which lacked justification. Out of the credit of ₹ 13.41 crore availed by the JVC, ₹ 11 crore was misappropriated by a nominee Director of MGPL and JVC incurred forward cover loss of ₹ 18.66 crore.

Though the Company recovered the advance, it spent ₹ 1.52 crore (2007-08 to 2009-10) to meet day-to-day expenses of the JVC not in operation. Thus, failure to ensure financial credentials of the JV partner resulted in unfruitful investment of ₹ 6.94 crore (₹ 5.42 crore equity plus ₹ 1.52 crore maintenance expenses) besides impending threat of invoking of Corporate Guarantee of ₹ 19.15 crore.

(Para 7.3)

10. Food Corporation of India (FCI) as well as State Government agencies procured foodgrains for the Central Pool from the mandis established by the State Marketing Boards. For transportation of foodgrains from these mandis to the storage points committees at district level were constituted to finalise appointment of labour and transport contractors in order to have uniform rates in all mandis/procurement centres.

The contracts for transportation from mandis to storage points were awarded in Punjab on adhoc basis by allowing a certain *percentage* enhancement over the previous years' rates. Examination of rates in five Districts in Punjab region revealed that the rates for same distance ranged from ₹ 6.25 to ₹ 36.05 *per* quintal *per* kilometer during 2005-06 to 2009-10. Fixation of different *per* quintal *per* kilometer rates for same distance resulted in extra expenditure of ₹ 24.34 crore for transportation of 23.52 lakh MT of foodgrains during 2005-06 to 2009-10.

(Para 6.4)

11. In September 2003, the Government of India decided to restructure Indira Gandhi International Airport, Delhi to develop it as a world class airport by involving private sector. Accordingly, Airports Authority of India (AAI) signed Operation, Management and Development Agreement (OMDA) with Delhi International Airport Private Limited (DIAL), a Joint Venture Company.

Audit observed that DIAL had formed 11 Joint Ventures (JV) to undertake non-aeronautical services with revenue share of DIAL ranging from 10 to 61 *per cent* of gross revenue generated by the JVs. Audit scrutiny of cargo and car parking services revealed that the revenue share of DIAL reduced substantially in spite of increase in business. This resulted in reduction in revenue share of AAI by ₹ 103.29 crore during the period December 2009 to December 2010. The JVs were not in consonance with OMDA provision on Annual Fee. The AAI was bound to suffer further losses during the currency of JVs in their present form.

Audit also observed that DIAL benefitted due to non-levy of interest on excess annual fee actually received over that provided for in OMDA. Besides, due to absence of enabling provisions, AAI was not in a position to levy penal interest on delayed payments by DIAL. It was also observed that there was delay in getting reimbursements for payments made by AAI to contractors on behalf of DIAL which was against the provisions of OMDA. Had AAI managed this contract more pro-actively, it could have earned additional revenue from 23 to 24 *per cent* of the revenue that they were earning.

(Para 2.3)

12. Aviation Fuel Station (AFS) of all three oil marketing PSU viz., IOCL, BPCL and HPCL at Chennai receive Aviation Turbine Fuel (ATF) from Chennai Petroleum Corporation Limited, a subsidiary of IOCL (Refinery). IOCL commissioned dedicated ATF pipeline between the Refinery and Chennai AFS at a cost of ₹48 crore. HPCL used the pipeline on two occasions and the sharing arrangement came to an end as IOCL's demand of transportation charges at the rate of ₹ 612 per MT was not agreed to by HPCL as it was incurring ₹183 per MT for transportation through tank trucks. The other two OMCs had transported a total of 2,82,466 MT of ATF by tank trucks during December 2008 to September 2010 incurring expenditure of ₹ 15.99 crore estimated towards quality checking, handling and other expenses and ₹ 5.17 crore on transportation which could be avoided by transportation through pipeline. Besides IOCL lost revenue on pipeline usage which would have been between ₹ 5.17 crore and ₹ 17.29 crore based on the rates to be decided by OMCs.

(Para 12.1)

13. Hindustan Steelworks Construction Limited (HSCL) entered into an agreement with Sricon Infrastructure Pvt. Ltd (SIPL) to form a Joint Venture (JV), sharing financial responsibility in the ratio of 51:49 respectively. JV submitted bid for 4 laning of Nagpur-Hyderabad Section of National Highway - 7 from KM 94 to KM 123. National Highway Authority of India (NHAI) awarded the work to JV at a contract price of ₹ 105.27 crore. JV could not complete the work and left the work site. NHAI terminated the contract and forfeited the Bank Guarantee of ₹ 8.00 crore. HSCL further incurred loss of ₹ 8.64 crore being the fund provided to JV from time to time.

It was noticed that the Chairman–Cum-Managing Director, HSCL approved formation of JV with SIPL for the purpose of executing a job of the value of ₹ 105 crore which was beyond his power. There was no record available with the company on method and criteria for selection of JV partner. Even the credentials of the JV partner were not evaluated before selection. Due to failure of the Company in providing adequate resources for the work and inadequate control over the functioning of JV and construction work it incurred a loss of ₹16.64 crore.

(Para 17.1)

14. On the proposal of a US based company *viz.* ETON, Bharat Electronics Limited undertook contract for manufacturing of 19,110 satellite radio receivers for supply to ETON. However, the Company failed to enter into any contract/agreement with ETON with specific terms and conditions detailing, inter-alia, the obligations and responsibilities of the buyer.

The Company manufactured and dispatched 11,748 radios to ETON during June 2005 to June 2006 as per the design, test procedures, quality checks and clearance by the agency designated by ETON. The radios failed in the field due to battery leakage, display failure, *etc.* ETON recalled radios and returned 3,718 radios to the Company during June 2006 to September 2008 for rectification. ETON did not make full payment even for the 8,030 radios retained. Even after rectification by the Company, ETON did not lift the radios on the ground of slump in the market and introduction of 'Regulations on Hazardous Substances' in July 2006 in USA and Europe.

Besides raw material, the Company ended with an inventory of 3,774 finished radios, 5,944 semi-finished radios. The radios could not be put to alternate use as the Company did not have license and necessary back up required for effective usage in India. In the absence of an agreement with ETON, the Company could not force the former to compensate it for the radios manufactured and not lifted and loss incurred by the Company due to defects in the design prescribed. As a result, the Company had to incur avoidable loss of ₹ 16.39 crore.

(Para 7.1)

15. Mumbai International Airport Private Limited (MIAL) –private operator of the Chatrapathi Shivaji Mumbai International Airport had been collecting Passenger Service Fee (PSF) from embarking passengers.

As per orders of the Government of India (GOI), Ministry of Civil Aviation ₹ 130 crore of the PSF was required to be deposited in an Escrow Account for payments to be made to Central Industrial Security Force (CISF). Any surplus in the Escrow Account is transferable by MIAL to the Airport Authority of India for making payments to CISF at other airports. Aviation security is an activity reserved for the GOI.
During the year 2007-08 and 2008-09 MIAL had withdrawn ₹ 15.22 crore from the PSF (SC) for deploying private security agencies at the airport, consultancy charges and for

II Highlights of significant paras included in the Report are given below:

1. Oil and Natural Gas Corporation Limited (ONGC) set up C_2C_3 plant at Dahej (Gujarat) at a cost of ₹ 573 crore for extraction of C_2 (ethane), C_3 (propane) and C_4 (butane) from the Liquified Natural Gas (LNG) for supply to IPCL/RIL through a pipeline till the Company could set up its own petrochemical plant. Though C_2C_3 plant had been mechanically completed by December 2008, it could not be commissioned till December 2010 as there was no arrangement to off-take the products.

Contract for laying of the pipeline was awarded in July 2009 and completed in July 2010 at a cost of ₹ 8.45 crore but no agreement could be reached with RIL till date (December 2010).

As RIL expressed interest in off-taking only C_2 for the interim period, ONGC awarded contract for truck loading facility for supplying C_3 and C_4 to oil marketing companies. An expenditure of ₹ 71.83 crore had been incurred on truck loading facility which had not been completed till December 2010.

As the petrochemical complex of ONGC was scheduled for completion by December 2012, the Company had to obtain the extended process performance guarantee for the plant and till December 2010 and an expenditure of ₹ 20.19 crore has been incurred on this account.

Consequently, the C_2C_3 plant completed in December 2008 at a cost of ₹ 573.29 crore proved to be unproductive besides incurring expenditure of ₹ 100.47 crore in creating interim facilities for offtake of the products and extended performance guarantee.

(Para 12.6)

2. MSTC Limited entered into agreements with associates for export of gold jewellery. The associates were required to indentify the foreign buyers, obtain export orders and export the jewellery in the name of the Company. The foreign buyers were required to pay the export proceeds after 170 days from the date of dispatch. The Company was required to release advance up to 80 *per cent* of the invoice value to associates immediately after export. It was also stipulated that the associates would bear all the risks and costs in the event of non payment of export proceeds by the buyers. The Company did not verify the credentials of the associates and the foreign buyers. A few of the associates and foreign buyers were having common Directors but the Company ignored the same. The Company ventured into this risky business with no security against the advances provided to the associates. The Company ended up with a financial burden of ₹ 611.79 crore due to non-recovery of advance and related financial expenses, from the associates for gold jewellery exports during the year 2008-09 as 46 out of 47 foreign buyers did not pay their dues. The insurers also refused to make good the loss on the ground that the Company did not have any insurable interest in the business as all the risks and costs in the business were to be borne by the associates only.

(Para 17.2)

3. The Ministry of Petroleum & Natural Gas restricted use of APM gas only for fertilizer and for power generating companies supplying electricity to the grid for distribution to the consumers through public utilities/licensed distribution companies. Accordingly, the Ministry revised the rates for APM gas supplied to consumers other than power and fertilizer sector consumer from ₹ 3200 to ₹ 3840 per Metric Standard Cubic Meter. GAIL (India) Limited continued to supply the gas at pre revised rates of

₹ 3200 to consumers generating electricity and supplying to their consumers at commercially agreed rates through wheeling arrangement with the state electricity board. Thus, GAIL extended benefit to private parties taking shelter under the argument that the matter stood referred to the Ministry for clarification and leaving the matter unresolved for an indefinite period. This resulted in loss of revenue of ₹ 227.37 crore during April 2006 to March 2010.

(Para 12.2)

4. STCL Limited carried out trading in iron ore by entering into agreements with Business Associates (BAs) for procuring iron ore from different sources and bringing the ore to the nominated port under the custody of the Company. The Company advanced 80 *per cent* (revised to 90 *per cent*) against the proposals from BAs who brought in the ore and made the shipments.

Audit observed that the system of selection of BAs was neither competitive nor transparent. The Company accepted to act as facilitator for iron ore trade with BAs without ensuring their financial credentials and without insisting on back-to-back contracts. The Company had not framed any guidelines for conducting iron ore trading.

Consequent to fall in iron ore prices from 2008-09 and in the absence of financial and contractual safeguards, the advance of ₹ 54.37 crore paid by the Company to three BAs became unrecoverable as on March 2010 due to the BAs failing to fulfill their export obligations.

On many occasions, the Company had advanced funds to the BAs in excess of sale proceeds. Advances released were not reconciled. Failure of internal control to keep track of payments resulted in excess payment of ₹ 11 crore to BAs.

The Company failed to exercise basic inventory control and was unaware of the physical unavailability of stocks valued at ₹ 95.79 crore. It relied entirely on the stock details furnished by the BAs and C&F agents which proved to be misleading.

(Para 4.1)

5. Government of India decided in February 2006 to import wheat in view of depleting stock position in the buffer stock. The import was planned in two phases i.e., Phase - I in 2006-07 and Phase II in 2007-08. The import was through STC/MMTC/PFC on high sea sales basis on behalf of Food Corporation of India. Planning by FCI for berthing of vessels at Indian ports was not proper. Out of 72 lakh MT wheat import throughout India 55 lakh MT (76 *per cent*) was routed through Mundra and Kandla ports. Out of 142 vessels 109 vessels were berthed at Mundra and Kandla ports and unscheduled arrival of large number of vessels at these ports resulted in heavy pre berthing demurrage, amounting to ₹ 24.05 crore. Portion of the wheat discharged from ships berthed at Chennai port was moved to various states viz. West Bengal, Assam, Bihar, Chhattisgarh etc. by incurring heavy rail freight amounting to ₹ 7.85 crore. These vessels could have been allocated to eastern coast ports like Vizag and Kakinada to avoid extra expenditure. Wheat from Kandla and Mundra ports was also transported to southern states by incurring heavy rail freight which resulted in excess transportation cost to the extent of ₹ 5.29 crore. Smaller ships of less than 36,750 MT were berthed at Kandla/Mundra ports carrying 3.29 lakh MT. By berthing smaller ships at Mumbai port additional expenditure of ₹ 10.51 crore on transportation by rail from Kandla and Mundra to places which were close to Mumbai port could have been avoided. Wheat was purchase of X-ray screening machine in violation of the orders of the GOI regulating operation of the Escrow Account and resulted in loss to the GOI.

(Para 2.5)

CHAPTER I: DEPARTMENT OF ATOMIC ENERGY

Nuclear Power Corporation of India Limited

1.1 Loss due to omission in the tariff notification

The Company did not include a clause on reimbursement of income tax in its proposal to the Department of Atomic Energy for tariff notification and could not claim the same from Rajasthan State Electricity Distribution Companies (DISCOMS), resulting in loss of ₹ 94.87 crore.

The Department of Atomic Energy (DAE) notifies from time to time the tariff rates for the sale of power by various units of Nuclear Power Corporation of India Limited (Company). The tariff rate consists of fixed and variable elements. The fixed cost element is determined with reference to the total estimated operating cost to the normative capacity and the variable element consists of fuel cost, income tax and insurance. The DAE notifies the tariff based on the proposal submitted by the Company. The various units of the Company raise the bills on the bulk purchasers of power at the tariff rates.

The Company negotiated (November 2000) with Rajasthan Rajya Vidyut Prasaran Nigam Limited (RVPNL) and the DAE notified (August 2001) different tariff rates applicable for the Units 3 and 4 of Rajasthan Atomic Power Station (RAPS) for the period 1 June 2000 to 30 November 2005 and 23 December 2000 to 22 December 2005 respectively. The notified tariff specifically provided that the tariff rate would not be adjusted towards Fuel and Heavy Water charges and Income Tax (IT) payable by the Company would not be reimbursed by the beneficiary Boards. The Company proposed (November 2003) a common tariff rate applicable for the Units 2, 3 and 4 of RAPS and submitted a draft tariff notification to the DAE, applicable from December 2003, which contained formula for computation of Fuel and Heavy water charges and insurance charges for dovetailing into the tariff rate but did not include the reimbursement element of IT payable by the Company. Accordingly, the DAE notified (February 2004) a uniform tariff applicable for the Units for the period December 1, 2003 to November 30, 2008 in line with the proposal made by the Company.

The Company started (March 2005) raising demand for reimbursement of IT for the year 2003-04 onwards for an amount of ₹ 84.07 crore pertaining to the billing period December 2003 to November 2005 and for ₹ 21.61 crore for the period December 2005 to January 2007. The RVPNL (which was reorganized into distribution companies as DISCOMS) disputed the claim on the ground that the notified tariff did not contain a specific clause for reimbursement of IT. The DAE clarified (June 2007) that though the tariff notification issued in February 2004 did not specifically provide for the reimbursement of IT, the exemption in the earlier notification was not applicable. The DAE further clarified (December 2008) that the tariff in the power sector was based on post tax return on equity and IT was reimbursable. After a series of correspondence with RVPNL, the Company held (February 2010) a meeting with DISCOMS and decided to waive 50 *per cent* of the IT dues pertaining to the period December 2005 to January 2007 and the balance 50 *per cent* were to be paid in six equal monthly installments from July 2010. In effect, the IT claim for the period December 2003 to November 2005 for ₹ 84.07 crore was fully waived along with waiver of 50 *per cent* of the claim (₹ 10.80 crore) for the period December 2005 to January 2007 without seeking the necessary approval of the Board.

The Management stated (August 2010) that the tariff notified in February 2004 was in partial modification of earlier 2001 notifications which specifically provided that IT would not be reimbursable and February 2004 notification was silent on this aspect. The reply further stated that in view of the above the claim for IT reimbursement for ₹ 84.07 crore for the period December 2003 to December 2005 was found legally non-sustainable and hence withdrawn.

The reply is to be seen in the light of the fact that February 2004 notification was scripted by the Company for all its contents and the omission on IT reimbursement rested only on the Company. The argument that the claim for reimbursement of IT was not legally enforceable was in contrast to the factual position that the other State Electricity Boards/Companies of Delhi, Chandigarh, Shimla, Uttranchal, Lucknow, Punjab, Haryana and Jammu who were also drawing power from RAPS reimbursed IT.

Thus, the failure of the Company to guide DAE in the tariff notification to protect its financial interests resulted in ambiguity relating to IT reimbursement and loss of ₹ 94.87 crore.

The matter was reported to Ministry in September 2010, reply was awaited (February 2011).

CHAPTER II: MINISTRY OF CIVIL AVIATION

Airports Authority of India

2.1 Management and Execution of Terminal Building Construction Projects

Introduction

The Airports Authority of India (AAI) came into existence on 01 April 1995 by merging the International Airports Authority of India with the National Airports Authority. The merger brought into existence a single organisation entrusted with the responsibility of creating, upgrading, maintaining and managing civil aviation infrastructure both in the air and on surface in the country. The major function of AAI is to manage the civil aviation infrastructure on the ground which accounts for 60 *per cent* of the total capital expenditure on infrastructure. AAI has 115 airports spread all over the country.

The AAI has taken up modernization and expansion of existing Terminal Buildings and construction of new Terminal Buildings at various airports. The AAI intends to create world class facilities for passengers and other users at these airports.

Audit Objectives

The audit objective of conducting this thematic study was to assess whether execution and Management of construction projects for new terminal buildings at the airports selected for audit were economic, efficient and effective.

Scope of Audit

Out of total 9 non–metro airports in the Northern Region, where cumulative project expenditure during 2006-07 to 2009-10 was more than ₹ 100 crore (approx.) and value of each completed capital work was not less than ₹ 30 crore (approx.), five airports namely Dehradun, Udaipur, Amritsar, Jaipur and Srinagar were selected for audit.

The following works taken up by AAI at these airports were selected for review in Audit:

Sl. No.	Airports	Particulars of work	Work Order No.
1	Dehradun	Construction of New Terminal Building, Sub station cum A.C. plant room, U.G. Tank, Pump room, car-park and associated works.	Work Order No. AAI/ Terminal Bldg./Engg (c)/329 Dated 30.01.2008
2	Udaipur	Construction of a New Terminal Building Complex.	Work Order No. AAI/Udaipur-TB/ Engg(c)/ 2484 Dated: 08.11.2005)
3	Amritsar	Modular expansion of Terminal Building	Work Order No. Engg./ DP/ME/ ASR/2006/2846-49 Dated 24.11.2006
4	Jaipur	Construction of New International Terminal Building and allied work	AAI/Jaipur- TB/Engg.(C) Dated : 12.07.2006

5	Srinagar	Extension and renovation of existing terminal building including internal water supply, sanitary installations, internal electrifications etc.	Work Order No. AAI/NAD / Srinagar/ TB/Engg(c)/246 Dated; 29.10.2004

Audit Criteria

Project works mentioned under Scope of Audit were examined with reference to policy on airports infrastructure, AAI's Works Manual and Technical Instructions issued by AAI from time to time.

Audit Methodology

Audit reviewed the records relating to Minutes and Agenda Notes pertaining to meetings of the Board of Directors of AAI, Management Information Reports, norms stipulated for assessing requirements at terminal buildings at each airport, records relating to tendering process, payments released to contractors and vendors, correspondence of AAI with various parties like contractors, various agencies of Central/State Governments etc, and information as well as other relevant records obtained from AAI which were necessary for conducting this study. After comparing actual status of the work with what the AAI had envisaged, audit observations were framed.

Acknowledgement

Audit acknowledges the co-operation and assistance extended by the Management during the course of audit.

Audit Findings

2.1.1 Time and Cost Overruns

Before proceeding to Audit Findings given in succeeding paragraphs, the basic data of the projects undertaken at the selected airports and delay in completion of these projects needs to be referred to which is given in the Tables below.

Table 'A'
Basic data of projects reviewed

(₹ in crore)

Airport & title of the related project	Project Cost Approved by BOD with date of approval´	Tendered cost	Awarded cost	Actual cost of completion	Increase in cost over initial cost approved by BOD	Increase in cost over latest cost approved by BOD
Dehradun: Construction of New Terminal Building (NTB) & allied works.	15.50 (09/03) 47.63 (11/08)**	29.86	34.64	37.14	(+) 21.64	(-) 10.49
Udaipur : Construction of NTB complex	42.88 (04/05) 46.64 (03/06)**	44.62	46.64	56.20	(+) 13.32	(+) 9.56
Amritsar: Modular expansion of terminal	54.30 (07/05) 113.01 (08/08)**	61.53	65.59	147.34*	(+) 93.04	(+) 34.33

Building						
Jaipur: Construction of New International Terminal Building & allied works.	58.47 (06/05)	58.47	63.73	76.70*	(+) 18.23	(+) 18.23
Srinagar : Expansion and renovation of existing terminal Building	22.95 (03/03) 34.96 (11/04)** 51.32 (07/07)**	28.11	36.15	52.35	(+) 29.40	(+) 1.03

(+) = increase, (-) = decrease, (*) Provisional figure subject to receipt of final bill and (**) Revised project cost

Table 'B'

Delay in completion of work

Name of Station	Date of Board Approval	Tender Opened	Date of Award	Stipulated Date of Completion	Actual Date of Completion	Delay in Months
Dehradun	(09/03)	01/08	01/08	08/08/08	15/09/09	13
Udaipur	(04/05)	09/05	11/05	17/11/06	17/04/08	17
Amritsar	(07/05)	10/06	11/06	18/10/07	30/06/09	20
Jaipur	(06/05)	04/06	07/06	21/10/07	27/06/09	20
Srinagar	(03/03)	08/04	10/04	08/11/05	31/05/09	43

The audit findings on individual projects were as below:

2.1.1.1 Dehradun

Although the Board approved (September 2003) the terminal building complex project at Jolly Grant Airport, Dehradun at an estimated cost of ₹ 48.20 crore inclusive of civil work amounting to ₹ 15.50 crore but the tenders were invited after a delay of more than four years i.e. in the month of December 2007. In the meantime the estimated cost of the project increased from ₹ 15.50 crore to ₹ 29.86 crore. The work was awarded (January 2008) to M/s Consolidated Construction Consortium Limited, Chennai (contractor) at contract value of ₹ 34.64 crore. The work was actually completed in September 2009 as against the stipulated completion by August 2008 by incurring an amount of ₹ 37.14 crore.

As per final extension of time (EOT) approved (September 2010) by AAI, delay in completion of the project was mainly due to belated receipt of drawings from the consultant, inclusion of substituted / extra items and change in the scope of work during execution. Out of total delay of 404 days in completion of the project, delay of 18 days only was attributable to the contractor. The AAI, therefore, granted EOT from 09 August 2008 to 28 August 2009 without levy of compensation and for 18 days delay beyond the above period, levied a compensation of ₹ 0.01 crore on the contractor. The Contractor raised (02 November 2010) a bill amounting to ₹ 6.89 crore towards price escalation for the EOT period which was under scrutiny (November 2010) with AAI. The AAI, as such, was liable to pay price escalation which was avoidable had the project been managed in a planned way. This indicated inefficient managerial control in implementing the project.

2.1.1.2 Udaipur

The Board of Directors of AAI approved (April 2005) terminal building complex project at Maharana Pratap Airport, Udaipur at an estimated cost of ₹ 69.45 crore inclusive of civil work amounting to ₹ 42.88 crore. The work was awarded (November 2005) on M/s Simplex Concrete Piles (India) Limited at contract price of ₹ 46.64 crore with a completion period of one year. The work could be completed on 17 April 2008 after a delay of 17 months from the scheduled date of completion. Analysis of delays by the Company revealed that delay of 89 days was on account of non availability of work fronts and 227 days towards non availability of design & drawings for which the Company granted extension of time to the Contractor.

Accordingly, AAI paid an amount of ₹ 2.31 crore towards escalation which was avoidable had the project been managed in a planned way. This indicated inefficient managerial control in implementing the project.

2.1.1.3 Amritsar

The Board of Directors of AAI approved modular expansion of terminal building project in July 2005 at an estimated cost of ₹ 80 crore inclusive of civil work amounting to ₹ 54.30 crore. The work was awarded, after lapse of more than one year to M/s. Unity Pratibha Consortium (November 2006). Against completion period of 10 months the work, however, could be completed in June 2009 after a delay of 20 months.

It was proposed to take up modular expansion of Terminal Building immediately after commissioning of phase-I terminal building which was under construction at that time. Initially the proposal was to increase the handling capacity from 500 passengers to 900 passengers, for which modular expansion of 17000 sqm. was projected considering a realistic growth rate of 12 *per cent.* Later on, the Management considered the growth rate at the rate of 20 *per cent per annum* in domestic and 30 *per cent per annum* in international passenger traffic and decided to increase the capacity to 1200 pax (passengers) with the annual capacity of handling of 20.27 lakh passengers. Accordingly it was proposed to expand the area by 32300 sqm. with suitable modifications in designs and provision of other facilities. Total passenger movement during the years 2007-08, 2008-09 and 2009-10 was 6.78, 5.73 and 6.85 lakh passengers, respectively indicating that the assumptions were far from reality and the facilities created were in excess of requirement.

Besides, changes in structural design, drawings, increase in the building layout and non-availability of work fronts resulted in delay in completion of work. The contractor was not able to start the work up to March 2007 due to (a) changes proposed causing hindrance of 93 days and (b) further delay of 78 days due to non-handing over of sites to contractor from time to time. Consequently, the AAI had to make avoidable payment of ₹ 2.62 crore towards price escalation for the work done beyond contractual date of completion. Till June 2010, the AAI had spent ₹ 147.34 crore, which was nearly 171 *per cent* in excess to the cost of the project approved initially. This was mainly due to increase in scope and deviation in scheduled quantities.

Prolonged construction activities (30 months against the stipulated completion period of 10 months) also resulted in less revenue generation from July 2007 to May 2008 to AAI. M/s. TDI International India Limited, to whom exclusive advertisement rights were awarded refused to pay the intended license fee on the pretext that full area was not handed over and that it could not use the area due to on-going construction activities. The AAI, accordingly, agreed to curtail 50 *per cent* of license fee which resulted in revenue loss of ₹ 1.06 crore.

2.1.1.4 Jaipur

The Board approved (June 2005) construction of New International Terminal Building at a cost of ₹ 94.87 crore inclusive of civil work amounting to ₹ 58.47 crore to accommodate introduction of regular international flights by Indian Airlines since February 2002 on Dubai-Jaipur-Dubai sector and also operation of other international chartered flights. But the work was actually awarded in July 2006 after a delay of more than one year with a completion period of 15 months. The work was completed in June 2009 at the cost of ₹ 76.70 crore.

The main reasons for delay of 20 months in completion of the work were delayed submission of drawings/designs by the architectural consultant specifically appointed for the purpose, deviations in quantities executed and extra items of work. Resultantly, the AAI paid escalation of ₹ 4.47 crore for the work executed beyond scheduled date of completion. It was observed that the New International Terminal Building started operations from July 2009, for domestic flights only.

Audit observed that the international flights could not be commenced (September 2010) from the new terminal building as was envisaged and continued operating from the old building.

2.1.1.5 Srinagar

The Board approved (March 2003) expansion and renovation of existing terminal building at Srinagar Airport at an estimated cost of ₹ 59.39 crore inclusive of civil work amounting to ₹ 22.95 crore. The work was awarded ₹ 36.15 crore to M/s. Vij Construction Limited in October 2004, after a delay of more than one and half years, with a completion period of 12 months. The work was completed in May 2009 after an inordinate delay of 43 months. The main reasons of delay were delayed submission of drawings, non-availability of work fronts, post award deviations and increase in the scope of work due to introduction of extra items. Further, the AAI paid an escalation of ₹ 1.36 crore towards price escalation for the work done beyond contractual date of completion. This indicated inefficient managerial control in implementing the project.

2.1.2 Idling of Assets

2.1.2.1 Dehradun

- The Government of Uttarakhand (GoU) approached (March 2003) the AAI to upgrade Jolly Grant Airport at Dehradun for operation of AB-320/B-737-800 type of aircrafts. The GoU provided land measuring 173 acres free of cost for development of airport. The GoU also assured to provide a four lane approach road between the airport and the city and a dedicated 11 KV feeder electricity line up to airport complex for effective utilisation of facility so created. Although it was economically unviable, the AAI took up the project, on the request of GoU and constructed (September 2009) the new terminal building costing ₹ 37.14 crore.

It was observed that the four lane approach road to connect newly constructed terminal building, as assured by the GoU, was not provided till June 2010 which resulted in idling of newly constructed terminal building. It was further observed that instead of pursuing with the GoU for providing feeder connection, the AAI paid (August 2008) an amount of ₹ 1.94 crore to Uttarakhand Power Corporation Limited to execute the work of laying feeder line as deposit work.

- Since the newly constructed Terminal Building was not put to use, the electricity consumption was below the minimum guaranteed load which resulted in wasteful expenditure of ₹ 0.02 crore (approx) per month from October 2009 onwards.
- Further, larger period of 'Defect Liability Period' of one year had elapsed even before the terminal building could be operationalised (July 2010).

2.1.2.2 Udaipur

The AAI procured (July 2009) two passenger Boarding Bridges (PBB) at a cost of ₹ 3.18 crore. It was observed that one of the PBBs installed in September 2009 could not be made operational (July 2010) due to non-availability of push-back arrangement and the other was awaiting installation as the apron[♣] on which it was to be installed was not ready (July 2010). Thus the intended purpose of providing better passenger facilities could not be achieved and investment of ₹ 3.18 crore remained idle for more than one year.

2.1.3 Non-Adherence to AAI's Works Manual

Audit noticed that AAI did not follow its own Works Manual as may be seen from the following cases:

2.1.3.1 Amritsar

As per Para 10.2.1(ii) of the Works Manual, the scope of work once approved would stand frozen and would not be changed without prior clearance of the competent authority. It was, however, observed that the scope of work in case of "Modular expansion of Terminal Building" work at Amritsar Airport, awarded in November 2006 with due approval of the Board was changed (February 2007) substantially from 17000 sqm approved initially to 32300 sqm, due to change in design, scope of work etc. without obtaining prior approval of the Board. The Board's ex-post facto approval in the matter was, however, obtained in August 2008.

2.1.3.2 Jaipur

Para 9.10.1 of AAI Works Manual stipulated that in case the actual expenditure exceeded the original technical sanction by more than 10 *per cent* then revised technical sanction from competent authority would be required. The original technical sanction for the work of construction of new terminal building and allied works was for an amount of ₹ 58.47 crore. Although, the cumulative cost of the work, as per pre-final bill submitted (May 2010) by the contractor at ₹ 75 crore exceeded the10 *per cent* limit stipulated as per above mentioned Para 9.10.1, the Management did not obtain revised technical sanction.

[♣] ***A defined area in an airport intended to accommodate aircraft for purposes of loading or unloading passengers or cargo, fuelling, parking or maintenance.***

2.1.3.3 Srinagar

The Works Manual of AAI laid down limits for deviation in quantities given in the contract as 100 *per cent* for below ground level (foundation work) items, 30 *per cent* for above ground level items and overall deviation limit of 30 *per cent* of the contract value. Audit observed that no such limits were fixed in the contract relating to expansion and renovation of existing terminal building though the same were prescribed by AAI in other similar contracts. There were abnormal deviations ranging between (-) 100 *per cent* and 3000 *per cent,* in the quantities estimated and actually executed. Audit observed that incorporation of permissible deviation as "unlimited" in the contract was not prudent as without stipulating the limits, execution and Management of the project in an economic, efficient and effective manner could not be ensured.

2.1.4 Non-Adherence to conditions of Agreement

2.1.4.1 Dehradun

- It was observed that as per item number 9.2 of Special Condition of Contract (SCC), labour welfare cess was required to be levied and recovered from the contractor at the rate of one *per cent* but the same was neither recovered nor deposited with the respective department.
- There was vast deviation in actual *vis-à-vis* the estimated quantities to be executed. In 60 items of Bill of Quantities, the deviation was beyond the limits specified in the contract and out of that, deviation in three items was more than 1000 *per cent* [11018 *per cent* in item no. 1.1, 3540 *per cent* in item No. 7.18(b) and 1915 *per cent* in item 7.17(b)] which indicated that the estimates prepared were unrealistic and changing the scope of work substantially after award of work was not justifiable.

2.1.4.2 Udaipur

The construction of the New Terminal Building was completed on 17 April 2008, after a delay of 516 days. As analysed by the Management while approving final EOT, out of delay of 516 days 227 days were attributable to delayed furnishing of structural design and drawings by the consultant appointed by the AAI. It was observed that despite the fact that delayed furnishing of drawings by the consultant contributed substantially to the delayed completion of the project, the liquidated damages amounting to ₹ 0.11 crore recoverable under the agreement were not recovered.

2.1.4.3 Srinagar

While approving final EOT, the AAI considered delay of 184 days towards non-working season (winter season) in the valley. As the contract entered in to for expansion of NTB at Srinagar did not contain any consideration on account of weather conditions, the above decision of the AAI was not prudent.

2.1.5 Undertaking Unviable Projects

The AAI formulated its 'Policy on Airport Infrastructure' in December 1997. Sub-para (7) of Para 14 titled 'Financing of Airport Infrastructure' of the said policy provided that AAI would only invest in projects with demonstrated economic viability and positive rate of return and wherever Government compels AAI to invest in a non-viable project for the fulfilment of social objectives, the initial capital cost of the project and the recurring annual loss sustained by AAI on this account, would be reimbursed by the concerned Government. The AAI, however, did not follow its own policy in the following cases test checked in Audit:

2.1.5.1 Dehradun

The Dehradun Airport, as already discussed in para 2.1.2.1, was a loss making project which the AAI took up at the request of GoU. The internal rate of return (IRR) of the expansion project was worked out at (-) 15 *per cent.* The Board suggested (March 2003) that AAI should seek directions from the MoCA for financing the project through budgetary grant. The AAI, accordingly took up (April 2003) the matter with MoCA in response to which the MoCA directed (August 2003) AAI to consider development of Dehradun airport in phases without government funding of the project. The AAI, consequently, decided to take up the work, which was having negative IRR, against its own Policy on Airport Infrastructure. The loss estimated by the AAI over the period of 15 years from 2006-07 to 2020-21 worked out to ₹ 43.98 crore.

2.1.5.2 Srinagar

The IRR of Srinagar Airport after execution of project worked out at (-) 16 *per cent,* was a loss making airport. The Finance Wing of AAI recommended that the Government may be approached for re-imbursement of the amount. However, the Board approved the project, in accordance with the GOI directives, as socio economic development project in contravention of its own Airport Infrastructure policy. The estimated loss during the period of 15 years from 2006-07 to 2020-21 as per AAI's own assessment worked out to ₹ 54.67 crore.

Conclusions

- There were time and cost overruns due to delayed submission of drawings, non-availability of work fronts in time, increase in the scope of work due to frequent changes in designs and drawings after award of work which led to extra expenditure towards escalation.
- Lack of effective pursuance with Central and State Governments to get resource support for civil aviation infrastructure by way of finance, road connectivity and electricity.
- AAI took up the projects with negative IRR without any assurance from State/Central Government, in contravention of AAI's own Policy on Airport Infrastructure, to get reimbursement of the cost incurred as well as recurring annual loss sustained by it.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

Recommendations

➢ ***AAI should strictly enforce clauses of Works Manual to check time/cost overrun in project execution and adhere to Airports Infrastructure Policy.***

> ➢ ***AAI should pursue effectively the commitments made on road connectivity and electricity by the state government of Uttarakhand.***

2.2 Procurement of Communication, Navigation and Surveillance Equipments

Introduction

Airports Authority of India (AAI) is the Air Traffic Service Provider over Indian Air space. AAI manages the Indian air space covering an area of 2.8 million square nautical miles of land mass and the adjoining oceanic area as recognized by International Civil Aviation Organization (ICAO). Communication, Navigation, Surveillance (CNS) and Air Traffic Management (ATM) are the vital elements for safe and reliable air traffic services over designated air space. AAI provides CNS/ATM facilities at 115 airports (75 Domestic Airports, nine International Airports, 22 Civil Enclaves[1] inclusive of three International Airports and nine Private Airports) located all over the country.

The AAI is taking up on a regular basis up-gradation of various airports which inter alia includes provision of navigational aids and communication facilities. The CNS Wing of the Authority assesses requirements of various equipments on need basis after considering life span of existing facilities. The CNS wing is also responsible for execution and up-gradation of the systems related to CNS infrastructure, electronic security equipments and miscellaneous equipments required for disseminating flight related information. The technical evaluation of the systems/ equipments proposed to be procured is carried out on the basis of International Civil Aviation Organization (ICAO)'s Standards & Recommended Practices (SARPs) and Civil Aviation Regulations (CARs) of Director General of Civil Aviation (DGCA). AAI levies Route Navigation Facility Charges (RNFC) at all airports and Terminal Navigation Landing Charges (TNLC) at International Airports and civil enclaves for providing CNS/ATM facility. The AAI collected ₹ 1518.92 crore, ₹ 1589.89 crore and ₹ 1782.57 crore towards RNFC/ TNLC during the years 2007-08, 2008-09 and 2009-10 respectively.

As per the guidelines issued by Ministry of Civil Aviation (August 2004), the AAI was responsible to procure, install, commission, replace and upgrade the CNS/ATM equipments as well as fund all the expenses thereon in respect of all existing and new Greenfield[2] airports not owned and operated by AAI. Subsequently, in May 2008, the Greenfield Airport Policy was revised by the Union Cabinet which stated that CNS and ATM facilities are to be provided on a cost recovery basis to new airports (Green Field) set up by private operators. As regards other airports owned by AAI, the CNS/ATM services were to be provided by the AAI at its own cost.

Audit observed that the AAI incurred losses during the period 2007 to 2010 in managing CNS/ATM systems. The details are discussed in the succeeding paragraphs.

Scope of Audit

The audit of AAI is conducted under Section 19 (2) of the CAG's (Duties, Powers and Conditions of Service) Act 1971. The Audit covered procurement, installation and

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[1] ***Civil enclaves are airports under the control of navy/defense authorities (Goa, Port Blair and Srinagar)***

[2] ***Greenfield Airport is a new airport built at a new location.***

commissioning of various equipments of CNS/ATM by AAI during the period of three years ended on 31 March 2010.

Audit Objectives

The objective of thematic audit was to ascertain whether:

- Procurement of CNS/ATM systems was done judiciously and economically.
- Installation and commissioning of CNS/ATM systems at various airports was done as per plan.
- CNS/ATM systems were utilized effectively.

Audit Criteria

Procurement, installation, commissioning and utilisation of CNS/ATM equipments was reviewed mainly with reference to Detailed Project Reports (DPRs) and Feasibility Reports of projects, norms for assessing the requirement of CNS/ATM equipments at various airports, Civil Aviation Regulations of DGCA, Standard and Recommended Practices (SRPs) of ICAO, CNS Manual, CNS/ATM agreements entered into by AAI with airport operators, terms and conditions laid down in the tender, purchase orders placed with the suppliers etc.

Audit Methodology

The audit reviewed Agenda Notes and Minutes of Meetings of Board of Directors of AAI, Management Information Reports, records relating to compliance of rules, regulations and guidelines issued from time to time by ICAO, tender and procurement documents, bills and payment vouchers, correspondence by the AAI with Customs Department, Ministry of Civil Aviation (MOCA), suppliers and contractors etc.

Audit was conducted during the period 30 June 2010 to 20 August 2010. The audit findings were framed after comparing the actuals with what was envisaged.

Acknowledgement

Audit acknowledges the co-operation and assistance extended by the Management at all levels during various stages of Audit.

Audit Findings

2.2.1 Procurement

2.2.1.1 Procurement of CNS/ATM equipments at Greenfield (New) Airports

AAI entered into agreements with Hyderabad International Airport Limited (HIAL) and Bangalore International Airport Limited (BIAL) on 6 April 2005 and 11 August 2005, respectively. As per the agreement, AAI was to provide, maintain and operate CNS/ATM services at all times and at its own cost, as per MOCA's prevailing guidelines. HIAL and BIAL started their commercial operations from 23 March 2008 and 24 May 2008, respectively. AAI incurred capital expenditure of ₹ 151.70 crore and revenue expenditure of ₹ 30.19 crore at both the airports till 31 March 2009.

Subsequently, the Ministry of Civil Aviation revised its guidelines (May 2008) regarding CNS/ATM services to be provided in the existing and Greenfield (New) airports not owned and operated by AAI. As per revised guidelines, the cost of services was to be borne by airport operators instead of by AAI.

However in the case of existing agreements with HIAL and BIAL, the agreement provided that "no modification, amendment or other change will be binding on any party unless consented to in writing by both parties". Accordingly, the cost of CNS/ ATM services in respect of HIAL/BIAL airports would continue to be met by AAI.

The Management replied (November 2010) that since CNS-ATM agreements with HIAL/BIAL were signed by AAI well before new Greenfield Airport Policy, AAI was considering to take up the matter with the MOCA as to whether the new policy required any change in the existing CNS-ATM agreements with HIAL/BIAL.

2.2.1.2 Non adherence to the delivery schedule

CNS (Planning) Directorate places purchase order for the procurement of various CNS/ATM equipments. As per the delivery schedule specified in the purchase order, the equipments were to be supplied in different lots for installation and commissioning. It was observed that the supplier supplied all the equipments in a single lot much before the agreed delivery schedule. AAI accepted the equipments before the scheduled date, without demanding extension of the warranty period. Further, the AAI released the payments in one go instead of in a phased manner. Audit observed that accepting of all the equipments in a single lot, instead of in a phased manner led to advance delivery of equipment even before the site was ready for installation. This resulted in reduction or even extinction of the warranty period provided in the agreement to the detriment to AAI.

Audit observed that the schedule for supply and delivery should have been synchronized with other ancillary and preparatory work to avoid the above situation. The Management did not even insist upon the supplier to follow the staggered schedule given in the agreement, which though in itself did not synchronize with the installation/commissioning schedule. Further, there was no enabling clause in the purchase orders to avoid or defer payment for equipments received ahead of scheduled delivery date. This resulted in blockage of funds of ₹ 12.89 crore and consequential loss of interest amounting to ₹ 0.38 crore.

The Management stated (December 2010) that corrective measures would be taken for future procurements.

2.2.1.3 Placing of Repeat Order

AAI placed repeat purchase order (October 2007) for seven Distance Measuring Equipment–Low Power (DME-LP) at ₹ 0.39 crore per DME-LP against the purchase order placed on M/s. Thales in October 2006. Tenders invited subsequently, in January/September 2008, for procurement of 8 DME-LP indicated rate of ₹ 0.30 crore per DME-LP.

Audit observed that as per Clause 7(2)(3)(vi) of Delegation of Powers, CNS Department/ Directorate was required to give a certificate that there was no downward trend of prices of the items covered in the proposed repeat order compared to the last purchase order. Further, the priority based repeat order equipments were customs cleared (22 December 2008) after a delay of seven and half months from the date of arrival (05 May 2008) at Mumbai Port by paying interest of ₹ 0.06 crore, demurrage of ₹ 0.03 crore and detention charges of ₹ 0.04 crore (total ₹ 0.13 crore). This resulted in loss of ₹ 0.76 crore (being the difference in the purchase price of 7 DME-LP of ₹ 0.63 crore +₹ 0.13 crore paid towards detention & demurrages)[1]. Had AAI procured all 15 DME-LP by inviting open tenders instead of placing repeat order it could have saved ₹ 0.76 crore.

The Management replied in December 2010 that as per the delegation of powers, indenter was required to give a certificate that there was no downward trend for items proposed for repeat order. In the instant case based on the prevailing rates for similar items a certificate to this effect was given by CNS (Planning) department.

The reply of the Management was not acceptable in view of the fact that instead of confirming the prevailing rate, the indenter i.e. CNS (Planning) department considered the willingness given by M/s Thales to supply at the rates of previous order, which could not be considered prudent.

2.2.1.4 Avoidable Payment of detention/demurrage charges of ₹1.40 crore

Audit observed that there were abnormal delays in getting the equipments cleared from Customs leading to payment of ₹ 1.40 crore by AAI during the period 2007-08 to 2009-10 towards detention/demurrage charges as noticed in 11[2] cases test checked in Audit. Levy of detention/demurrage charges was mainly on account of delay in obtaining import/Wireless Planning Cell (WPC) License by AAI, delay in getting duty credit license and release advice, non-availability of customs appraiser, bank endorsed shipping documents etc. The reasons cited for delay in customs clearance could have been avoided, had prompt and timely action been taken by AAI.

The Management while admitting the audit observation stated (December 2010) that AAI would prepare a set of guidelines for processing of clearance of imports to avoid delays leading to payment of demurrages.

2.2.1.5 Application of different rates of customs tariff for the same item at various airports

The AAI placed two purchase orders, one on M/s Frequents GmbH, Germany on 30 April 2007 and other on M/s Schmid, Zurich on 08 January, 2008 for supply of Voice Communication Control System components. It was observed that against purchase order of April 2007, delivery was made at Chennai Airport and no customs duty was paid. However, against the second purchase order for identical item, while no customs duty was paid for the item delivered at Mumbai Airport, 10 *percent* duty was paid for the item delivered at Delhi Airport.

As observed by Audit, equipments usually procured by AAI were not specifically classified under the Customs Tariff. Therefore, different rates of duty were applied for identical equipment by the customs officials of different airports. The AAI, therefore, should have approached the appropriate authority of the Customs Department/Directorate

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[1] ***Difference of purchase price (₹ 0.39 crore- ₹ 0.30 crore) x 7= ₹ 0.63 crore***

[2] ***(i) P.O. No.19/2007-08/PROC/ILS-7Nos./2007 dated 03-01-2008 (ii) P.O. No. 12/2007-08/PROC/DME/2005 dated 09-10-2007 (iii) P.O.No. 8/2007-08/PROC/ILS/2005 dated 07-07-2007 & 31-07-2007 (iv) P.O. No.06/2008-09/PROC/FIDS/2007 dated 09-8-2008 (v) P.O.No. 12/2006-07/PROC/ILS/2005 dated 11-01-2007 (vi) P.O.No. 06/2009-10/PROC/HFT//2008 dated 31-08-2009 (vii) P.O.No. 08/2008-09/PROC/DME/2008 dated 24-09-2008 (viii) P.O.No. 05/2008-09/DATIS/2007 dated 25-7-2008 (ix) to (xi) PO No.01/2008-09/PROC/DVOR/2245 DATED 28-4-2008.***

of Foreign Trade for proper classification of item under Customs Tariff, prior to the procurement of the equipments.

The Management while admitting the audit observation stated (December 2010) that it would approach appropriate authority wherever such classification was not available in customs tariff to avoid multiplicity of classification at different airports.

2.2.2 Installation, Commissioning and Utilization of CNS/ATM equipments

The AAI planned to replace/upgrade the existing equipments by introducing new equipments. However, this process was either delayed or the equipments could not be put to use due to procedural problems such as, non-synchronization of allied activities and poor contract Management as discussed below:

2.2.2.1 Delay in installation and commissioning of Dedicated Satellite Communication Network (DSCN)

The delay in installation and commissioning of DSCN had already been commented in the Report of the Comptroller and Auditor General of India, Union Government (Commercial) No. 17 of 2007. Though the project was expected to be completed by October 2006, however, as on date (June 2010), out of the 80 airports, antennas were installed on 74 airports, of which 62 were operationalised (16 sites operationalised in March 2009 only). Thus the intended objective of upgrading communication network by October 2006 could not be achieved.

The Management replied (December 2010) that the supplier had been providing the warranty support till the date of commissioning.

The above contention of the Management was not acceptable as the fact remained that inordinately delayed commissioning of DSCN deprived AAI of the benefit of fully operational high speed digital network at these airports.

2.2.2.2 Delay in installation and commissioning of Voice Communication and Control Systems (VCCS)

Voice Communication and Control Systems are used for carrying out smooth Air Traffic Control (ATC) operations. The Authority placed purchase order (01 July 2009) on M/s. Schmid Telecom A.G. Switzerland for supply, installation and commissioning of 30 Nos. of Voice Communication and Control System (VCCS) at various airports. The equipments arrived at Chennai Airport on 21 December 2009 which was to be installed by 21 February 2010.

Audit observed that although the tender process was started as early as in April 2008 and the purchase order was placed on 01 July 2009, the AAI gave directions to all the airports identified for installation and commissioning of VCCS only on 07 October 2009. Thus there was abnormal delay in finalizing the works to be carried at the various locations for installation and commissioning of the equipments which led to the delay. Out of 30 VCCS equipments to be commissioned, only nine VCCS could be commissioned by July 2010.

The Management replied (December 2010) that as the delay was on the part of the supplier in installation and commissioning, liquidated damages as per the terms of the purchase order was being recovered. However the fact remained that the envisaged benefits of VCCS could not be achieved.

2.2.2.3 Delay in installation, testing and commissioning of Advanced Surface Movement Guidance and Control System (ASMGCS)

ASMGCS supports surveillance, routing, guidance and control functions for authorized aircrafts and vehicles to manoeuvre safely and effectively on the movement area. The AAI placed purchase order (15April 2008) on M/s Holland Institute of Traffic Technology B.V, Netherlands for supply, installation, testing and commissioning of ASMGCS for Chennai, Mumbai and Kolkata airports at a total cost of EURO 45,77,726 and ₹ 1.09 crore. All the equipments were cleared by 12 June 2009.

Audit observed that:

- Though the equipments for Chennai arrived by 06 January 2009, Wireless Planning Cell (WPC) license issued by the Ministry of Telecommunication required for the import of ASMGCS was received only on 06 February 2009. The delay in receipt of WPC license resulted in delay in clearance of imported goods.
- The ASMGCS were to be installed at Chennai, Mumbai and Kolkata by January 2009, March 2009 and May 2009 respectively. However; the site preparedness work was still (July 2010) in progress. As per the terms and conditions of the purchase order, the warranty for the equipments was 12 months from the date of installation or 18 months from the date of shipment whichever was earlier. The dates of last shipment for Chennai, Mumbai and Kolkata were 20 December 2008, 19 December 2008 and 17 March 2009, respectively. Thus the warranty expired even before installation of the three equipments. Further, delay in commissioning of these equipments resulted in blocking up of funds of ₹ 16.29 crore (₹ 13.26 crore paid to the supplier and ₹ 3.03 crore paid as customs duty) since May 2009 without the desired benefit to AAI.

The Management replied (December 2010) that it was considering to take up the matter for extension of warranty with the supplier.

2.2.2.4 Delay in receipt, installation & commissioning of Doppler Very High Frequency Omni Directional Radio Range (DVORs)

AAI is taking up on regular basis up-gradation of various airports which inter alia includes provision of navigational aids to enable these airports to handle various types of aircrafts under adverse weather and terrain conditions. DVOR is one of the crucial aids which assist the pilots in homing[♣] the aircraft. The installation of DVOR is linked with Distance Measuring Equipment (DME).

The AAI placed (October 2006) order for supply of 40 DMEs on M/S Thales, Germany. Out of these 40 DMEs [26 High Range DMEs meant to be installed along with DVORs and 14 Low Range DMEs were meant to be installed along with Instrument Landing System (ILS)]. However, the order for supply and installation of DVORs was placed only in April 2008.

Out of 40 DMEs procured, 12 high range DMEs were commissioned between January 2008 and February 2010 and 14 LP DMEs between September 2007 and May 2010. Thus

[♣] ***A process of navigation by which a destination is approached by keeping some navigation parameters constant.***

14[♠] high range DMEs were awaiting installation and utilization since February 2008. As stated above the installation of DVOR was linked with installation of DME, however, the Company placed order for supply & installation of 22 DVOR after a delay of one and half year after placing order for DMEs in October 2006. Against the ordered quantity of 22 only 16 DVORs were received till 21 May 2010. Out of these 16, only 3 DVORs were commissioned (February 2010) and the remaining 13 DVORs were awaiting commissioning due to non readiness of site, non receipt of DGCA approval etc.

Thus procurement of the DVOR equipments even before completion of site preparedness work resulted in blocking up of ₹ 1.75 crore without the desired benefit to the Authority.

Further, due to improper planning and co-ordination, 14 High Range DMEs were lying idle for want of installation and utilization since February 2008, resulting in blocking up of funds amounting to ₹ 4.99 crore.

The Management stated (December 2010) that DVOR and DME-HP would be procured together in future.

2.2.2.5 Delay in installation and commissioning of Flight Information Display System (FIDS) and Instrument Landing System (ILS)

The terms and conditions contained in the purchase order for supply, installation, testing and commissioning of FIDS and ILS provided 18 months warranty from the date of dispatch or 12 months from the date of commissioning, whichever, was earlier.

It was noticed in audit that even though these equipments were received within the delivery schedule, due to delay in site preparedness work by the AAI, these equipments could not be commissioned within the warranty period. Most of the equipments were awaiting (August 2010) commissioning even after lapse of warranty period as detailed below:

Name of equipment	Date of order (quantity in Nos.)	Name of supplier	Order value	Date of dispatch of last lot	Date of receipt	Date of commissioning
FIDS	19-8-08 (10)	M/s Solari Di Udine, SPA, Italy	Euro 14.03 lakh	29-12-2008	29-01-09	None was commissioned (8/2010)
ILS	11-01-07 (08)	M/s. Thales ATM, Germany	US $ 15.03 lakh	04-9-2007	22-10-07	Only 08 were commissioned within warranty period and the remaining were not commissioned till August 2010.
	31-7-07 (04)	--do--	US $ 7.98 lakh	22-3-2008	01-5-08	
	3-01-08 (9)	--do--	US $ 18.40 lakh	31-3-2008	28-4-08	

Thus, inordinate delay in completion of site preparedness work led to non-commissioning of equipments within warranty period, which consequently, deprived AAI of getting warranty benefits in respect of these equipments.

The Management while admitting the above observations stated (December 2010) that implementation of terminal building project had been the major cause of delay in

[♠] ***2 DMEs were received in December 2007 and 12 DMEs in February 2008*** installation and commissioning of FIDS. AAI was considering a procedure linking the supply of FIDS with the completion of terminal building project in future. Further, they were also considering a procedure to ensure that procurement action was initiated only after completion of site preparedness works and receipt of consent from Indian Air Force in the case of civil enclaves.

2.2.2.6 Payment of Spectrum Charges

AAI pays spectrum/license fee to the Ministry of Communication for the operation of DSCN, DME, ASMGCS etc. The fee has to be paid from the date of issue of the license irrespective of whether the equipments had been put to use or not. The amounts of spectrum charges paid were as follows:

Name of equipment/ system	**Number of equipment/system**	**Period of delay**	**Amount (₹ in crore)**
DSCN	80	2006 to 2009	10.01
ASMGCS	3	2009 to 2010 (August)	0.51
HP DME	14	2009 - 2010	1.26
Total			**11.78**

Thus, due to delay in installation and commissioning of these equipments, as brought out in Para 7.2.1 (for DSCN), Para 7.2.3 (for ASMGCS) and Para 7.2.4 (for HP DME), the AAI did not get any benefit of spectrum charges of ₹ 11.78 crore paid by it to the Ministry of Communication.

The Management stated (December 2010) that a system would be devised to synchronise procurement of equipment with sanction of spectrum to avoid payment during period of non-usage of facility.

Conclusion

There was lack of synchronization of activities in procurement of equipments, site preparedness and installation and commissioning. This resulted in payment of demurrage charges, lapse of warranty period even before installation and commissioning of equipments and delay in getting the intended benefits of up-graded technology.

Further, the AAI could not make use of spectrum charges/license fees of ₹ 11.78 crore paid by it to the Ministry of Communication, Department of Information Technology due to non utilisation of equipments. It was observed that the CNS/ATM agreements entered into with the HIAL/BIAL were not financially favourable to AAI.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

Recommendations

- ***All activities necessary for installation and commissioning of equipments should be synchronized with the procurement of equipments.***
- ***Procedural formalities with regard to imports should be completed in time to avoid demurrage.***

2.3 *Implementation of Operation, Management and Development Agreement entered into by Airports Authority of India with Delhi International Airports (P) Limited*

Introduction

In September 2003, the Government of India decided to restructure Delhi Airport to develop it as a world class airport by involving private sector. The reason for involving private sector was to arrange huge capital investment needed for development of the airport. Accordingly, Airports Authority of India (AAI), in the capacity of State Promoter signed Operation, Management and Development Agreement (OMDA) with Delhi International Airport Private Limited (DIAL), a Joint Venture Company (JVC), on 4 April 2006. As per shareholding pattern of the JVC, the State Promoter (AAI) has equity share of 26 *per cent* while private promoters including foreigners, led by GMR Group, has equity share of 74 *per cent.*

As per Chapter XVIII of OMDA, the term of concession granted to DIAL is for 30 years. Further, Chapter XI of OMDA provided that DIAL shall pay to AAI, an annual fee during the term of OMDA, at the rate of 45.99 *per cent* of the revenue of DIAL. After implementation of OMDA, Indira Gandhi International Airport (IGIA) would have capacity to handle 100 million passengers annually by year 2030. DIAL commissioned Terminal–3 or T-3 on 3 July 2010 at IGIA which is capable of handling A 380 aircrafts.

Audit Objectives

The objective of the thematic audit was to evaluate implementation of OMDA as per laid down terms and conditions entered for better management of the airport and services to the passengers.

Scope of Audit

The audit of AAI is conducted under section 19(2) of the CAG (Duties Powers and Conditions of Service) Act 1971. This thematic audit covers implementation of the terms and conditions laid down in OMDA for the period from May 2006 to March 2010.

Audit Criteria

Audit of implementation of OMDA was carried out with reference to the terms and conditions laid down in the agreement regarding man power services, revenue sharing arrangements and other related issues.

Audit Methodology

The audit included examination of the records maintained at the OMDA Monitoring Cell, Independent Engineer's Report, Independent Auditor's Report, MIS Returns, and records and information obtained by issuing audit requisitions/ enquiries.

Acknowledgement

Audit acknowledges the co-operation and assistance extended by the Management at all levels, at various stages of audit.

Audit Findings

Audit has examined the issues of Revenue Sharing (Chapter XI), Operation Support (Chapter VI) and other issues related to implementation of OMDA. The following are the audit findings:

2.3.1 Revenue Sharing

As per the Article 11.1.2.1 of OMDA, DIAL shall pay to AAI an annual fee at the rate of 45.99 *per cent* of the projected revenue as set forth in the Business Plan. Further, Article 11.2.2 provided that the Annual Fee shall be payable in twelve equal monthly installments on or before the 7th of the month. Further, in the event that in any quarter, the actual revenue exceeds the projected revenue, then DIAL shall pay to AAI the additional annual fee attributable to such difference between the actual quarterly revenue and the projected quarterly revenue within 15 days of the commencement of the next quarter. Article 11.1.2.3 further states that if the actual revenue in any quarter is greater than 110 *per cent* of the projected revenue for such quarter, DIAL shall pay to AAI interest for difference between the actual revenue and the projected revenue at the rate of State Bank of India prime lending rate plus 300 basis points (bps). Accordingly, three, two and one months' interest shall be calculated on 1/3rd of the difference between the projected revenue and the actual revenue.

The projected revenue and actual revenue earned by DIAL for the four years ended 31.03.2010 is given below:

(₹ in crore)

Year	2009-10		2008-09		2007-08		2006-07	
	Revenue (DIAL)	AAI Share 45.99%	Revenue (DIAL)	AAI Share 45.99%	Revenue (DIAL)	AAI Share 45.99%	Revenue (DIAL)	AAI Share 45.99%
Projected Revenue	1031	474.16	937.97	431.37	755.19	347.31	582.09	314.39
Actual Revenue	1171.81	538.92	958.65	440.88	875.65	402.71	591.38	271.98

From the above table, it is seen that actual revenue had increased over the projected revenue every year during the period from 2006-07 to 2009-10.

In this connection following observations are made:

2.3.1.1 Loss due to defective revenue sharing by DIAL with Joint Ventures (JVs)

Chapter II of the agreement deals with the scope of Grant. Under clause 2.1.1 of the said Chapter, the AAI granted to the DIAL the exclusive right and authority to undertake some of the functions of AAI viz. operation, maintenance, development, design, construction, upgradation, modernization, finance and management of the IGIA and to perform services and activities constituting Aeronautical Services and Non-Aeronautical Services. As per clause 2.1.2(iv) of the agreement the AAI recognized the exclusive right of DIAL to contract and /or sub-contract with third parties to undertake the above functions on behalf of DIAL.

DIAL formed 11 JVs♣ to undertake the above functions wherein equity shareholding of DIAL ranged from 26 *per cent* to 50 *per cent* and revenue share agreed to by DIAL with these JVs ranged from 10 *per cent* to 61 *per cent* of the gross revenue generated by these JVs.

Audit examined cargo and car parking operations undertaken by DIAL through following JVs:

<table>
<tr><th>Sl. No.</th><th>Name of JV</th><th>Type of business</th><th>Date when formed(started operation)</th><th>Percentage of share held by DIAL in equity</th><th colspan="2">Revenue Share of DIAL (%)</th></tr>
<tr><td>1</td><td>M/s. Celebi Delhi Cargo Terminal Management India Pvt. Limited (Celebi)</td><td>Cargo-Brownfield</td><td>August 2009 (November 2009)</td><td>26</td><td colspan="2">36</td></tr>
<tr><td>2</td><td>M/s. Cargo Service Centre (India) Pvt. Ltd (CSCL)</td><td>Cargo-Greenfield</td><td>November 2009 (April 2010)</td><td>26</td><td colspan="2">24</td></tr>
<tr><td rowspan="5">3</td><td rowspan="5">M/s. Delhi Airport Parking Services Pvt. Limited (DAPSL)</td><td rowspan="5">Car Park</td><td rowspan="5">March 2010 (July 2010)</td><td rowspan="5">49.90</td><td>Contract year</td><td>Per cent</td></tr>
<tr><td>Year 1-3</td><td>10</td></tr>
<tr><td>Year 4-5</td><td>15</td></tr>
<tr><td>Year 6-10</td><td>20</td></tr>
<tr><td>Year 11-25</td><td>40</td></tr>
</table>

Audit observed that while DIAL was required to pay to AAI, an annual fee at the rate of 45.99 *per cent* of its gross revenue, DIAL's agreement with the JVs provided for sharing of gross revenue on the contracted out services which resulted in substantial reduction in annual fee receivable by AAI as detailed in succeeding paragraphs.

Audit analysis revealed that though tonnage of cargo handled by DIAL during December 2009 to November 2010 increased by 24.88 *per cent* over the preceding period of one year i.e. December 2008 to November 2009, the cargo revenue of DIAL decreased by 37.08 *per cent* when the cargo operations were undertaken by the JVs. Similar reduction in revenue from car parking operations undertaken by the JV for the period July 2010 to December 2010 was observed. The amount of reduction in revenue share of AAI from cargo and car parking operations undertaken by respective JVs for the period December 2009 to December 2010 worked out to ₹ 103.29 crore as under:

♣ ***(i) Travel Food Services (Delhi T3) Pvt. Ltd.(ii)Devyani Food Street Pvt. Ltd.(iii) Delhi Select Services Hospitality Pvt. Ltd. (iv)Delhi Duty Free Services Pvt. Ltd.(v)Delhi Airport Parking Services Pvt. Ltd.(vi)Delhi Aviation Fuel Facility Pvt. Ltd.(vii)Celebi Delhi Cargo Terminal Management India Pvt. Ltd.(viii)Delhi Cargo Service Centre Pvt. Ltd.(ix)Wipro Airport IT Services Ltd.(x)Tim Delhi Advertising Pvt. Ltd.(xi)Delhi Aviation Services Pvt. Ltd.***

(₹ in crore)

Business	Gross revenue of JV during the period up to 31-12-2010	Gross Revenue from business	Revenue accounted for as per concession agreements with these JVs		45.99 Per cent of gross revenue (Col 3 X 45.99 per cent)	Difference (Col. 6-Col. 5)
			DIAL	AAI (45.99 per cent X Col. 4)		
1	2	3	4	5	6	7
Cargo	Celebi 237.38 CSCL 6.48	330.22	124.28	57.15	151.87	94.72
Car Parking	DAPSL 21.48	21.48	2.85	1.31	9.88	8.57
TOTAL		**351.70**	**127.13**	**58.46**	**161.75**	**103.29**

The independent auditors had also qualified in their quarterly reports that after handing over of cargo business to the newly formed JVs, revenue share to AAI was reduced which required to be looked into by AAI in terms of OMDA. Audit did not find on records, corrective action initiated / taken up, if any, by AAI on the independent auditors report.

The Management stated (March 2011) that car park and cargo concession involved capital investment on infrastructure by the concessionaires which was factored in the revenue share; that DIAL entered into concession arrangements with bidders who quoted the highest revenue share.

The reply of the Management was not acceptable as the agreement provided for payment of gross revenue of DIAL at the given percentage of 45.99 to AAI in consideration of Grant of exclusive rights to DIAL of the stated functions including non-aeronautical functions of AAI. The agreements of DIAL with its JVs were not in consonance with said clause of OMDA relating to Annual Fee. AAI should have ensured that 45.99 *per cent* of the gross revenue as stipulated was received while DIAL concessioned out the non-aeronautical services. Failure to do so resulted in AAI sustaining loss of ₹ 103.29 crore till December 2010. The AAI was bound to suffer further losses during the currency of concession agreements with the JVs in their present form.

2.3.1.2 Non levy of interest for excess of annual fee received against the projected annual fee.

On examination of projected annual fees and annual fee actually received, it was noticed that actual revenue in the quarters ended on 30 September 2007, 31 December 2007, 31March 2008 and 31 March 2010 was greater than 110 *per cent* of projected revenue for such quarters, However, AAI had not levied and recovered from DIAL any interest as stipulated in Article 11.1.2.3 of OMDA. Thus the AAI had sustained a loss of interest of ₹ two crore.

The Management stated (January 2011) that AAI had raised bill amounting to ₹ 2.66 crore on this amount.

2.3.1.3 Non-inclusion of penalty clause in OMDA for delayed payment of short fall in actual annual fee against the projected annual fee.

Article 11.1.2.3 of the OMDA is silent on penalty to be charged for delay beyond 15 days of commencement of the next quarter in making payment for shortfall, if any, in actual annual fee to be received.

Scrutiny of annual fee received from DIAL showed that there was delay of two to 45 days in remittance of amount of shortfall in actual annual fee leaving a cushion of 15 days. The AAI suffered loss of ₹ 1.21 crore due to delay in remittance of shortfall of annual fees. Due to not incorporating any provision in OMDA for penalty for delayed remittance of amount of shortfall of actual annual fee, AAI was not in a position to levy interest on DIAL.

The Management accepted (January 2011) the above observation and stated that Airport Operators were being advised for release of payments in time.

2.3.2 Operation Support

As per Article 6.1 of OMDA, AAI shall provide Operation Support (OS) to DIAL for a period of three years from 03 May 2006 through the general employees in the manner and subject to the terms provided in OMDA. The DIAL had to pay to AAI, monthly OS cost in relation to such general employees who were in the service of DIAL. As per Article 6.1.3 of OMDA, DIAL should from time to time cause the Escrow Bank to make payment of monthly OS cost to AAI in advance on or prior to the 7th day of each month by cheque drawn in favour of AAI. Accordingly DIAL had been making payment of certain fixed amount (about ₹ 7 to ₹ 8 crore) on 7th of every month to AAI towards OS cost. As AAI has been making payment of wages to its employees posted at IGI airport with DIAL, the difference of actual monthly wage bills and advance payment made by DIAL was required to be billed to DIAL immediately on completion of month and DIAL was required to release payment immediately.

2.3.2.1 Delay in realizing wage bills claims from DIAL on account of Operation Support Cost.

Test check of OS bills revealed that there was delay in realizing bills ranging from 25 to 387 days. This resulted in loss of interest of ₹ 0.79 crore as shown below:

(₹ in crore)

Sl. No.	Claim for differential OS cost due on	Amount of claim	Amount realised on	Delay in realizing bill giving a cushion of one month. (Days)	Loss of interest at the rate of 8 *per cent*
1	07.5.2008	0.17	28.8.2009	82	-
2	07.6.2008	10.55	28.8.2008	52	0.12
3	07.7.2008	0.14	6.11.2008	91	-
4	07.8.2008	1.13	6.11.2008	60	0.01
5	07.9.2008	3.53	6.11.2008	30	0.02
6	07.1.2008	14.41	2.12.2008	25	0.08
7	07.11.2008	0.53	29.12.2009	387	0.04
8	07.12.2008	1.02	29.12.2009	356	0.08
9	07.01.2009	1.96	29.12.2009	325	0.14
10	07.02.2009	1.35	29.12.2009	297	0.09
11	07.03.2009	1.10	29.12.2009	266	0.06

12	07.04.2009	2.65	30.12.2009	236	0.14
13	07.5.2009	0.17	30.12.2009	206	0.01
				Total	**0.79**

Thus AAI did not safeguard its financial interests by incorporating a provision in OMDA with regard to penalty for delay in payments of differential amount of OS cost by DIAL. Resultantly, AAI had to sustain loss of interest of ₹ 0.79 crore.

The Management stated (January 2011) that the AAI had advised all concerned to ensure timely raising of bills and realisation thereof within a reasonable time period.

2.3.2.2 Non-inclusion of provision in OMDA for levy of interest for delayed payment of Retirement Compensation by DIAL

As per Chapter VI of OMDA, AAI shall provide Operation Support (OS) to DIAL through the general employees for a period of three years commencing from 03 May 2006. As per Article 6.1.4, 60 *per cent* of the general employees had to be offered employment by DIAL. DIAL had to pay AAI retirement compensation in respect of employees who were not offered employment/did not accept the offer.

It was observed that a total 2221 number of general employees were in service as on 02 May 2006. As per conditions of OMDA mentioned above, DIAL had to offer employment to 1333 (60 *per cent** 2221) employees. A total of 141 employees had accepted employment with DIAL during the OS period. The OS period was due to elapse on 02 May 2009, and AAI raised a claim on 15 April 2009 for ₹ 233.11 crore, which was subsequently revised to ₹ 250.88 crore on 9 March 2010 towards retirement compensation for 1192 employees (1333-141). DIAL released an amount of ₹ 80 crore in two instalments (₹ 30 crore on 16 June 2009 and ₹ 50 crore on 31 March 2010). Release of balance amount of ₹ 170.88 crore was delayed by it on the plea that there was no specific provision in OMDA as to the timing of payment of Retirement Compensation to AAI.

Thus due to non-incorporation of relevant clause in OMDA on the timing of payment of retirement compensation or for creation of an Escrow account for the purpose, AAI was not in a position to charge interest for delayed payment resulting in loss of interest of ₹ 19.73 crore (June 2010) as shown below:

(₹ in crore)

Sl. No.	Date (From)	Date (To)	No of days	Principal	Rate of Interest	Interest Amount
1	03.05.2009	15.06.2009	44	250.88	8 *per cent*	2.42
2	16.06.2009	30.03.2010	288	220.88	8 *per cent*	13.94
3	31.03.2010	30.06.2010	90	170.88	8 *per cent*	3.37
Total						**19.73**

Also the AAI lost opportunity to leverage these funds for its operations as they resorted to short term loan of ₹ 250 crore at the rate of 5.85 *per cent* on 13 May 2009 for a period of 11 months.

The Management stated (January 2011) that in the absence of any clause in OMDA regarding timing of payment of retirement compensation or for creation of an Escrow Account for the purpose, action could not be taken for raising the interest bills.

2.3.3 Other issues

2.3.3.1 Payment to contractors of DIAL in contravention of the provision of OMDA.

As per Article 5.1 of OMDA, from the effective date (3 May 2006), DIAL shall be liable to perform all obligations of AAI (including payment obligations) under all contracts and agreements between AAI and any third party as existing on effective date. Further, as per Article 5.2 (b) (ii), DIAL shall also be liable for performance of all work- in- progress at the airport and shall be liable for making all payments in respect of all capital work-in-progress at the airport from 30 August 2005. The payments shall be made by DIAL to AAI within fifteen days of effective date on the basis of detailed separate accounts maintained by AAI in this regard.

Ministry of Civil Aviation vide its letter no. AV.24011/012/1998 dated 29 August 2005 had also directed that AAI can also undertake other capital work of operational and emergent nature during the period between the issue of transaction documents and effective date of OMDA subject to a cap of ₹ 50 crore. The effective date for transfer of airport was 3 May 2006.

A meeting was held on 23 May 2006 with DIAL for deciding mode of payment for ongoing capital works beyond 3 May 2006. In the meeting, AAI proposed two possibilities viz. (i) the payment against each work shall be made by AAI and the invoice shall be submitted to DIAL for reimbursement and (ii) the works executed beyond 3 May 2006 shall be measured and the bills are directly submitted to DIAL for payment to the contractors. DIAL agreed to the first option. It was also agreed that AAI would make the payment and raise the claim on DIAL within a fortnight and DIAL should make the payment to AAI within two to three days.

Audit observed that this arrangement was against the provisions of OMDA as the liability for settlement of contractor's bills had fallen on AAI even after the effective date (3 May 2006). Further, there was delay of one and a half months on the part of AAI in preferring claims on DIAL while DIAL had taken 11 to 894 days in settlement of the claims resulting in loss of interest of ₹ 0.33 crore at the rate of 8 *per cent* and undue benefit to the private operator.

2.3.3.2 Non recovery of Service Tax from DIAL

The Finance Act, 2007 introduced a service tax category of "renting of immovable property". This new taxable category was effective from 1 June 2007. On 8 October 2007, the service tax consultant (M/s. AK Batra & Associates) of AAI opined that "AAI should charge service tax from DIAL and the incidence of service tax should be borne by DIAL". AAI raised bills towards service tax on annual fee received from DIAL with effect from 1June 2007.

DIAL disputed the applicability of service tax on renting of immovable property and hence did not pay the outstanding dues. However, AAI had been depositing the tax on these receipts on monthly basis as per the provision of the Act from June 2007 to February 2008 amounting to ₹ 31.77 crore (February 2008).

DIAL filed writ petition (W.P(C) No.2707/2008) before High Court of Delhi, against the GOI where AAI was also a respondent. The Court gave direction (28-04-08) that AAI would not deposit the installment towards service tax due in each succeeding month until the next hearing. Although, final decision in the matter was awaited from the Court, yet the AAI withdrew the bills raised on DIAL and reduced their debtors by showing the amount in their accounts as recoverable from Service Tax Department. Reasons for withdrawing the bills were not on record.

Conclusion

It was observed that DIAL was unduly benefitted due to non-levy of interest on excess annual fee actually received as per the provision of OMDA. Besides, due to the absence of enabling provisions AAI was not in a position to levy penal interest on delayed payments by DIAL. It was also observed that there was delay in getting reimbursed the payments made by AAI to contractors from DIAL which was against the provisions of OMDA. Had AAI managed this contract more effectively, it could have earned additional revenue of 23 to 24 *per cent* of revenue received.

The matter was reported to Ministry in July 2010; reply was awaited (February 2011).

Recommendation

The provisions of OMDA need to be amended in terms of Article 20.3.1 of Chapter XX to include penalty clauses for protecting interests of AAI against delayed payments by DIAL.

2.4 Injudicious investment on development of airport at Coochbehar

Airports Authority of India made an injudicious investment of ₹ 30.92 crore on development of Coochbehar Airport without ensuring availability of adequate runway length resulting in the airport remaining non-operational for more than 3 years. The Authority had also incurred additional expenditure of ₹ 3.14 crore on maintenance.

The Parliamentary Standing Committee on Transport, Tourism and Culture suggested (October 2003) studying the feasibility of development and upgradation of Coochbehar airport. The erstwhile Indian Airlines and Air Deccan also expressed (November/December 2004) their willingness to operate ATR-42 type of aircrafts from Coochbehar subject to availability of required infrastructure. The Board of Airport Authority of India approved (January 2005) renovation and development of Coochbehar Airport at an estimated cost of ₹ 20 crore. The civil works included resurfacing of runway, extension of runway by 60 meters in the north-east direction, construction of terminal building, fire station, perimeter road, boundary wall and connected electrical works. The airport was ready for operation in August 2007 with uni-directional landing with a runway of 1129 meters strengthened and extended incurring capital expenditure of ₹ 1.93 crore. The capital expenditure on civil and electrical works including the expenditure on runway as above was ₹ 30.92 crore (March 2010). The revenue expenditure incurred on maintenance of the facilities during 2007-08 to 2009-10 was ₹ 3.14 crore.

Audit scrutiny revealed that the extension of runway and other civil and electrical works were undertaken by the Authority even while it was fully aware that the runway length would not be sufficient for operation of ATR-42 at full load. Further extension of runway in the north-east direction depended on diversion of a river (Mora Torsa) which was not considered feasible by the State Government. No airlines had commenced regular scheduled operation from Coochbehar and Bureau of Civil Aviation Security (BCAS) permission/clearance for operation of the airport was awaited as of August 2010.

Management stated (July 2010) that capital investment at Coochbehar Airport was for the infrastructure of the country, developed in the interest of spurring aviation growth in the region. It was also stated that one private airline had proposed to operate non-scheduled 18 seater passenger aircraft from the airport.

The Management's reply was not tenable as the runway length of the airport was not sufficient for operation of ATR type of aircrafts for which the airport was originally planned and developed for increasing traffic in the region. Further, operating non-scheduled aircrafts having lesser capacity would not result in sizable aviation growth.

The Authority, therefore, made an injudicious investment of ₹ 30.92 crore on development of Coochbehar Airport, without ensuring availability of adequate runway length resulting in the airport remaining non-operational for more than 3 years.

The matter was reported to Ministry in September 2010, reply was awaited (February 2011).

2.5 *Unauthorised withdrawal from the Escrow Account held in a fiduciary capacity on behalf of the Government of India by MIAL*

The orders of the Government regarding expenditure from Passenger Service Fee (Security Component) Escrow account were violated by the airport operator-Mumbai International Airport Limited, resulting in loss to Government/Airport Authority of India by ₹ 15.22 crore.

In terms of Rule 88 of the Aircraft Rules 1937, the licensee of an airport is entitled to collect fees named as Passenger Service Fee (PSF) from the embarking passengers at such rate as the Government of India (GOI) may specify and is also liable to pay for security component to any security agency designated by the GOI for providing the security service.

Consequent to allowing private companies and joint venture companies to own and operate airports in the country, the Government of India, Ministry of Civil Aviation (MOCA) issued an Order on 9 May 2006 which was later amended by Order dated 20 June 2007.

The order, *inter-alia,* stated that:

- Passenger Service Fee (PSF) at Airports would be collected by the respective airport operator, which could be Airports Authority of India (AAI), a Joint Venture Company (JVC) or a private operator;
- An Escrow account would be opened and operated by the airport operator in fiduciary capacity. An amount of ₹ 130 of the PSF collected per passenger by such airport operator would be deposited in the Escrow account for payments to be made to Central Industrial Security Force (CISF). The Escrow account would be subject to Government Audit by the Comptroller and Auditor General of India.
- The remaining amount, if any, would be transferred to AAI by the airport operator through a process of mutual consultation for payment to CISF deployed for security purposes at other airports.

It was observed in Audit that:

- Mumbai International Airport Private Limited (MIAL), which is the operator of the Chatrapathi Shivaji Mumbai International Airport with effect from 3 May 2006, had met expenses amounting to ₹ 14.21 crore relating to consultancy and other professional charges (₹ 1.87 crore) and deployment of private security agencies (₹ 12.34 crore) from the PSF (SC) Escrow Account during the years 2007-08 and 2008-09 which was not in accordance with various orders/instructions issued by the GOI regarding operation of PSF (SC) Escrow account.
- MIAL purchased an x-ray screening machine costing ₹ 1.01 crore in 2008-09 out of PSF (SC) Escrow account for screening of export cargo. The income earned by MIAL by offering the use of cargo screening machine to airlines and their agents was not credited to PSF (SC). However, as per clarifications issued (January 2010) by MOCA, "if expenditure for screening items including X-ray machines, multi view X-ray machine on inline baggage system is included in the scope of expenditure to be met out of PSF (SC), airport operator shall not be charging any hiring fees from concerned agencies viz., airline, cargo etc., and if the airport operator is charging any hiring fees/charges for use of screening equipment from the airlines, cargo agents, etc., then the expenditure relating to the installation and use of these screening equipment shall not be included in the scope of expenditure to be met out of the PSF (SC)".

The MIAL Management stated (September 2010) that:

- As the CISF had not been able to take care of landside/cityside security due to non availability of adequate staff, MIAL had to engage private security agencies. MIAL also contended that MOCA orders of June 2007 made it clear that all security related expenses of airport could be met out of PSF (SC) account.
- The amount of ₹ 1.87 crore paid to consultant engaged by MIAL was to provide technical consultancy services for airport security services and also to assist MIAL in finalisation of technical specification of Perimeter Intrusion Detection System and to ensure that the airport met all the safety and security requirements as per applicable guidelines and industry practices which was directly related to security expenditure.
- Cargo brought inside the airport was screened thoroughly and that the expenditure on X-ray machine was an absolutely necessary expense related to security which should be allowed to be incurred from the PSF (SC) account.

The above reply was not acceptable as:

- MOCA order of 2007 has to be read with order issued in January 2009 prescribing the 'Standard Operating Procedure for Accounts/Audit of Passenger Service Fee (Security Component) {(PSF)(SC)} by JVC/Private Operators' on preparation of the Annual Financial Accounts for PSF (SC) from the years 2006-07 and 2007-08. The said order made it clear that aviation security was an activity reserved for the GOI and that force deployment at airports, security requirement including requirement of capital items and specifications thereof were laid down by the Government/Bureau of Civil Aviation Security (BCAS). The order further stated that the security component could be used only in terms of directions issued by the Government/BCAS from time to time.

- In January 2010 and April 2010, the MOCA had clarified the scope of "security related expenses" stating that permissible expenditure out of PSF (SC) should not include expenditure on any other security staff or other administrative set-up created/engaged by the airport operators. In view of GOI orders and clarifications, withdrawal of ₹ 15.22 crore from PSF (SC) Escrow Account by MIAL during the two years 2007-08 and 2008-09 for expenses in connection with employment of private security agencies and towards consultant fees and purchase of cargo screening machine was not only in violation of the Government's orders regarding the PSF (SC) account but also a loss to the Government/AAI since any surplus in the PSF (SC) Escrow account should be ultimately transferred to AAI by the airport operator through a process of mutual consultation for related expenses at other airports. MIAL also stated that in a meeting of MOCA in April 2010 it was discussed that expenses on account of private security could not be incurred from PSF (SC) Account.

Prior approval of Ministry of Home Affairs was not obtained by MIAL for engaging private agencies at Mumbai International Airport for Civil Airport Security.

The matter was reported to Ministry in September 2010, reply was awaited (February 2011).

The matter was brought to the notice of Ministry of Home Affairs also (February 2011).

Recommendations

The Ministry of Civil Aviation should:

- ***Direct MIAL immediately to remit back into the PSF (SC) Escrow Account the amount appropriated by MIAL in violation of instructions for utilization of PSF (SC) Account.***
- ***Obtain approval of the Ministry of Home Affairs for engagement of private agencies by MIAL.***
- ***Conduct internal audit periodically to oversee the withdrawals from the Escrow Account.***

2.6 Idle investment on cargo handling equipment

AAI did not ensure taking over of cargo handling activities from Air India before procurement of Elevated Transfer Vehicle for export cargo resulting in idle investment of ₹ 9.23 crore.

The Airports Authority of India (AAI) set up an Integrated Cargo Complex (ICC) (December 2006) at Kolkata airport. The plant and machinery installed included Elevated Transfer Vehicle (ETV) in the export area of ICC to enable expeditious handling of export cargo. The order for ETV was placed in February 2007 and the same was commissioned in January 2008 at a cost of ₹ 9.23 crore. AAI incurred ₹ 0.82 crore till

January 2011 towards annual maintenance charges of ETV out of a total amount of ₹ 2.28 crore payable to the vendor for a period of seven years up to January 2015.

Air India had been providing cargo handling services to their own flights and on behalf of other airlines like Biman Bangladesh Airlines, Singapore Airlines, Thai Airways and Ethiad Airways through M/s Global Airport and Ground Services (P) Limited since April 2007 for a period of two years up to April 2009. Air India extended (July 2009) the contract up to April 2011 in continuation of an interim extension from April to July 2009.

AAI intimated (December 2009) the airlines of taking over of cargo handling from them with effect from 15 January 2010. Air India, however, declined to accept the taking over of cargo handling performed by them. The ETV was not put to use. Audit observed that AAI did not finalise the issue of taking over of cargo handling activities from Air India prior to placement of order for the ETV.

Management stated (December 2010) that a ground handling agency had been appointed who would utilise the ETV. As Air India had a subsisting contract to provide cargo handling services the reply of the Management was not acceptable.

Thus procurement of ETV done without ensuring utilization resulted in idle investment of ₹ 9.23 crore since January 2008. The objective of expeditious handling of export cargo of airlines was not accomplished.

The matter was reported to Ministry in October 2010; reply was awaited (February 2011).

CHAPTER III: MINISTRY OF COAL

Central Coalfields Limited

3.1 Loss of revenue due to road sale of coal instead of sale as washed coal

Despite price advantage of washed coal over raw coal, Pundi Mines of Kuju Area resorted to road sale instead of sending raw coal to Rajrappa Washery for washing and sale thereafter, resulting in a net loss of revenue of ₹ 19.34 crore to the Company during the period from 2006-07 to 2009-10.

The Rajrappa Washery of Central Coalfields Limited (Company), with installed capacity of 30 lakh tonne, was commissioned in June 1987 with a capital investment of ₹ 76.41 crore for beneficiation of raw coal i.e. washing of raw coal for production of washed coal. The Washery was designed for raw coal feed with ash content of 26 *per cent*. Washed coal fetches higher price than raw coal. Since inception, the Rajrappa Washery suffered shortage of raw coal due to poor production performance of the linked Rajrappa Coal Project. To meet the shortage, other coal producing projects[1] (OCPs) were linked to the Washery since May 2002 and from 2006-07 onwards. The entire production of the Pundi Mines of Kuju Area was linked to the Rajrappa Washery.

It was revealed in audit (December 2007 and October 2010) that despite sufficient availability of raw coal, Pundi Project[2] supplied a total of 14.29 lakh tonne of raw coal to the Rajrappa Washery during the period 2006-07 to 2009-10. This included 9.38 lakh tonne of better washery grade coal and 4.91 lakh tonne of inferior E grade coal having high ash percentage and thus unsuitable for the Washery. However, during the same period, it sold 5.69 lakh tonne of washery grade coal by way of road sale to private parties instead of transferring the same to the Washery which was suffering from acute non-availability of better washery grade coal. During the period, the Rajrappa Washery was left with a shortfall of 12.82 lakh tonne of washery grade coal as its requirement was 22.20 lakh tonne. As the price advantage for washed coal over raw coal varied between ₹ 230.95 and ₹ 730.00 per tonne for the period from 2006-07 to 2009-10 even after considering better price fetched by the Company on road sale of coal at the price above one grade higher than the notified price, the Company suffered a net loss of revenue of ₹ 19.34 crore for diversion of 5.68 lakh tonne of washery grade coal for road sales instead of feeding the same to the Rajrappa Washery for producing washed coal.

While admitting the facts, the Management stated (December 2010) that road sale of raw coal had to be resorted to for the following reasons:

- The supply of raw coal from Pundi was restricted as the stock of raw coal was building up at Rajrappa Washery since 2006-07 which was exposed to spontaneous heating and fire. Further, the decision of road sale was justified as

[1] ***Jharkhand, Pundi, Pindra, Topa projects of CCL***

[2] ***The production as well as road sale of other linked OCPs was less***

otherwise it would add to the cost of transportation and stocking at Rajrappa Washery.

- The designed parameter of the Washery (for feeding raw coal with ash content of 26 *per cent*) was not sufficient to handle the poor quality of raw coal which restricted the transfer and feeding of raw coal from Pundi mines having ash content of more than 30 *per cent.*
- By selling coal at the price above one grade higher than the notified price the Company had not only earned the maximum possible revenue by way of an additional profit of ₹ 45.73 crore but at the same time saved the Company from the impending loss due to occurrence of spontaneous fire.

The Management's contention is not tenable for the following reasons:

- As stated by the Management, the designed parameter of the Washery was not capable of handling poor quality of raw coal received from Pundi. In such a situation, the decision of the Management to sell better washery grade coal to private parties and to supply inferior grade coal to Rajrappa Washery was injudicious.
- Instead of resorting to road sales, transferring of washery grade coal to the Rajrappa Washery was better option to tackle the space problem in stocking of coal and avoiding the possibility of spontaneous fire as it would reduce the building up of unsuitable quality of coal stock at Rajrappa Washery.
- Transferring of washery grade coal to the Rajrappa Washery would have ensured proper utilization of installed washing capacity of Rajrappa Washery and would have generated more revenue.
- Although the Company got the price of coal one grade higher than the notified price and earned an additional profit of ₹ 45.73 crore on road sales, even considering the same the net loss of revenue remained substantial i.e. ₹ 19.34 crore due to non-beneficiation of washery grade coal.
- The decision to go for road sales by local Management was unilateral which was against the plan of the Company to supply the same to the washery for its optimum capacity utilisation.

Thus, the Company suffered net loss of revenue of ₹ 19.34 crore on road sale of washery grade coal instead of transferring the same to the washery and sale as washed coal. This also led to under utilization of washing capacity of the Washery. The Company should ensure supply of washery grade raw coal from linked projects to its washeries instead of road sale of the same to private parties for optimal utilization of the installed washing capacity and for generating higher revenues.

Eastern Coalfields Limited

3.2 Avoidable expenditure due to failure to follow the procedure prescribed for obtaining direct power supply from generating company

Failure of the Company to complete formalities required for obtaining open access permission from Jharkhand State Electricity Regulatory Commission resulted in avoidable expenditure of ₹ 10.62 crore for drawing power at enhanced rate.

Eastern Coalfields Limited (Company) and National Thermal Power Corporation (NTPC) constructed (June 1990) 220 KVA Farakka Lalmatia Transmission Line at Rajmahal Project to receive electricity directly from NTPC. The drawing of electricity directly from NTPC at the rate of ₹ 3/- per KWH was more economical than the prevailing rate of ₹ 4 per KWH charged by the Jharkhand State Electricity Board (JSEB) (erstwhile Bihar State Electricity Board). However, the Company could not avail power at cheaper rate from NTPC as its transmission line was under the command area of JSEB and the Electricity Act in force did not permit such supply of power directly from NTPC. Subsequently, Electricity Act 2003 allowed consumers to draw power directly from NTPC for which open access permission was to be granted by the State Electricity Regulatory Commission.

As per Electricity Act 2003 and notification of Jharkhand State Electricity Regulatory Commission (JSERC) (Open Access in Intra State Transmission & Distribution) Regulations 2005 (June 2005), the Company was required to apply in the prescribed format containing requisite technical information along with non-refundable application fees to the State Transmission Utility (STU) being the nodal agency. Audit, however, observed (March 2008 and August 2010) that instead of applying to JSERC through STU, the Company applied directly to NTPC in January 2006 i. e. after a lapse of 6 months from the date of issue of notification by JSERC. In reply, NTPC advised the Company (March 2006) to apply to the JSERC. The Company applied to JSERC in June 2006 i.e. after a lapse of another three months. JSERC advised the Company (July 2006) to follow the JSERC Regulations 2005, as per which the Company was required to submit the application to STU, along with technical details and application fees for long term open access permission. The Company applied for a second time to JSERC in May 2009 i.e. after a lapse of two years and eleven months. In turn JSERC again drew attention (June 2009) to the JSERC Regulations 2005. But till date, the Company had not complied with the required formalities. As a result, the Company failed to obtain direct power supply from NTPC w.e.f. 1 April 2008 onwards. Consequently, the Company had to pay electricity charges at the higher rate of ₹ 4 per KWH instead ₹ 3 per KWH, resulting in avoidable expenditure of ₹ 10.62 crore for the period from April 2008 to March 2010.

The Management stated (February 2009 and August 2010) that after getting permission from JSERC, the Ministry of Power had to be approached for allocation of power directly from NTPC.

The reply of the Management was not convincing as the Company failed to follow the procedure prescribed in the Regulations of JSERC 2005.

As the formalities required for obtaining the necessary access were not completed, the Company incurred as of March 2010 avoidable expenditure of ₹ 10.62 crore for drawing power at enhanced rate.

The matter was reported to the Ministry in October 2010; reply was awaited (February 2011).

Recommendation

The Company should take immediate steps to obtain open access by following the prescribed procedure to save on electricity charges.

Neyveli Lignite Corporation Limited

3.3 Capital Financing

Introduction

Power generation projects are capital intensive and have long gestation periods. The power sector is also subject to regulatory control, with administered prices and therefore the methods of capital financing assume great significance. As per the extant Central Electricity Regulatory Commission (CERC) Regulations (Regulations), the capital cost of a power project, including the capitalised interest of the debt used to finance the project, is reimbursed over a period of time through a mechanism called capacity charge[1], a part of the new Availability Based Tariff (ABT) regime introduced since April 2003.

The Regulations implemented after April 2004 inter alia impose restrictions on the means of financing the project by limiting the debt equity ratio[2] in determining the capital cost of the project. The Regulations further stipulate that the normative[3] Return on Equity (ROE) should be restricted to actual equity investment, subject to a ceiling of 30 *per cent* of the capital cost. It allowed recovery of entire cost of debt from the beneficiaries through tariff.

Neyveli Lignite Corporation Limited (Company) got the approval from Government of India for implementing four projects comprising a mine and a power project each at Neyveli and Barsingsar. The approved cost of the projects was ₹ 5540.30 crore (revised to ₹ 6630.19 crore in 2008-09) to be financed out of borrowings of ₹ 3878.21 crore (revised to ₹ 4641.13 crore) and internal resources of ₹ 1662.09 crore (revised to ₹ 1989.06 crore).

For timely implementation of projects, the Company considered the factors like magnitude/timing of requirement, mode and funding options in the borrowing programme/action plan (December 2004) and adopted CERC stipulated funding pattern of 70:30 for the entire project cost including interest during construction (IDC). The Company also decided to deploy internal resources judiciously to avoid excess deployment as it would lead to foregoing investment income (opportunity loss).

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[1] Comprises depreciation of assets, interest on loan, return on equity, O&M expenses, insurance, taxes and interest on working capital

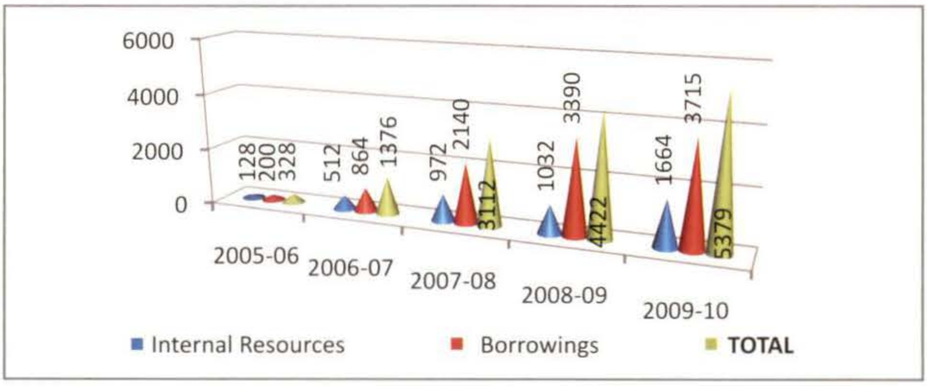
[2] Percentage of debt/equity to total capital cost, which is expressed in terms of ratio, limited to 70:30.

[3] Norm for return on equity specified in the tariff regulations from time to time.

Total expenses incurred on these projects cumulated at the end of financial year and means of their finance as at the end of March 2010 are depicted in the graph 1 below:

Graph:1 Expenses on a mine and power project each at Neyveli and Barsingsar

(₹ in crore)



Scope of Audit

Audit examined actual financing of all the four projects undertaken by the Company between 2005-06 and 2009-10. This examination is limited to assessing the methodology of financing the projects and consequent impact on capacity charges/opportunity loss and does not extend to utilisation of funds.

Audit objective

Thematic examination was conducted to ensure that the capital financing was done

- At optimum cost to the Company; and
- At optimum cost to the beneficiaries.

Audit methodology

Audit Methodology involved a review/examination of proposals and validation of calculations.

Audit criteria

The objectives of the framework is to keep the cost of power to the beneficiaries at the minimum possible level while compensating the power generating stations adequately for their capital investments. The criteria used as a benchmark for determining the optimum finance ratio is the maximum extent of capital, which could be recovered through capacity charges as per CERC regulations. The criterion for the interest rate paid is the minimum possible alternative that was available to the Company for financial debt compensation and earning capability of equity if alternatively invested in short term deposits.

Project financing - background

The Company submitted two proposals (December 2004 and January 2005) at initiation of the process of project financing viz. (a) a proposal seeking sanction of ₹ 1200 crore for funding the identified requirements of foreign exchange for the project and (b) a proposal to raise ₹ 2000 crore as Rupee Term Loan (RTL). In the course of these two proposals, the Management stated to the Board that:

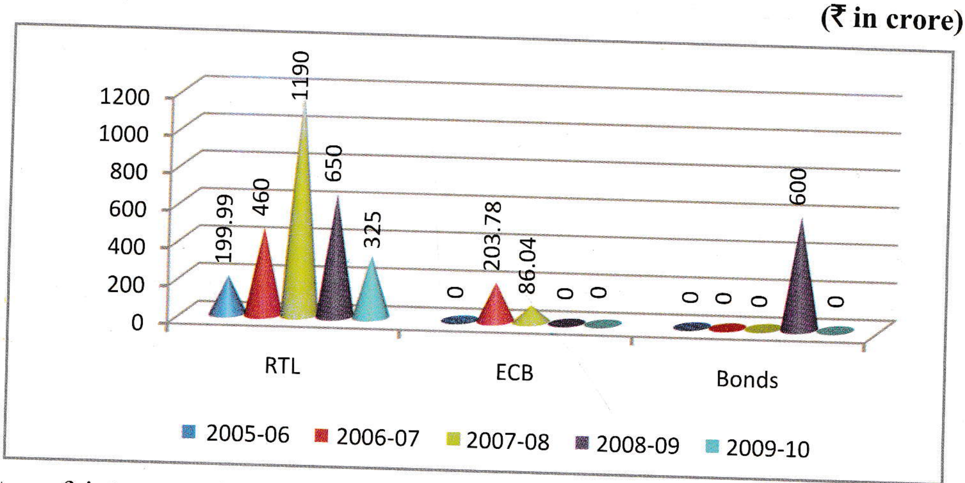
- the foreign exchange component would be funded through External Commercial Borrowings (ECB) or foreign currency loan from Export Credit Agencies (ECA) and the Rupee component funded through Bonds/RTL;
- to follow judiciously the CERC-stipulated funding pattern to derive maximum return;
- though foreign exchange component identified to be Euro 68 million and USD 177.916 million (equivalent to ₹ 1201.84 crore) forming the basis for seeking sanction of ₹ 1200 crore for ECB, there was no certainty that the equipment would have to be imported because of the possibili tion of indigenous vendors; and
- as and when the requirements were clearly identified for procurement, it would choose to fund it through the lowest cost option.

The Board approved (January 2005) both the proposals. Audit, however, observed that in the above proposals, the Board was not appraised of relative cost of each option in detail.

The Company also sought approval (December 2008) from the Board for issuing Neyveli Bonds with a face value of ₹ 10 lakh each for ₹ 600 crore with coupon rate ranging from 8.5 to 9 *per cent* per annum payable annually and a tenure of ten years with put/call option after seven years. This was approved in January 2009. Accordingly, the Company executed agreements with banks/financial institutions for RTL (November 2005), ECB (March 2006) and also raised bonds (January 2009) with due approval. The graph below summarises the funds raised through these sources during the five years ended 2009-10:

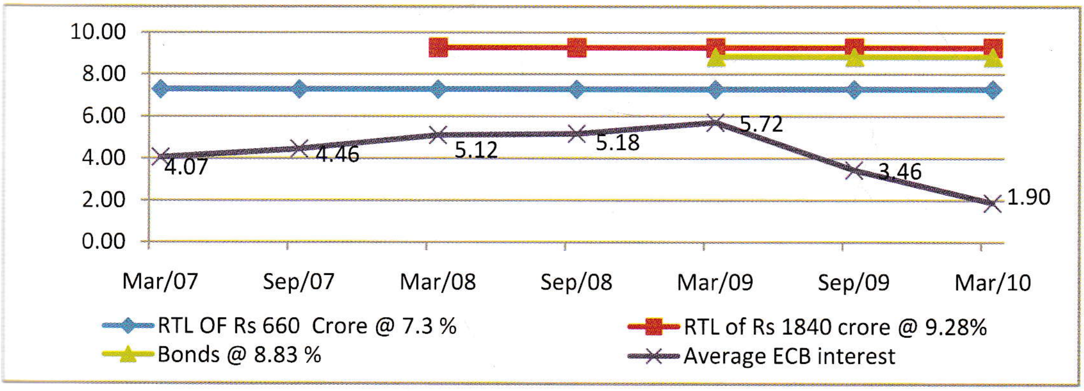
Graph 2: Funds raised during past five years ending March 2010

(₹ in crore)



The rates of interest paid by the Company on the above sources of borrowings are indicated in the Graph 3 given below:

Graph 3: Rates of interest paid on the borrowings



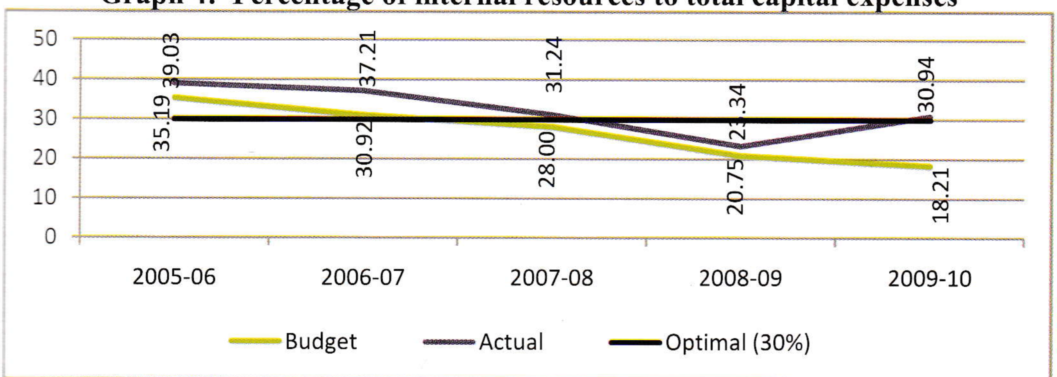
Audit findings

The major audit findings are discussed in detail in the succeeding Paragraphs.

3.3.1 Non-maintenance of stipulated Debt-Equity ratio

The Company prepares annual financial budget for both capital works and revenue items. The graph 4 below represents the budgeted and actual percentage of internal resources deployed to cumulative capital expenses during the five years ended 31 March 2010.

Graph 4: Percentage of internal resources to total capital expenses



Audit observed that even in the annual financial budget estimates, debt equity ratio of 70:30 was not maintained by the Company in meeting the budgeted capital expenditure.

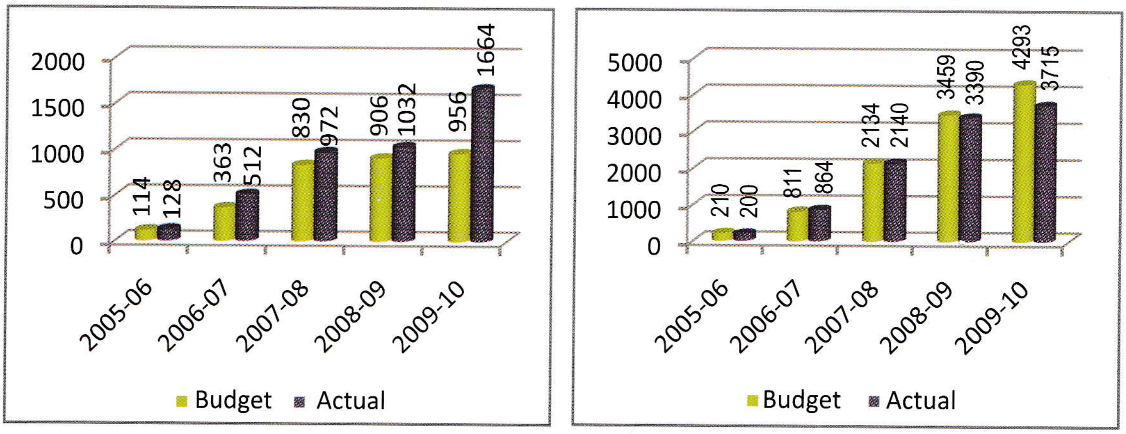
3.3.2 Cash budget:

Cash budget is a tool for ensuring efficient cash Management both for Revenue and Capital expenditure. Though the Company obtained the detailed schedules for supplies and payments in advance from the contractors/suppliers, it did not prepare/review Cash Flow Statement for the entire project period to assess the quantum of funds required and to plan the timing of finance requirements. Consequently, the Company met the capital expenses out of its internal resources in excess of 30 *per cent* as depicted in graph 4. The graph 5 below indicates the budgeted and actual capital expenditure met out of internal resources and borrowings:

Graph: 5

Capital Expenses met out of Internal Resources (Cumulative)

Capital Expenses met out of Borrowings (Cumulative) (₹ in crore)



Audit observed that on account of deployment of its internal resources in excess of 30 *per cent* of capital cost, the Company incurred opportunity loss as discussed in Para.7.4.

The Ministry stated (January 2011) that the Company prepared its monthly cash budget duly considering every aspect of project funding through online system being monitored on daily basis and monthly forecasts for managing and drawing high value payments.

The cash budget prepared by the Company was not, however, found to consider the detailed schedules of supplies and payments, obtained from the contractors/suppliers under the agreement, for the entire project funding plan. Even though at the end of each year of the project period, the optimum debt equity ratio was more or less maintained, the deployment of equity in excess of the stipulated 30 *per cent* in the interim quarters led to an opportunity loss that need to be avoided.

3.3.3 External Commercial Borrowings

3.3.3.1 Low cost ECB contracted insufficiently

As against the sanction for ₹ 1200 crore, referred to in Para 6, the Company contracted (March 2006) an ECB of only Euro 50 million (₹ 286.60 crore) for imported components worth Euro 50.51 million (₹ 289.48 crore) to fund foreign exchange requirements (identified up to June 2005) of Mine II expansion and Barsingsar Mine. The procurement process for TPS II Expansion and Power Project at Barsingsar was thereafter completed in June 2006. The total imported component of the procurement worked out to Euro 75.21 million and US$ 21.02 million (expenditure in foreign currency was ₹ 683.49 crore up to 31 March 2010). In the meantime an unsolicited offer from the existing ECB lender for Euro 50 million was received (May 2007) offering similar terms. Despite assertion in the earlier proposal to the Board that foreign exchange was to be funded through ECB/ECA, action for further ECB was only taken belatedly in July/August 2008 that did not fructify. The Management finally submitted (December 2008) a note to the Board for funding it through bonds instead of ECB without inviting a reference to the earlier note which stated that imported components would normally be funded through ECB or ECA loans. There was no justification in the note for delay in seeking or considering ECB.

The interest rate on ECB was the cheapest among the three sources as shown in graph 3. Thus, raising funds through Bonds at higher rates resulted in additional interest burden of ₹ 17.66[1] crore for 2009-10 alone. This indicated that the Company did not implement its own stated intent of seeking lower cost ECB for the project.

The Company stated (July 2010) that the foreign exchange requirement of other equipment/ services spread over a long period were not so significant as to go in for additional ECB. Further the LIBOR interest rates and Euro currency were fluctuating frequently during the review period. The limited average maturity, stringent financial covenants and market disruption clause of ECB would have exposed it to the risk of early repayment of entire loan before the project attaining the rated capacity. There was more possibility of ending with higher interest and FERV, had it signed the ECB in 2007. The Ministry stated (January 2011) that the Company's decision to have a mix of RTL with flexible drawdown, longer and divided maturity, a dose of inflexible ECB at low cost and Bond at moderate and fixed terms was the best choice and was a necessity to fund the normative equity at 30 *per cent.*

It is pertinent to note that the actual expenditure in foreign currency was Euro 120.91 million and US$ 5.77 million (₹ 683.49 crore) as against the actual ECB of Euro 50 million (₹ 286.60 crore) up to 31 March 2010. Since, the Company's belated attempt in July/August 2008 to avail additional ECB did not fructify, it was forced to resort to raise bonds and, therefore, the issues stated were not considered then. As regards the Ministry's reply on best financial mix it should be noted that at the end of 31 March 2010, the actual interest during construction (₹ 612.38 crore[2]) had exceeded the approved estimate (₹ 464.32 crore) indicating the Company's ineffective pursuance of its own policy decision.

3.3.3.2 Non-consideration of minimum drawdown variable during evaluation of ECB offer

The agreement executed for ECB of Euro 50 million in March 2006 had important conditions that the loan amount should be drawn in instalment (known as drawdown) of minimum five million Euro each on or before 31 December 2006 (Tranche A)/31 December 2007 (Tranche B) and payment of commitment charges, calculated at 0.20 *per cent* per annum on the aggregate daily undrawn amount from 1 October 2006 (Tranche A) and 1 April 2006 (Tranche B), on the last day of each successive quarter period.

While some of the competitive bidders had not specified any drawdown in their quotes, others quoted different minimum drawdown. The Company had not, however, factored this in its commercial bid evaluation though this condition involved opportunity loss and it was also aware of the break up of payables against import commitments. Thus, the Company's failure in factoring the minimum drawdown in the bid evaluation process led to opportunity loss of ₹ 4.93 crore. It also resulted in avoidable payment of commitment charges of ₹ 10.11 lakh out of ₹ 43.52 lakh actually paid.

The Ministry stated (January 2011) that in the bids, only major points like loan amount, interest rates and other fees were quoted but other procedural aspects on drawdown,

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[1] *Interest on Bonds for 2009-10 ₹ 25.50 crore; Interest paid for ECB loan in 2009-10 ₹ 7.84 crore; Difference ₹ 17.66 crore*

[2] *Comprising Interest on Bonds ₹ 62.85 crore; ECB ₹ 40.65 crore and RTL ₹ 508.88 crore*

representation and warranties, covenants etc. were discussed and finalised after identifying the lender.

The fact remained that the bid evaluation note (July 2005) submitted to the Board considered uniform drawal schedule in evaluating the offers. As the bidders stipulated different minimum drawdown schedule in their offers, this should have been factored in.

3.3.3.3 Deficient execution of ECB Contract

In view of contractual terms for drawal of minimum amount and owing to constraints in following RBI stipulations for parking surplus ECB funds abroad till maturity of payment, the Company decided (June 2006) first to incur the expenditure out of internal resources and to draw the ECB as recoupment of such expenses. The Company got recouped an amount of Euro 50 million (₹ 286.60 crore♣) on six occasions between August 2006 and August 2007 after due approval.

A scrutiny of the recoupment revealed omission of some expenses that were claimed in the subsequent occasion. Further, the time taken for recoupment ranged between 26 and 105 days after accumulation of expenses up to Euro 5 million. These omissions/delays resulted in opportunity loss of ₹ 1.61 crore.

The Company stated (July 2010) that procedural requirements involved collection of supporting documents and lead time to accumulate enough claims to match minimum drawdown. The Ministry endorsed (January 2011) the views of the Management.

In regard to time delays and omissions, it is pertinent to note that in one instance alone, the proposal (4 June 2007) for recoupment of Euro 5 million (expenses incurred up to 4 April 2007) was deferred and resubmitted (16 July 2007) without considering the additional expenditure of Euro 8.021 million (equal to ₹ 44.16 crore) incurred between 3 May 2007 and 13 July 2007. The loss involved in this specific instance was ₹ 1.15 crore (opportunity loss ₹ 1.07 crore and commitment charges ₹ 7.50 lakh). Had the Company put in place a system for recoupment of all expenses at the earliest available opportunity, it could have avoided loss of ₹ 1.61 crore out of ₹ 6.54 crore.

Recommendation

The Company may critically analyze and factor each condition of foreign currency loan in the evaluation process for selection of most favourable source.

3.3.4 Rupee term loan – Premature revision of interest rate

The Company executed (November 2005) an agreement with consortium of seven banks (Consortium Members) led by Canara Bank for availing of term loan of ₹ 2500 crore. The loan was repayable in 20 half yearly instalments starting on completion of four years from the date of first disbursement. The agreement further enabled the consortium members to revoke in part or full or withdraw or stop financial assistance at any stage by giving reasonable notice.

The agreement stipulated a fixed interest rate of 7.35 *per cent* per annum (compounded quarterly i.e., 7.30 *per cent* per annum payable monthly), to be reset at Benchmark Prime Lending Rate (BPLR) of Canara Bank minus 3.40 *per cent* per annum after five years

♣ ***Excluding foreign exchange gain of ₹3.20 crore.***

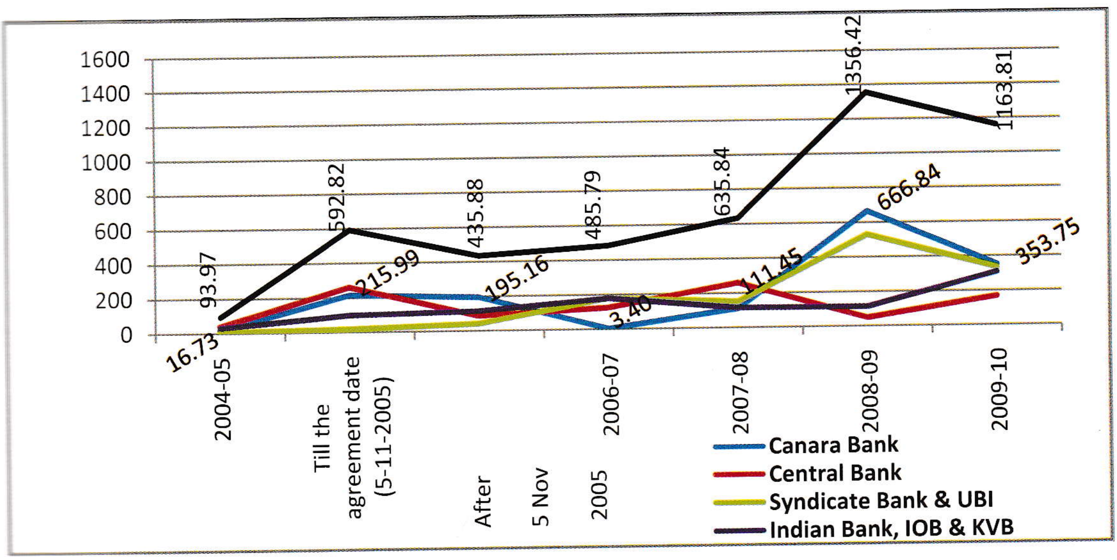
from the date of first drawal and at the end of every five years thereafter. There was also a mutual understanding (June/July 2005) that the Company would place its surplus funds with Canara Bank based on their competitiveness to justify their terms of interest for RTL.

The first loan instalment of ₹ 62.42 crore was drawn in February 2006 and hence, the interest was to be reset from 23 February 2011 as per the agreement. The Company had drawn an aggregate amount of ₹ 660 crore up to March 2007. Canara Bank, however, demanded (March 2007) premature revision in the interest rate from 7.35 to 9.85 *per cent* (BPLR of 13.25 less 3.40 *per cent*) for the remaining ₹ 1840 crore presumably because of non-placement of deposits with them. The consortium members declined to release further funds without consent for enhanced rate.

Regarding short term deposits, the daily average amount placed with consortium members, in particular with the consortium leader Canara Bank, reduced drastically after executing the agreement and up to March 2007 as shown in graph 6 below:

Graph 6: Daily average short term deposits placed with consortium members

(₹ in crore)



The Company had to agree (January 2008) for the enhanced rate of 9.35 *per cent* (BPLR net of 3.40 *per cent*) and drew the balance ₹ 1840 crore between January and December 2008. Thus, failure to factor in the contractual obligations in the investment decisions, resulted in an increase in the project cost by ₹ 64.94 crore being the differential interest on ₹ 1840 crore reckoned from their dates of disbursement to 31 March 2010. Further, deployment of internal resources, in excess of 30 *per cent* of project cost, during the intervening period of nine months led to an opportunity loss of ₹ 32.02 crore (at the quarterly average rate of interest earned on deposits).

The Company contended (July 2010) that it could not place the deposits with Canara Bank as it had to adhere to DPE* guidelines on obtaining the best possible rate. The

* *Department of Public Enterprises*

Ministry stated (January 2011) that there was no direct link between preferential placement of deposit with banks and their upward revision of interest. In order to avoid cost and time over run, the expenses were met out of internal resources, as project funding strategy.

The Company's claim of adherence to the DPE guidelines should be viewed in the light of the fact that deposits were placed with various banks at different rates during the same time. While it is a moot point as to what role the lack of business played in premature increase of a fixed interest rate by the Canara Bank, it is clear that there is no incentive to economise on the cost of debt as it is fully pass-through and thereby exposes the ultimate consumer to higher costs.

Recommendation

The Ministry may provide suitable incentive to the Companies to ensure that the cost to the ultimate customer is as least as possible.

Conclusion

- The Company planned Debt Equity ratio of 70:30 and would probably maintain 70:30 at conclusion, which is appreciated.
- The Company did not prepare a detailed cash budget covering the entire project period and had to lose out by deploying internal funds in the interim periods.
- The Ministry did not consider the reduction of the overall cost to the customer. The policy framework did not provide the right incentive for ensuring this.

CHAPTER IV: MINISTRY OF COMMERCE AND INDUSTRY

STCL Limited

4.1 Iron Ore Business Segment

Introduction

Spices Trading Corporation Limited, a wholly owned subsidiary of State Trading Corporation of India Limited, whose core business was trading in whole range of spices, amended (July 2004) the objects clause in its Memorandum of Association to include trading in iron ore and other metal scrap including third country exports and the erstwhile Spices Trading Corporation Limited was renamed as STCL Limited. Turnover of iron ore trade of STCL Limited (Company) ranged from ₹ 2.62 crore (0.61 *per cent)* of the turnover of the Company in 2004-05 to ₹ 22.55 crore (20.96 *per cent)* in 2009-10.

Trading in iron ore is carried out by the Company by procuring iron ore from different sources through Business Associates (BA) and bringing the ore to the nominated port plots under the custody of the Company. The Company nominates an inspection agency for analysis of the ore as per the requirement of the contract. Cost and freight (C&F) agent holds stock on behalf of the Company. The Company by availing of packing credit loan from its bankers, funds the procurement of ore as per the investment pattern agreed with BAs. Payment is made through internet Real Time Gross Settlement (RTGS) transfer against the stock at the mine head or FOR basis and thereafter progressively through FOB expenses as and when incurred.

Scope of Audit

Activities involved in the trade of iron ore carried out by the Company during the period 2007-08 to 2009-10 covering 47 shipments involving sales turnover of ₹ 367.29 crore and transactions relating to four BAs *viz.* Future Resources India Private Limited (FRIPL), SS Exports, Trimurthi Exports and Devi Minerals Resources Private Limited (DMRPL) were covered in this thematic audit with special emphasis on BAs in respect of whom stocks of iron ore were not disposed off and the Company was yet to recover its dues.

Year-wise turnover of the Company *vis-à-vis* turnover from iron ore trading for the last three years ended 2009-10 was as follows:

Year	Total Turnover (₹ in crore)	Turnover in iron ore trade (₹ in crore)	Percentage of iron ore trade to total turnover	No of shipments
2007-08	2,440.91	265.41	10.87	33
2008-09	2,170.43	80.11	3.69	11
2009-10	107.46	22.55	20.96	3

The decline in turnover in iron ore trading was due to fall in iron ore price from 2008-09.

Audit Objectives

The objectives of audit were to examine whether:

- BAs were selected in a transparent manner based on adequate risk analysis;
- Agreements entered into with the BAs safeguarded the financial interests of the Company and the trading assets retained by the Company; and
- Trading transactions were supported by adequate internal control procedures.

Audit criteria

The criteria adopted for judging the trading activity were as follows:

- Policies and Guidelines issued by the Board of Directors and the Management of the Company;
- Procedure for selection of BAs and agreements with them; and
- Industry best practice for trading in back to back contracts.

Audit Methodology

Audit methodology involved examination of agreements with the BAs, documents relating to shipments effected through BAs and discussions with the Management in reviewing the documents relating to trading in iron ore segment.

Audit findings

A review of the trading activity in iron ore revealed the following:

4.1.1 Feasibility study of the new business

In the Revised Market Plan for 2004-05, approved (July 2004) by the Board of Directors (BOD), the Company proposed to undertake export of iron ore considering the then market trend and potential of sourcing in Karnataka State in view of the geographical advantages as per the modalities framed. The BOD directed the Management to seek guidance from the Holding Company before diversifying into new product line. Despite the directives of the Board, the Company neither sought guidance from the Holding Company before diversifying into new product line nor conducted any market survey/SWOT♦ analysis/ risk analysis.

The Management admitted (December 2010) that neither any guidance of the holding Company was sought nor risk analysis conducted before venturing into new business.

4.1.2 Selection of Business Associates

The Company had not floated tenders calling for Expression of Interest (EOI) from the prospective Business Associates (BAs).

The Management while admitting (December 2010) that the Company never followed the practice of floating tenders for EOI from the prospective BAs, stated that the Company continued iron ore trade with the existing BAs considering their past performance, credibility *etc.*, who were responsible for identifying the overseas buyers and suppliers of

♦ ***Strength, Weakness, Opportunities and Threat*** iron ore as per the terms of back-to-back contract since the entire transactions were carried out at their risk and cost.

Audit observed that 44 of the 47 shipments traded during the period were carried out by three BAs. Of the three, two BAs (Devi Minerals Resources (P) Limited and S. S. Exports) were dealing in trading of agricultural commodities and the third BA (Trimurthi Exports) was a new Company for whom financial credentials, risk analysis and relevant past experience in iron ore trading was not on record. As iron ore trade was a new line of business, not calling for open tenders deprived the Company of choice of BAs. The system of selection of BAs was neither competitive nor transparent. The Company should have ensured relevant past experience of even the existing BAs to justify their capability to handle the iron ore trading.

4.1.3 Modalities of trading arrangement

4.1.3.1 The Company had not framed any guidelines for conducting iron ore trading. The annual Business Plan approved by the Board in 2004-05 included two options, viz. (i) the Company would identify the prospective sellers/ mine owners for sourcing of iron ore in India as well as overseas and (ii) the Company would enter into overseas contract through nominated BA who will be the sole performer for sourcing as well as fulfilling the export obligations as per contract and terms of letter of credit (LC). Though the Company could have better control over the business by selecting competent BAs, it carried out the transactions through BAs who were neither the mine owners nor the ultimate buyers of the ore.

The Management admitted (December 2010) that as per Business Plan, the Company proposed to identify the source of supply (Sellers/Mine owners). Subsequently, considering the business practice in iron ore trade, responsibility for identifying the source of supply under the back-to-back contract was assigned to the BAs since the transactions were carried out at their risk and cost.

However, the fact remained that the change in the trading arrangement was not brought to the notice of the Board for its approval.

4.1.3.2 The modalities for trading in iron ore stipulated (2004) that the suppliers should submit performance bond at 2 *per cent* of FOR/FOB value. This clause was deleted from the subsequent market plans exposing the Company's investments to market risks as no additional security other than the stock brought in by the BAs existed. The reason for this change was not placed on record.

The Management stated (December 2010) that the clause was amended to be in line with the market practice prevalent in iron ore trade, since the sourcing of material had been entrusted to the BAs at their risk and cost on back-to-back contract terms.

Reply of the Management was not tenable as by deleting the clause the Company exposed itself to market risk as it held no other security other than stock.

4.1.3.3 The Delegation of Power (DOP) approved (January 2006) by BOD provided for non-fund based back-to-back contracts. The Managing Committee comprising the Managing Director (MD) could enter into contracts up to ₹ 20 crore only beyond which the proposals were to be approved either by one Director or the Chairman/BOD. DOP was silent about the maximum extent to which the MD could commit the Company by entering into such contracts within his delegated powers.

Audit observed that in three cases, payments for ₹ 9.30 crore were released with the approval of the Finance Manager who was not competent to authorise the payments.

4.1.4 Deviation from the approved investment pattern in the business

As per the Market Plan and also the agreements, the Company's investment pattern was approved at 80-90 *per cent* of FOR cost and progressively for other expenses. The investment pattern of 80 *per cent* by STCL and 20 *per cent* by the BAs was revised by the BOD (May 2007) in the Marketing Plan for 2007-08, to either 80 *per cent* by STCL and 20 *per cent* by the BAs or 90 *per cent* by STCL and 10 *per cent* by the BAs.

Audit observed that on many occasions the Company had advanced funds in excess of sale proceeds resulting in excess funding. Further, non-reconciliation of advances released resulted in retention of surplus advance by the BAs. Failure of internal controls to keep a track of payments resulted in excess payment of ₹ 11 crore to BAs in respect of five cases wherein funding was made in excess of 80 *per cent.*

Management admitted (December 2010) that the Company advanced only to the extent of 80 *per cent* against each proposal against which BA brought in quantities less than proposed and made shipments to that extent and that the realisation had been adjusted by STCL towards the advances. As a result, the advances recoverable were more than the stocks available against the investments made by STCL. Management further stated (December 2010) that though justifications were not recorded in the file, the investment ratio was changed to suit the market conditions prevalent at that point of time depending upon the merit of the case.

Reply of Management was not tenable as change in investment pattern from 80 to 90 *per cent* involved outflow of Company's funds and, justification should have been kept on record taking approval of competent authority considering fluctuations in the iron ore prices and additional exposure involved.

4.1.4.1 The Company extended undue benefit to M/s. Trimurthi Exports by giving a running advance of ₹ 24 crore (in 17 shipments) which resulted in 100 *per cent* financing of their activities through the funds of the Company.

The Management stated (December 2010) that agreement with Trimurthi Exports was based on running advance of ₹ 12 crore which was increased to ₹ 24 crore based on the pledge of 1.5 lakh Metric Tonne (MT) of iron ore cargo at Litho Ferro Mines valued at ₹ 1,200 *per* Dry Metric Tonne (DMT).

Reply was not acceptable as providing running advance to BA was in deviation of the Marketing Plan approved by the BOD and acceptance of iron ore pledged valuing only ₹ 18 crore as against the running advance of ₹ 24 crore was not financially prudent.

4.1.4.2 The Company despite being aware of the inability of a BA (FRIPL) in fulfilling the export obligation (May 2008) and resultant accumulation of stock of ore at the Krishnapatnam port, entered into an agreement (July 2008) with another BA *viz.* S.S. Exports and the overseas buyer *viz.* Elgenburg Limited (August 2008) for facilitating export of 40,000 MTs of iron ore. Based on the request of the BA and without ensuring the deployment of BA's share of contribution, the Company released advance of ₹ 6.68 crore between July 2008 and September 2008 for procurement of iron ore accepting bank guarantee in lieu of the BA's contribution to the extent of 20 *per cent* and, thus, extended finance for 100 *per cent* value of the material. The shipment was to be completed within

45 days. However, the BA did not execute the shipment till December 2008. The Company asked (December 2008) the BA to either complete the shipment or settle the amount outstanding (including interest) and informed that the existing bank guarantee of ₹ 8 crore available with the Company would be invoked, if the issue was not resolved. Audit observed that the Company waited for 14 months before requesting (March 2010) the Bank to invoke the BG. S.S Exports obtained (April 2010) a court injunction order restraining STCL from invoking the BG.

The Management while admitting the observation stated (December 2010) that as per the records available, the BA was given extensions for performance up to March 2010 i.e. to the validity of the BG. The BG was invoked during March 2010 without giving any further extensions against which the BA took an injunction. When STCL tried to vacate the injunction through High Court, the BA requested for arbitration proceedings as per the arbitration clause of the contract, which was under progress.

The Company could have avoided fresh exposure to the extent of ₹ 6.68 crore made with SS Exports as it could have utilised the existing unsold stocks lying at Krishnapatnam port brought by M/s FRIPL.

4.1.5 Failure to enter into Tripartite Agreement

4.1.5.1 As per the modalities of trade, the Company was to enter into agreement for sale with the overseas buyer on a back-to-back agreement with the BA for procurement of the required quantity of ore simultaneously. However, while in respect of one contract with FRIPL (for which no agreement was signed with BA also) for export of ore at Krishnapatnam port, the advances against procurement of ore was not backed by any back-to-back sale contract, in another two contracts with SS Exports (May 07 and July 08) the agreement with the overseas buyer was executed subsequently in July 2007 and August 2008 respectively and not at the time of entering into the said contracts.

Management while admitting (December 2010) the observation on SS Exports stated that the proposal during August 2007 for contract with overseas buyer was on record. As regards ore brought by FRIPL it was treated as stock advance pending finalisation of overseas contract.

However, the fact remained that no back-to-back contract was available at the time of entering into agreement with BA in respect of the above contracts.

4.1.5.2 The Company invested (April 2008) ₹ 12.45 crore being 80 *per cent* of the value of 40,360 MTs of iron ore stocked at Vishakapatnam port and proposed to be exported by the BA (FRIPL). However, due to litigations with the group company *viz.*, Future Metals Private Limited, (FMPL), FRIPL did not fulfill the contractual obligations inspite of repeated notices for shipment. The stock remained unsold and the Company's efforts to sell the same were not fruitful as the BA initiated legal proceedings and the matter was pending for adjudication.

Further, the Company without entering into any contract either with the BA (FRIPL) or identifying the overseas buyer, also invested ₹ 16.80 crore being 90 *per cent* of the value of 52,000 MTs of iron ore procured at Krishnapatnam port which was proposed to be exported by the BA. The BA failed to identify the overseas buyer resulting in accumulation of the stock at the port. The Company sold (December 2009) the iron ore stock lying at Krishnapatnam port through tenders to Shiva Shankar Minerals Limited, Hyderabad for ₹ 13.37 crore resulting in non-realisation of ₹ 4.26 crore (inclusive of ECGC premium charges recoverable from the BA) on the sale of the ore.

The Management admitted (December 2010) that 52,000 MTs of iron ore brought by FRIPL to Krishnapatnam port was treated as stock advance pending finalisation of the overseas contract. In view of the litigations with the group company, Future Metals Private Limited (FMPL)[♣], the contracts could not be fulfilled. The unrealised balance money of ₹ 4.26 crore in respect of stocks sold at Krishnapatnam Port was recoverable from FRIPL as of December 2010. As regards, 40,360 MTs of iron ore stocks held at Vishakapatnam port, FRIPL had initiated legal proceedings and the matter was pending (December 2010) for adjudication.

4.1.6 System of Procurement - Determination of purchase price

Purchase price paid to the BA was computed keeping the agreed sale price as the base and deducting therefrom the Company's profit margin, handling charges, transportation charges, interest and other expenses.

Audit observed that the purchase price did not reflect the prevailing market price leading to absence of correlation of the actual price of ore procured with the amount advanced to the BA. Further, no safeguard clauses were incorporated in the agreements to protect the Company's interest on account of fluctuations in the price of ore.

The Management stated (December 2010) that the Company had realised the sale price and the same was considered for arriving at the purchase price at the time of giving advance except in a few cases wherein the sale had taken place after considerable time gap due to delay in convergence of stocks, which resulted in differential sale price realised by Company. However, the Company had realised its investment, interest on investment and margin in all the cases.

Reply was not relevant as the Company was not aware of the prices of iron ore from where it was sourced, and the procurement price derived was not representative of the prevailing market price.

4.1.7 Profit margin

4.1.7.1 The profit margin of STCL which was originally fixed in 2004-05 at 1.5 *per cent* of free on board (FOB) / C&F at the named port of destination (CFR) value stood revised to US$ 0.75 *per* DMT to US$ 1.50 *per* DMT or at the rate of 1.5 *per cent* to 2.5 *per cent* of the FOB/C&F value in Business Plan 2007-08 and to US$ 1 to US$ 2 *per* DMT during 2008-09. Audit observed that, no record of discussions as to the basis / adequacy of the margin charged by the Company was available. The margin of profit foregone in respect of 16 shipments where the Company had changed its margin at US$ 1/1.5 instead of 1.5 *per cent* of the contract, was ₹ 0.43 crore whereas in respect of 20 shipments the margin of profit increased by ₹ 2.15 crore.

The Management stated (December 2010) that though initially it was envisaged that the margin of profit would be collected at 1.50 *per cent* on FOB value as followed in other commodities, it was changed to USD 1 to 2 *per* DMT as per prevailing market practice

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[♣] ***Failure to devise internal controls in entering into and executing contracts with the same and another Business Associate leading to a loss of ₹ 1167.48 crore was reported vide in CAG para 4.3.1 of Audit Report No. 9 of 2009-10 (Commercial)*** and as followed by other PSUs related to iron ore trade and that the above practice had not resulted in any loss to the Company.

Reply was not acceptable as the factors considered for profit margin were not on record. In order to maximise the trading profit/margin the Company should have considered the nature of the product, market practice, competition, expected turnover and risk involved.

4.1.8 Lack of inventory control

4.1.8.1 The Company did not maintain any stock register to monitor the receipt/issue of ore from its storage points despite the fact that the stock of ore was being received and stored at the ports on behalf of the Company. The Company did not also have the system to physically verify the stocks at the ports before releasing payments. In the absence of the same, it relied solely on the certification of ore as indicated by the BAs / C&F agents. On being pointed out by Audit, the Company during 2009-10 reversed stocks valued at ₹ 95.79 crore certified as available as on 31 March 2009 as 'purchase returns' as these stocks were not available at the designated ports.

The Management stated (December 2010) that the stock details were obtained from the BAs or C&F agents since Company was giving advance to the BAs for investing in iron ore stocks. The Company booked the stocks of iron ore as inventory in the books only during 2008-09 and found that in some cases the BAs had not invested for the stocks or stocks invested had been already sold out without depositing the sale proceeds with the Company. The balance purchase was reversed as purchase return in the books during the year 2009-10.

Reply was not tenable as by relying on the certification done by C&F agents, the Company was unaware of the fact whether the BAs had not invested for the stocks for which advances were released or that the stocks had been sold without routing the sale proceeds through the Company. Further, the entire stock of iron ore valuing ₹ 95.79.crore including ₹ 29.50 crore provided in the accounts for the year 2008-09 was reversed as purchase returns in the books during the year 2009-10 as per the provisional accounts submitted to Audit.

4.1.8.2 Apart from the stocks reversed by the Company during 2009-10, the Statutory Auditors had conducted (April 2010) physical verification of iron ore stock and pointed out non-availability of iron ore stock of 25,214 MTs at various ports valuing ₹ 7.37 crore (based on sale price of ₹ 2,924 *per* MT realised during 2009-10).

The Management stated (December 2010) that the total closing stock has been reversed and accounted for as secured or unsecured advances recoverable from the BAs.

However, the fact remained that the Company was unaware of the unavailability of stocks valued at ₹ 95.79 crore till the same was pointed out by Audit. Further, the Company did not get its accounts for 2009-10 approved by the BOD till date (December 2010) due to which the actual quantity and value of closing stock remained unascertainable and amount remained unrealised so far (December 2010) from the BAs.

4.1.8.3 The Company did not have any records for two shipments (Doric Pride and Rishkesh) which had taken place as per the reports of the C&F agent of the Company through Devi Minerals during December 2008 and January 2009.

The Management stated (December 2010) that in respect of shipment through Doric Pride, as the Company could not make further investment towards port charges, customs duty *etc.*, BA diverted the shipment to other trader with a condition that the cargo so released would be replaced. Further, it was stated that in respect of shipment through Rishikesh, the details of movement of stock and shipment was not intimated by BA /C&F agent.

Reply was not tenable as the undertaking from BA regarding replacement of cargo for the shipment through Doric Pride was not on record.

4.1.9 Poor Financial Control

As a safeguard against breach of contractual obligations by the BAs, the agreements provided that BAs should furnish Corporate/ Personal Guarantee together with post dated cheques to the Company.

Audit observed that the reasons for accepting cheques as security without verifying the financial credentials of the BAs were not on record. As of March 2010, a sum of ₹ 36.58 crore was outstanding against Devi Mineral Resources (P) Limited, (DMRPL). Despite holding 11 cheques (including 6 blank cheques) for ₹ 33.65 crore issued by DMRL, the Company deposited only two cheques for ₹ 1.24 crore which were however, dishonored and returned (February 2010) by the banks. The bank slips giving the reasons for return of the cheques by the banks and for not presenting the other cheques by the Company were also not on record.

The Management stated (December 2010) that the cheques held as security against the investment were not presented in view of the shipment effected during May 2010 and the party had come forward for discussions to reduce its dues. As regards 2 cheques for ₹ 0.62 crore each, though initially dishonoured, subsequently one cheque of ₹ 0.62 crore was cleared. DMRL paid ₹ 0.32 crore and issued fresh cheque for the balance amount of ₹ 0.30 crore, which was also dishonoured by the Bank and returned during October 2010. Legal proceedings had been initiated for the same.

Reply was not tenable as even though the BA had come forward for discussion to reduce its dues, the Company should have deposited the cheques on due dates for realisation of the outstanding dues..

The Ministry, while forwarding (December 2010) the reply of the Management to Audit, did not offer any comments on the ground that issues related to commercial activities of the Company.

Conclusion

- The Company accepted to act as facilitator for iron ore trade with BAs without ensuring their financial credentials and without insisting on back-to-back contracts to safeguard its interests.
- Investment pattern was modified to benefit the BAs and the release of money by Company to the BA (3 cases) for procurement of ore was not linked to establishing of the tripartite agreement with the overseas buyers. The Company's action of venturing into trading in iron ore without such a contract exposed itself to the risk of non-fulfillment of the contracts.

- Consequent to fall in iron ore prices from 2008-09 and in the absence of financial and contractual safeguards, the advance of ₹ 54.37 crore paid by the Company to three BAs (FRIPL, SS Exports and Devi Minerals) became unrecoverable as on March 2010 due to the BAs failing to fulfill their export obligations.
- The Company failed to exercise basic inventory control and was unaware of the physical unavailability of stocks valued at ₹ 95.79 crore. Instead it relied entirely on the stock details furnished by the BAs and C&F agents which proved to be misleading.

Recommendations

- ***The Company should formulate guidelines in consultation with the holding company keeping in view the best industry practice before venturing into any new product line to safeguard its interests:***
- ***The Company should conduct a SWOT analysis/market survey and frame guidelines /procedures for selection of BAs in a competitive and transparent manner after calling for expression of interest through open advertisement.***
- ***The Company should carry out an analysis of financial capabilities of the BAs for risk assessment through an independent risk analyst.***
- ***Release of advances for procurement should be linked to the tripartite agreement with the overseas buyer.***
- ***The Company should establish a system of linking its financial exposure to the prevailing price of ore so as to be in a position to seek/obtain additional securities whenever required.***
- ***The Company should have a system of physical control over the receipt of stocks and sale thereof and also physically verify the stocks before releasing any payments to the BAs.***
- ***The agreements with the BAs should be in accordance with the guidelines approved by the BOD and vetted by a legal authority.***
- ***The Company should carryout the transactions with the BAs strictly in accordance with the provisions of the agreements with them and take immediate remedial measures in case of default/non-fulfillment of contract terms by the BAs.***

CHAPTER V: MINISTRY OF COMMUNICATIONS AND INFORMATION TECHNOLOGY

Bharat Sanchar Nigam Limited

5.1 Basic Telephone services in BSNL

Introduction

In India the state owned Bharat Sanchar Nigam Limited (BSNL) is one of the major telecom service providers. Two thirds of the revenue of BSNL is generated from its landline telephony[1] as against which the majority revenue generation of the private players is from their mobile operations. Hence strategically the performance of BSNL is mainly dependent on its landline telephony.

Although BSNL has diversified into mobile services its basic telephone service still continues to be a major revenue earning service. As against the overall income of ₹ 31,074 crore (2009-10), income from basic service was ₹ 19,599 crore and constituted nearly two thirds of overall revenue from services. The monopolistic status of BSNL in telecom sector ended by March 2009 with the advent of private players providing basic and cellular mobile services.

Scope of Audit

The audit was carried out during September 2009 to March 2010 covering a period of five years from 2005-06 to 2009-10 and audit examined the relevant records relating to 15 telecom circles[2] out of 24 telecom circles.

Audit objective

The main audit objective was to assess if BSNL had taken adequate measures to sustain its landline telephony.

Audit criteria

The main criteria used for audit were as follows:

- Codal provisions and orders issued from time to time by the BSNL
- Performance indicators fixed by the Telecom Regulatory Authority of India (TRAI) in respect of quality of service

Audit Findings

Audit findings on lack of proper planning, dynamic tariff structure, ineffective marketing strategies, inadequate capacity utilization, injudicious procurement of equipment and ineffective monitoring mechanism of landline telephony are brought out in the succeeding paragraphs.

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[1] ***Also known as basic services***

[2] ***Andhra Pradesh, Bihar, Gujarat, Haryana, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttarakhand, Uttar Pradesh (East) and Uttar Pradesh (West)***

5.1.1 Revenue generation

The growth of subscriber base and revenue generation from basic telephone service vis-à-vis the overall revenue of BSNL during the last five years was as follows.

Year	Equipped capacity as of March (lakh lines)	Working Connections as of March (lakh lines)	Income from Basic service (₹ in crore)	Overall revenue (₹ in crore)	Percentage of revenue from Basic to overall revenue
2005-06	513	379	32355	39117	82
2006-07	526	372	27147	37768	71
2007-08	539	361	23715	35599	66
2008-09	541	347	21819	33701	64
2009-10	546	340	19599	31074	61

From the above table it could be seen that since 2005-06 there had been a steady decline in the landline customers of BSNL and the revenue generation had also registered a sharp decline. Audit noticed that although there had been a significant decline in the customer base and revenue from landline telephony over the last five years, still BSNL failed to arrest the decline by taking adequate measures on all fronts. To the contrary the private service providers improved their customer base by 64 *per cent* (Bharti Airtel) to 120 *per cent* (Tata Teleservices Limited) during 2006-07 to 2009-10 as shown below.

Customer base of landline telephony of private operators

Year	Bharti Airtel Limited	Tata Teleservices Limited	Reliance Communications Limited
2006-07	1871387	527256	568179
2007-08	2283326	722951	873969
2008-09	2726240	918680	1108564
2009-10	3066859	1162276	1177412

5.1.2 Impact of Tariff Changes

Tariff plans play an important role in strategic planning for retaining customer base. BSNL introduced different tariff plans relating to landline telephony and the major tariff changes effected during the period 2005-06 onwards were as following.

Year	Tariff change
2005-06	Revision of rental for Basic, WLL services and alternative packages
	1. BSNL One India Scheme- Reduction of STD tariff. 2. Reduction of Pulse for Dial Up Internet Access under BSNL One India.
2006-07	1. Reduction in fixed monthly charges under Sulabh plan. 2. Revision in Tariff minimum guarantee security deposit and pulse rates for all types of PCOs
2007-08	1. Reduction in ILD Tariff for calls originated from BSNL during festival season. (60 Days) 2. Revision of tariff, new STD/ISD calling cards under 'Call Now'.

2008-09	1. New optional plan-Gramin 75 for rural areas and reduction of fixed monthly charges of Sulabh 2. Revision of ISD tariffs for Oman and Qatar 3. Revision in pulse rates. 4. Revision in call charges from ITC.

Tariff changes aimed towards sustaining the landline service was not given adequate thrust as very few tariff changes were made during 2005-09 and this was reflected by the decline in the subscriber base. Audit noticed that the tariff plans were not aggressive enough to meet the highly competitive market. Further, since 2004 very limited competitive tariff plans were introduced for basic service whereas the mobile service tariff plans changed frequently with the market dynamics. This was one of the reasons that led to migration of subscribers from basic telephony to mobile communications within BSNL and to other service providers. The downward trend in the number of connections and revenue showed that the tariff changes could not help in preventing the negative growth of subscriber base and decline in revenue generation.

5.1.3 Decline in the number of Public Call Offices

Public Call Office (PCO) business was an important source of revenue for BSNL. Comparison of the PCO base of BSNL with other operators revealed that the PCO base of BSNL for the test checked circles remained more or less static between 14 and 18 lakh PCOs during the last five years while that of the other operators registered a sharp growth from 4.10 lakh PCOs (March 2005) to 22.32 lakh PCOs (March 2010).

As of	**No. of PCOs**	
	BSNL	**Other operators**
March 2005	1608719	410237
March 2006	1767157	1172745
March 2007	1819047	2622957
March 2008	1763255	3158270
March 2009	1596843	3471546
March 2010	1412549	2232367

No effective action was taken by BSNL to boost its PCO business. On this being pointed out by audit, the Chief General Manager (CGM), Karnataka circle stated (March 2010) that the purpose of PCOs was to give access to public when the teledensity was poor and PCO as a revenue model would not work with the higher teledensity.

The reply was not acceptable as the PCO base of the competitors had registered significant growth during the last six years as stated above while BSNL's PCO base remained static and started a downward trend from 2007-08.

5.1.4 Capacity utilization

5.1.4.1 Telephone exchanges

Utilisation of equipped capacity of the telephone exchanges plays a vital role in generating more revenue. The Corporate Office of BSNL fixed annual targets for growth of landlines as 7.50 lakh and 13 lakh lines for the years 2004-05 and 2005-06 respectively, but the actual performance did not have any relationship with the targets as there was negative growth in all the circles. It was observed in the 15 test checked circles that the working connections declined sharply from 307.47 lakh lines (March 2005) to 229.32 lakh lines (March 2010), i.e., by 25 *per cent*. The overall loading of the exchanges in the 15 test checked circles decreased from 77 *per cent* (March 2005) to 60 *per cent* (March 2010).

Comparison of the performance among the circles showed that the percentage of loading of exchanges in Kerala and Bihar circles remained consistent around 80 *per cent* and 70 *per cent* respectively throughout the period. However, loading in the other 13 circles dropped between 49 and 64 *per cent* in March 2010 as against 70 to 81 *per cent* in March 2005. Maharashtra circle recorded the highest drop in loading in percentage terms from 77 *per cent* to 53 *per cent*. The Company has to concentrate on circles having drastic decline in capacity utilisation of telephone exchanges.

5.1.4.2 Injudicious procurement of exchange equipment

The decline in the subscriber base and loading of the exchanges underlined the need for judicious utilization of equipped capacity and avoid procurement of switching equipment. BSNL Corporate office issued instructions (December 2006) that wherever the working lines fell short of 75 *per cent* of equipped capacity, the excess equipment could be diverted from no demand areas to demand areas.

Injudicious procurement of switching equipment by BSNL without taking into consideration the downward trend in subscriber base was already commented upon in the Audit Report No. CA 12 of 2008. Avoidable expenditure on procurement of switching equipment for replacement of life expired E10B equipment was, however, observed in some circles in the subsequent period as detailed below.

Name of circle	Type of equipment procured	Quantity procured	Month of ordering equipment	Cost (₹ in lakh)
Andhra Pradesh	EWSD	4K♦	July 2008	117
	OCB	5K	November 2008	99
Bihar	OCB	3K	July 2008	68
	EWSD	3K	July 2008	52
Madhya Pradesh	EWSD	8.75K	August 2008	193
Orissa	OCB	5K	November 2008	109
Tamil Nadu	OCB	5K	December 2008	172
Uttar Pradesh (West)	EWSD	8K	September 2008	202
	OCB	13.5K	February 2009	306
	EWSD	4K	March 2009	84
Total:		**59.25K**		**1,402**

Had the circles reviewed availability of spare capacity and taken action to divert the surplus capacity to places of demand, fresh procurement at a cost of ₹ 14.02 crore could have been avoided.

On this being pointed out by Audit, the Tamil Nadu circle stated (March 2010) that although 6K lines were required to replace the outlived E10B main exchange which had nine Remote Line Unit exchanges parented to it, only 3K for main and 2K equipment for

♦ ***1K = 1000 lines***

Remote Switching Unit were ordered taking into consideration redeployment of the spare capacity of OCB exchanges in Tamil Nadu circle. No replies were received from other circles.

As against the fresh procurement of 59.25K lines exchange equipment pointed out above, working lines in BSNL decreased by 11 lakh lines during the period 2007-08 and further by 14 lakh lines during the period 2008-09. Further, the overall capacity utilization was below 70 *per cent* in the telecom circles (2009-10). The spare capacity that was available in other places should have been utilized by suitable redeployment instead of resorting to fresh procurement to avoid additional investment.

5.1.5 Broadband connections

BSNL introduced Broadband service under the brand name of Data One from January 2005. The broadband service was provided through the existing copper wire connectivity from the telephone exchange to the subscriber premises by installing additional equipment like DSLAM at the telephone exchange. The introduction of broadband service should have, therefore, facilitated retention of the existing landline customers as well as addition of new landline customers.

The following table shows the year-wise target and achievement in the test checked circles for provision of broadband connections during the years 2005-06 to 2008-09.

Year	**Target**	**Actual number of connections given**	**Percentage of shortfall**
2005-06	534305	359159	32.78
2006-07	323387	301590	6.74
2007-08	1157889	741136	35.99
2008-09	2463889	1073924	56.41

A review of the number of broadband connections provided to existing landline subscribers in six circles showed that in five circles[♥], 71.70 *per cent* to 100 *per cent* of the broadband connections were provided to existing subscribers. These five circles mainly could not succeed in providing broadband connections to new customers. Against the overall installed capacity of 83.19 lakh broadband connections in BSNL network, the working connections were 53.76 lakh only (March 2010), i.e., capacity utilisation of 64.62 *per cent.* The circles failed to realize increase in subscriber base by providing broadband connections to new customers despite availability of spare broadband capacity.

5.1.6 Monitoring and control

5.1.6.1 Constant monitoring of quality of service is highly essential to ensure customer satisfaction and arrest decline in customer base especially in the competitive environment. In the regulatory regime, the TRAI prescribed benchmarks for various Quality of Service (QoS) parameters like provision of new connection within seven days, fault incidence/clearance, etc. TRAI conducted an objective assessment of QoS for basic service in various circles during the year 2008. Analysis of the TRAI reports for 15 test checked circles except Uttarkhand revealed the following position.

[♥] ***Andhra Pradesh, Bihar, Gujarat, Kerala, Tamil Nadu***

Sl. No.	Parameter	TRAI Benchmark	No. of circles that did not meet the target
1	Provision of telephone after registration of demand: Connections completed within 7 days	100 *per cent*	13
2	No. of faults/100 subscribers/month	<3	13
3	Faults repaired within 24 hours	>90 *per cent*	12
4	Faults repaired within three working days	100 *per cent*	10
5	Mean Time to Repair (MTTR)	< 8 hours	9
6	Call Completion Rate	> 55*per cent*	4
7	Billing complaints per 100 bills issued	<0.1*per cent*	3
8	Percentage of billing complaints resolved within 4 weeks	100*per cent*	7
9	Shift requests attended within 3 days	95*per cent*	12
10	Closure within 24 hours	95*per cent*	12
11	Additional facility provided within 24 hours	95*per cent*	9

The performance on provision of facilities, incidence of faults and fault clearance required improvement as they would result not only in customer dissatisfaction but also in loss of revenue due to non-provision of service. It could be seen from the above that most of the test checked Circles did not meet the TRAI bench marks relating to QoS parameters. Maintenance of QoS within norms needed utmost attention as it would negatively impact the customer satisfaction, revenue and customer base.

5.1.6.2 Decline in customer base

Though the basic service customer base of BSNL started declining from 2005-06 onwards, but only in 2008 BSNL appointed a consultant (IMRB) for determining the reasons for the surrender of landlines. The consultant's report cited the following main reasons for surrender of BSNL landline:

- shift to mobile phone on account of mobility, lower call rates
- dissatisfaction of subscribers with the quality of service offered and long time taken for complaint/query resolution
- lack of better tariff plans for landline
- limited point of contact for getting connections activated, problem resolution, etc.

While the shift to mobile phone on account of mobility was technology driven, the other factors should have been addressed adequately by BSNL. Being the basic service provider in the field for long, BSNL should have taken measures much earlier to ensure customer satisfaction instead of allowing the customer base to decline due to such reasons. This could have been achieved with continuous monitoring and control at Corporate, circle and SSA levels.

5.1.6.3 Unexploited investment of over ₹24,000 crore on basic telephony

Basic telephony has been strategically important for BSNL as around 70 *per cent* of its revenue was generated from it over the years. However subscriber base and revenue generation from basic telephony had declined from ₹ 32,355 crore in 2005-06 to ₹ 19,599 crore in 2009-10. Further, the basic telephony segment had been incurring losses from

2006-07 onwards which impacted the financial health of the Company and during the year 2009-10 it had run into the red.

Till March 2010, the Company had invested ₹ 89,118 crore to build up equipped capacity of 546.32 lakh lines against the working connections of 339.75 lakh lines for its basic telephony network. After considering a margin of 10 *per cent* on conservative basis, i.e., the connectable capacity of 90 *per cent,* the BSNL had spare capacity of 151.94 lakh lines which reflect the corresponding investment of ₹ 24,784 crore. Thus, failure of the BSNL to revive basic telephony resulted in unexploited investment of over ₹ 24,000 crore on spare capacity of over 1.51 crore lines (March 2010) for the entire basic telephone network.

5.1.7 Corporate/Circle initiatives

5.1.7.1 Dynamic and timely initiatives at the corporate and circle level were required to sustain the landline service and to arrest the decline in the landline customer base. In this direction various tariff plans were introduced at corporate and circle level to reverse the negative growth. Initiatives were taken at circle and SSA level also by organizing open sessions, melas, road shows, participation in exhibitions, signing Memorandum of Understanding with builders for bundling BSNL landline with residential unit, etc. These measures produced some positive results, yet these were not adequate to reverse the negative growth in subscriber base and decline in revenue from basic service.

The CMD, BSNL in the Annual Report 2008-09 reported that to arrest the continued decline in the physical and financial performance, BSNL had appointed a consultant (2008) to advise the BSNL on the business strategy and growth plans. Key priorities for the BSNL were identified and measures initiated like reconfiguration of organizational structure addressing gaps and sales and distribution improvement in service delivery and provisioning times etc.

In the fierce competitive environment in the telecom sector, BSNL should have proactively taken the above steps and arrested the downslide in customer base of landline telephony in the initial stages beginning from 2006-07.

5.1.7.2 Marketing

Marketing and business promotion activities such as advertisements in print/electronic media, hoardings, road shows, door to door campaigns, displays in public exhibitions, appointment of franchisees/direct selling agents were undertaken by the BSNL. However, the expenditure on marketing was not commensurate with the huge investment on infrastructure by BSNL. Business promotion and marketing expenditure of ₹ 286 crore and ₹ 378 crore were 2.56 *per cent* and 3.30 *per cent* of overall administrative expenditure in the years 2007-08 and 2008-09 respectively. In comparison, the business promotion expenditure of other major private operators ranged from 5.88 *per cent* to 12.08 *per cent* of their overall administrative expenditure during the same period. This underlined the need for thrust in marketing BSNL products.

Conclusion

Subscriber base and revenue from basic telephone service of BSNL declined drastically over the last five years as also its overall revenue. Lack of dynamic tariff structuring, slack marketing efforts especially in the face of competition from private operators, lack of quality in service were major contributing factors for erosion of customer base and revenue of BSNL. Opportunity to increase subscriber base by capturing more broadband connections was also not realized. Erosion of subscriber base resulted in accumulation of spare exchange capacity and consequent unexploited capital investment.

These issues are to be addressed urgently by BSNL for sustaining their landline telephony segment and improving overall financial health.

The matter was referred to Ministry in October 2010; reply was awaited (February 2011).

Recommendations

- ***BSNL should have a time bound programme and fix milestones for increasing its landline subscribers through aggressive marketing strategy, competitive tariff plans and improving its quality of service.***
- ***BSNL should revamp its tariff plans to revive the demand for landline telephony and improve the capacity utilisation of telephone exchanges.***
- ***Broadband should be marketed effectively to attract new customers and increase customer base of land line telephony.***
- ***Tariff structure for PCO market must be redesigned to ensure retention and enhancement of PCO base.***

5.2 Planning and implementation of rural broadband in BSNL

Introduction

Telecom services have been recognized the world-over as an important tool for socio-economic development of a nation. Promotion of rural telephony and accessibility of telephones in remote areas is an important thrust area of the telecom department. Broadband Policy 2004 was framed to accelerate the growth of broadband services. It was also envisaged that internet and broad-band subscribers would increase to 40 million and 20 million respectively by 2010.

Scope of Audit

Audit covers aspects of planning, procurement, utilisation of Rural Broadband equipments in the Bharat Sanchar Nigam Limited (BSNL) along with claiming and collection of Universal Service Obligation (USO) subsidy. Audit was conducted during the period 2009-10 covering the period 2007-08 to 2009-10 and records of five telecom circles viz. Karnataka, Madhya Pradesh, Maharashtra, Rajasthan and Tamil Nadu were examined.

Audit findings

Audit observed deficiencies in planning of projects, utilisation of installed capacity and claim of USO subsidy in respect of Rural Broadband. The BSNL needs to address these deficiencies to achieve the objectives envisaged for Rural Broadband in the Broadband Policy 2004 and Universal Service Obligations. These deficiencies are discussed in the succeeding paragraphs.

5.2.1 Planning

Recognising the potential of Broadband service in growth of GDP and enhancement in quality of life through societal applications including tele-education, tele-medicine, e-governance, entertainment as well as employment generation by way of high speed access to information and web-based communication, Government finalised Broadband Policy 2004 to accelerate growth of Broadband services.

The Rural Broadband Scheme was framed to provide wire-line broadband connectivity to rural and remote areas by leveraging the existing rural exchanges infrastructure and copper wire-line network. The rural broadband connectivity would cover institutional users, such as Common Service Centers (CSCs), being set up by Department of Information Technology (DIT) under Ministry of Communications, Gram Panchayats, Higher Secondary Schools and Public Health Centers as well as Individual Users located in the villages. 27,789 rural exchanges were planned to be covered throughout the country out of which 11,071 rural exchanges falling in five telecom circles were covered by Audit.

The Rural Broadband scheme was funded jointly by DIT and Universal Services Obligation Fund (USOF). BSNL received an amount of ₹ 170 crore from DIT (November 2006) against the total capital outlay of ₹ 340 crore. Further an agreement was signed between USOF and BSNL in January 2009 which provided the BSNL the right to claim subsidy for rural telephone services. The subsidy included:

- a front loaded component which was to be paid in the quarter when the service was installed and made functional, and
- an equated annual subsidy component, to be paid quarterly against claims raised by the Universal Service Provider (USP) within 30 days of the end of the quarter, upto a maximum period of validity of the relevant agreement. The subsidy was payable for connections provided to individual/institutional users and also for setting up of Kiosks in the rural areas.

5.2.1.1 Avoidable expenditure due to planning of higher capacity Broadband ports than requirement

BSNL Board decided (August 2006) to implement the scheme of Broadband connectivity in 20,000 villages where the BSNL's telephone exchanges with fibre connectivity existed i.e. to cover all Short Distance Charging Areas /Talukas. As per planning guidelines of BSNL (September 2006), 64P DSLAM[1] (Digital Subscriber Line Access Multiplexer) was planned for exchanges with less than 500 lines capacity and 120P DSLAM for higher capacity exchanges.

Circle records showed that no survey was conducted to identify those villages/locations which had potential market for Rural Broadband and to plan the actual capacity requirement of DSLAMs. Out of 5,760 64P DSLAMS installed in the five telecom circles[2] test checked, the working connections in respect of 3,795 DSLAMs were either zero or in single digits even after one to two years of their commissioning.

[1] ***Broadband equipment located at the rural telephone exchange of the USP that connects multiple Customer Premises Equipments to a high speed internet core network; from 64 P, 64 connections can be provided***

[2] ***Karnataka, Maharashtra, Madhya Pradesh, Rajasthan and Tamil Nadu***

Name of the Circle	Number of villages identified for installation	DSLAMs allotted for the Circle	DSLAMs installed in the SSA[1]s test checked	DSLAMs with Zero connections	DSLAMs with single digit connections	Number of SSAs covered by Audit
Karnataka	2206	2133	1890	281	835	18
Madhya Pradesh	1982	812 372[2]	1184	363	577	34
Maharashtra	3991	4112	1834	537	801	13
Rajasthan	1959	1034	328	69	119	5
Tamil Nadu	933	933	524	0	213	6
		TOTAL	**5760**	**1250**	**2545**	
				3795		

This showed that BSNL did not explore the technical option of procuring 64P DSLAMs and installing them at two locations/villages by splitting them into two 32P DSLAMs in the places where expected loading would be very low. However in the past BSNL had procured 32P DSLAMs which were split into two DSLAMs of 16P each, to meet the demand of two exchanges.

The cost of DSLAMs equipment also showed a decreasing trend during 2005-09 with the cost of 64P DSLAMs being ₹ 64,371 in May 2009 against ₹ 92,182 in September 2005. BSNL could have planned to procure as per the actual requirements and resorted to additional purchase on demand thereby getting the benefit of price reduction. This would not only have resulted in provision of capacity commensurate with the existing demand in those villages but would have also helped in covering more villages. In addition, provision of rural broadband could have been accomplished at a substantially lower capital investment.

BSNL assessed the fact of poor loading of rural exchanges to the tune of around 10 *per cent* on an average during the subsidy proposal for the operational expenditure of Broadband in Rural areas (August 2008). Based on this calculation BSNL would be incurring huge loss in view of the operational expenditure calculated at ₹ 10,494 per line per year even though 50 *per cent* of the cost of the equipment was to be subsidized to BSNL through DIT. BSNL field units also assessed the demand in rural exchanges (May 2008) as 10 to 20 connections and requested for lower capacity equipment, either 24P or 48P instead of allotted 64P (Tamil Nadu circle) which was approved by BSNL Headquarters (May 2008).

Hence by splitting the 64P into two 32P DSLAMs, BSNL could have easily managed the above 3,795 locations with 1,900 64P DSLAMs thereby saving the capital expenditure to the tune of ₹ 12.17 crore calculated at ₹ 64,076 being the cost of one DSLAMs in test checked circles. This defective planning resulted in blocking up of capital of equivalent amount.

The issue was brought to the notice of Corporate office, BSNL (September 2010) along with a specific query whether any survey was conducted to plan the requirement of capacity of DSLAMs, on which it was replied that as per the USOF agreement BSNL had

[1] ***Secondary Switching Area***

[2] ***Diversion from Gujarat, Uttar Pradesh – PO dated 5.12.07***

to deploy DSLAMs of 64 ports in rural areas. The reply was not convincing as clause 15.4.1 of the USO Agreement provided for a minimum of 32 ports at each location and not 64 ports as claimed by BSNL. Further, clause 15.6 stipulated that USOF shall not provide any subsidy beyond 32 connections and hence it would have been prudent to go in for 32 ports instead of 64 ports as there was no initial demand for Broadband connections in rural areas.

5.2.2 Installation, commissioning and utilization of DSLAMS

The DSLAMs received were installed by the respective circles during the period 2008 to 2010. Any delay in creating demand for broadband connections and loading the exchanges optimally in rural areas results in loss of revenue to BSNL by way of monthly rental and subsidy.

5.2.2.1 Loss of revenue due to under utilization of Rural Broadband equipped capacity

Though all rural exchanges in the test checked circles were loaded adequately for provision of Broadband connectivity, connections to the extent of even 50 *per cent* of equipped capacity was not achieved as shown below in three of the five circles test checked. This led to potential loss of revenue of ₹ 11.17 crore per year in circles test checked based on the tariff of ₹ 99 per broadband connection.

Circle	DSLAMs installed	Equipped capacity	Working connections	50 *per cent* loading	Shortfall in connections (col 5-col 4)	Short fall in annual revenue at the rate of ₹ 99 per month (Col 6x₹ 99x12)
1	2	3	4	5	6	7
Karnataka	1890	121394	14630	60697	46067	5,47,27,596
Madhya Pradesh	1184	76552	6245	38276	32031	3,80,52,828
Tamil Nadu	933	61632	14887	30816	15929	1,89,23,652
		259578	35762		94027	11,17,04,076

5.2.3 Inadequate and ineffective marketing strategy

USOF conditions (Clause 14.12 of Agreement) stipulated that adequate marketing activities should be carried out by BSNL for popularising USOF products to public. There was need to educate, advertise and create awareness amongst rural masses about the advantages of having Broadband facility under USOF subsidy scheme which provided concession in rentals and supply of PCs at subsidized rates in equated monthly installments. BSNL directed all circles (February 2009) to give wide publicity through media, advertisements, road shows, banners, display boards etc. to promote broadband connections in rural areas.

To an audit query on the marketing strategy adopted by BSNL and its implementation, the field units responded that installation of DSLAMs and marketing of rural Broadband was as per the directives of BSNL. However, Telephone Melas of general nature were being held without much effect.

DoT strategy for rapid connectivity of Rural Broadband in conformity with the Broadband Policy 2004 included the following:

- HRD Ministry-About 1.5 lakh Higher secondary and intermediate schools and 12,000 Colleges/Universities to be covered (70 *per cent* of these institutions were in rural areas).
- Rural Development–More than two lakh Panchayats were to be provided broadband under Bharat Nirman and "Sakshar Bharat" programme.
- Broadband connectivity in village Post Offices.

Audit scrutiny of the records of Tamil Nadu circle revealed that no centralised data and monitoring system was in place at circle level regarding rural broadband connections required by Union Government, State Government and Educational Institutions. In Madhya Pradesh circle, against the demand of 7,062 connections from three institutions, only 1,066 broadband connections were provided categorizing the remaining connections as "Not feasible".

In spite of huge potential for Rural Broadband connections in government and private sector as detailed above, no effective action was taken by the circles to utilize the unique opportunity of attaining optimum utilization of installed capacity of rural exchanges.

5.2.4 Potential loss of revenue

Audit noticed that BSNL failed to achieve the minimum Broadband connections and kiosks to avail the front load subsidy and subsidy for Broadband Kiosks. It was also observed that USO subsidy procedures were not followed resulting in loss of revenue. These issues are brought out in detail as below:

5.2.4.1 Potential loss of subsidy revenue due to failure to exploit the maximum number of broadband connections eligible for USO subsidy

- The USOF Agreement with DoT provided that BSNL was eligible to claim a front loaded subsidy of around ₹ 5000 per Broadband connection provided by it in rural areas. The subsidy was limited to a maximum of 31 broadband connections per DSLAM.

Audit noticed that in Maharashtra and Rajasthan telecom circles, 31 broadband connections were not provided per DSLAM. Consequently subsidy to the full extent could not be claimed resulting in potential loss of subsidy revenue of ₹ 60.45 crore as shown below:

Circle	Quarter ending	Amount of subsidy claimed (in ₹)	No of DSLAM working	Amount of eligible subsidy (in ₹)	Difference (in ₹)
1	**2**	**3**	**4**	**5 (Col 4x31x₹5000)**	**6 (Col 5-3)**
Maharashtra	March 2009 to March 2010	15,03,80,802	4112	63,73,60,000	48,69,79,198
Rajasthan	March 2009 to December 2009	4,27,44,057	1034	16,02,70,000	11,75,25,943
				Grand Total	**60,45,05,141**

- The USOF Agreement also provided that BSNL was entitled for a subsidy of ₹ 20,000 per broadband Kiosk and that BSNL would set up at least one internet Kiosk for every 10 DSLAMs.

Subsidy of ₹ 1.23 crore could have been earned in five test checked circles, if the earmarked villages were provided with minimum of 615 Kiosks as shown below against which only an amount of ₹ 6.76 lakh was earned.

Circle	DSLAM installed in the circles test checked	Minimum Kiosks (one Kiosk per 10 DSLAM)	eligible subsidy per Kiosk (in ₹)	Total loss of subsidy (in ₹)
Karnataka	1890	189	20,000	37,80,000
MP	1184	118	20,000	23,60,000
Maharashtra	1834	183	20,000	36,60,000
Rajasthan	328	32	20,000	6,40,000
Tamil Nadu	933	93	20,000	18,60,000
	6169	**615**	20,000	**1,23,00,000**

5.2.4.2 Non observance of USO subsidy procedures led to loss of ₹1.36 crore

As per clause 18.5 of the USOF Agreement, the USP shall submit the claims for subsidy within 30 days of the end of the quarter along with the supporting documents duly complying with the conditions of agreement. Test check of USO claim related records revealed that USO subsidy (i) was disallowed in Rajasthan circle as the broadband speed was below the stipulated minimum of 512 Kbps (ii) was withheld in Karnataka, Madhya Pradesh and Maharashtra circles due to non furnishing of required supporting documents to USOF Administrator.

Circle	Quarter ending	Subsidy disallowed (₹ in crore)	Subsidy withheld (₹ in crore)	Reasons
Rajasthan	March 2009 to December 2009	1.36	Nil	Broadband speed below 512 kbps
Karnataka	December 2009	Nil	1.36	Non submission of supporting documents
Madhya Pradesh	December 2009	Nil	0.24	
	March 2010	Nil	0.31	
Maharashtra	December 2009 to March 2010	Nil	5.93	
	Total	**1.36**	**7.84**	

Thus, in spite of providing rural Broadband connections the Company lost ₹ 1.36 crore due to non compliance with subsidy procedures which reflected weak controls and follow-up procedures.

Conclusion

Under Broadband Policy 2004, Government recognized the potential of broadband service in growth of GDP and enhancement in quality of life through societal applications including tele-education etc. In order to achieve the objective of providing broadband connectivity for rural population, the BSNL had to plan and execute various schemes to popularize broadband in rural areas. Audit observed systemic deficiencies in planning, utilization of installed capacity and marketing of Rural Broadband which resulted in blocking of capital of ₹ 12.17 crore, revenue loss of ₹ 11.17 crore and loss of USO subsidy of ₹ 63.04 crore in the test checked circles. These deficiencies are to be addressed urgently by the BSNL to improve Rural Broadband connectivity besides achieving the objectives of the Broadband Policy 2004.

The matter was referred to Ministry in October 2010; reply was awaited (February 2011).

Recommendations

The BSNL may:

- ***plan the broadband port capacity requirements in tune with the potential of the village***
- ***devise effective marketing strategy to utilize the rural exchanges optimally to earn revenue and take advantage of Universal Service Obligation subsidy***
- ***provide connections strictly as per Universal Services Obligation Fund standards and adopt mechanism to get the due subsidy in time***

5.3 Leased circuits in Bharat Sanchar Nigam Limited

Introduction

Bharat Sanchar Nigam Limited (BSNL) provides leased line/circuit services to subscribers for a specific period as dedicated telecommunication links for internal communication between offices at various sites within a city and different cities on point-to-point basis. The leased lines are active through connective courses or channels, called 'circuits' during the period of lease. These circuits are available on fibre optic, radio, copper wire and satellite medium or a combination of these media.

There are different types of circuits according to the use, viz., speech circuits (carry only speech signals), data circuits (carry data signals at various speeds), Closed User Group (circuits used by more than one legal entity), telegraph and tele-printer circuits, international circuits etc. Except international circuits, all other types of circuits mentioned above, are leased by BSNL to subscribers for local or long distance connections. The subscribers can be individuals or bulk users e.g. Railways, Defence, Banking Organisations, Public Sector Undertakings etc. The tariff of leased circuits is fixed by BSNL from time to time.

Scope of Audit

The audit was carried out covering a period of three years from 2007-08 to 2009-10 and audit examined the relevant records relating to 17 telecom circles♣, spanning over 73 Secondary Switching Areas (SSA) and two telecom districts (Kolkata and Chennai) out of 26 telecom circles and three telecom district of the Company.

Audit Objectives

The main objectives of audit were to assess:

- Whether there was efficiency in provisioning and billing of leased lines/circuits in various circles of BSNL.

♣ ***Andhra Pradesh, North-East (I), Kerala, Gujarat, Bihar, West Bengal, Jammu & Kashmir, Himachal Pradesh, Jharkhand, Haryana, Maharashtra, Orissa, Punjab, Rajasthan, Uttar Pradesh (East), Uttar Pradesh (West) and Uttarakhand***

- Whether the instructions issued by BSNL Corporate office regarding provisioning and billing of the leased circuits were followed by the SSAs uniformly throughout the circles of BSNL.

Audit Criteria

The main criterion for conducting audit was the orders issued by BSNL regarding the billing of leased circuits and co-ordination between the Operation Centre and the TRA wing which were in force since September 2004.

Audit Findings

On receipt of request from a subscriber, Commercial branch issues a provisional demand note for payment of provisional fee for connection. On payment of the same by the subscriber, Engineering branch issues a provisional advice note with a copy to the maintenance region/field unit(s) for checking feasibility of providing such connection. After carefully considering the feasibility report, the Commercial branch issues a final demand note to the subscriber specifying the actual rentals for leasing the connection. The connection is to be provided within seven days of the issue of final advice note. Thereafter TRA wing of BSNL initiates issuance of advance annual bills as per the existing tariff rates.

During scrutiny of records in SSAs, Audit observed deficiencies in provisioning and billing of leased circuits by BSNL as discussed in succeeding paragraphs.

5.3.1 Delay in commissioning of leased circuits

BSNL Corporate office issued (March 2001) instructions, regarding timely provision of leased circuits, according to which provisional demand note should be issued immediately on receipt of application from subscriber. Thereafter, final advice note should be issued on receipt of payment of demand note. The circuits should be commissioned within seven days of issue of final advice notes.

Further, according to instructions issued (October 2004) by the BSNL Corporate office, whenever installation work of leased circuits is completed by BSNL as per the request of the customer, the subscriber should be intimated in writing about the completion of installation of the circuits. If the circuits cannot be commissioned due to reasons on customers part, then a written request should be sent to the party to accord its permission to commission the circuit within a period of maximum of 15 days from the date of completion of work, failing which the rental should be made effective on completion of 15 days as per the billing cycle option selected by the subscribers.

Audit scrutiny of records in 73 units covering 4,401 circuits in 17 telecom circles[♣] and Kolkata telecom district of BSNL for the period 2007-08 to 2009-10 revealed that BSNL incurred potential loss of revenue to the tune of ₹ 20.76 crore (***Annexure-I***) due to delayed commissioning of leased circuits up to over five years.

On this being pointed out by Audit, most of the units stated that reply would follow after receipt of the same from the field offices. Others accepted the facts stating that delay was

[♣] ***Andhra Pradesh, Bihar, Gujarat, Haryana, Himachal Pradesh, Jammu & Kashmir, Jharkhand, Kerala, Maharashtra, North-East (I), Orissa, Punjab, Rajasthan, Uttar Pradesh (East), Uttar Pradesh (West) Uttarakhand and West Bengal*** mainly due to technical reasons like non-availability of equipments at customers' end, non – feasibility due to lack of Optical Fibre Cables (OFC), MUX, Modems etc. The contention of the SSAs was not acceptable because BSNL is supposed to have examined feasibility of providing leased circuits before issuance of final advice notes for commissioning of circuits.

5.3.2 Non – commissioning of leased circuits

Audit Scrutiny of records in 14 units in seven telecom circles[1] and Kolkata and Bangalore telephone districts revealed that on the date of Audit 1,356 circuits had not at all been commissioned, despite delay of up to three years, causing a loss of potential revenue to BSNL to the tune of ₹ 17.13 crore (***Annexure-II***).

On this being pointed out by Audit the units attributed delay to several factors like non-availability of equipments, OFC, delay at customer ends, delay due to external agencies like public infrastructure projects etc. Others stated that final reply would follow.

The contentions of the SSAs were not acceptable because BSNL should have examined feasibility of providing leased circuits before issuance of final advice notes.

5.3.3 Delay in issuance of bills

As per instructions issued by BSNL Corporate office, rentals for the first year should be recovered in advance while the rentals for the subsequent years should be charged from the period of conventional billing cycle for a particular subscriber.

Audit Scrutiny of records in six telecom circles[2] and Kolkata and Chennai telephone districts, revealed that bills worth ₹ 6.77 crore in respect of 271 circuits were not issued in time between November 2006 and March 2010. Out of this an amount of ₹ 4.93 crore was recovered after being pointed out by Audit leaving ₹ 1.84 crore still outstanding.

The main reason for non billing was non receipt of completed Advice Notes in TRA wing of BSNL.

5.3.4 Loss of interest due to delay in issuance of bills

Scrutiny of records in Gujarat, Rajasthan and Kerala telecom circles and Bangalore telephone district revealed that bills of ₹ 43.29 crore were outstanding in nine units on the date of Audit involving delay ranging from 30 to 1,606 days causing loss of interest (***Annexure-III***) to the BSNL.

5.3.5 Failure to apply correct rental in respect of guaranteed leased line services

Whenever telecom services like dedicated circuits requested by a subscriber are provided by new construction of asset, rent at capital cost is to be charged. The rent and guarantee (R&G) calculation arises only in case of involvement of new construction. In June 2002 BSNL Corporate office, clarified that the R&G charge was fixed at 35 *per cent* of the capital cost. To make tariff structure attractive and simple, BSNL Corporate office announced (September 2002) a new scheme for provision of bandwidth (High Speed Leased Line Services) with Optical Fibre (OF) connectivity requiring special construction. Detailed guidelines were issued regarding terms and conditions and rental

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[1] ***Gujarat, Rajasthan, West Bengal, North East (I), Maharashtra, U.P. (East) and Orissa***

[2] ***Jharkhand, Assam, Rajasthan, Maharashtra, Kerala and Uttarakhand***

charges for local leads and local circuits, replacing the existing R&G tariff by commitment scheme for new leased line services. Accordingly, the Corporate office prescribed annual rental for provision of Synchronous Transport Module 1 (STM 1) system of 140 Mbps at ₹ 12 lakh per annum effective from October 2002 with commitment period of three years. After expiry of the commitment period, normal prevailing rental was to be charged at the rate of ₹ 17.88 lakh per annum.

Audit noticed (November 2009) that Pune SSA under Maharashtra telecom circle charged the rental at 28.6 *per cent* instead of 35 *per cent* of the capital cost in 11 R&G cases which were provided before October 2002. Further audit examination (February 2010) also revealed that Gurgaon SSA under Haryana telecom circle failed to apply the revised tariff in two cases under the new scheme of September 2002. This resulted in short billing of ₹ 2.36 crore in the two circles. On being pointed out by Audit the SSAs replied that the supplementary bills in respect of the objected amount of short billing had been raised and recovery of the dues was being pursued.

Conclusion

Failure of units to follow extant orders of BSNL Corporate office coupled with lack of co-ordination between the executing and the billing wings of leased line services resulted in loss of potential revenue of ₹ 37.89 crore.

The matter was referred to Ministry in October 2010; reply was awaited (February 2011).

Recommendations

- ***Proper survey on feasibility of provisioning of leased circuits by BSNL should be done.***
- ***The orders/instructions of BSNL Corporate office need to be complied with and leakage of revenue due to non/short/late billing to be avoided.***
- ***The BSNL needs to strengthen co-ordination between operational and TRA wing.***

5.4 Injudicious procurement of Global System for Mobile communication based Fixed Wireless Phone

Introduction

In July 2006, Bharat Sanchar Nigam Limited (BSNL) headquarters decided to introduce Global System for Mobile communication based Fixed Wireless Phone (GSM FWP) as a product in the market as Airtel had started providing fixed phones using GSM technology in its licenced areas and was targeting the fixed lines with very aggressive tariffs. The proposal was based on the justification that there was a provision in GSM Mobile Switching Centre (MSC) switches to connect FWPs with them and the coverage of GSM technology FWPs would be better than the existing CDMA technology FWTs. GSM based Fixed Communication Terminal was meant for meeting Village Public Telephone (VPT) requirements and as a substitute for landline in rural areas serviced by small telephone exchanges.

Based on a tender of December 2006, BSNL Corporate office placed (September 2007) Purchase Order (PO) on Himachal Futuristic Communications Limited (HFCL) for supply of 3.06 lakh GSM based FWPs at a cost of ₹ 43.18 crore. The supply of GSM FWPs was to be made by January 2008 and as the firm failed to supply the equipment till the extension period of March 2008, the purchase order was short closed after forfeiting the Performance Bank Guarantee of ₹ 2.16 crore. In June 2008 another PO was placed on Teracom Ltd., Goa (L2) for the same quantity at the same price for supply to 11 telecom circles.

Scope of Audit

Audit scrutiny was conducted between March 2009 and September 2010 in seven telecom circles* and Chennai and Kolkata telephone districts out of a total of 26 telecom circles and two telephone districts covering a period of four years from 2006-07 to 2009-10 with a view to examine planning, procurement and utilization of GSM FWPs.

Audit Criteria

The audit criteria adopted were to evaluate planning, procurement and utilization of GSM FWPs in BSNL based on the "Manual of Procurement of Telecom Equipment and Stores" and the instructions issued in this regard by BSNL Corporate office from time to time.

Audit Findings

Audit scrutiny of the records revealed inadequacies in planning, procurement and utilization of GSM FWPs which are discussed in the succeeding paragraphs.

5.4.1 Planning

Planning forms an integral part of the procurement process. It is important to procure the right quantity at the right time failing which there could be a pile up of inventory. Considering the importance of planning, the BSNL Procurement manual provides that the starting point of the procurement process for any item is estimation or forecast of its requirements.

Scrutiny of records indicated that procurement of GSM FWPs was made without any attempt to ascertain the customer preference and estimate of requirement. On this being pointed out by Audit (April 2010) it was stated (June 2010) that the Management Committee of BSNL Board decided to procure GSM FWPs because of its compatibility with the existing system. Thus, it was evident that no survey was conducted for estimation of the quantity to be procured prior to induction of this new product in the market.

The BSNL Procurement Manual also stipulated that the Material Management cell of the Corporate office should finalise the requirement after discussion with the concerned circles. Audit noticed the following:

- In seven telecom circles test checked by Audit, only two telecom circles viz. Tamil Nadu and Andhra Pradesh had placed their requirement for 5,000 and 43,600 GSM FWPs respectively in 2006. However, a total quantity of 3.06 lakh GSM FWPs was ordered by the BSNL Corporate office without ascertaining the requirement of the remaining user circles.

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* ***Andhra Pradesh, Himachal Pradesh, Jammu and Kashmir, Karnataka, Maharashtra, Tamil Nadu, Uttaranchal***

- Even while the purchase order on HFCL was short closed, the BSNL Corporate office once again placed orders (June 2008) for the entire quantity on Teracom Ltd. Goa (L2) without assessing the field requirement. Teracom Ltd. also supplied only 2.04 lakh FWPs against the ordered quantity of 3.06 lakh GSM FWPs within the scheduled delivery date of October 2008. However, BSNL once again failed to short close the order although Uttaranchal circle rejected the entire allotment and Orissa and Himachal Pradesh demanded only 511 and 1,000 FWPs against their allotted quantity of 30,600 FWPs each. The other test checked circles had no requirement of the allotted quantity. Audit noticed that the Corporate office granted extension to Teracom Ltd. to supply balance of 1.02 lakh FWPs up to December 2008.

It can be seen that at each stage the BSNL Corporate office repeatedly failed to get the requirements of the user circles before procuring the GSM FWPs.

Thus, failure to assess requirement initially in 2006 and omission to assess the requirement subsequently in 2008 resulted in mismatch of demand and supply. Consequently most of the FWPs could not be utilised. On this being pointed out by Audit the circles replied that GSM FWPs were allotted in excess of requirement.

5.4.2 Non utilization of instruments

BSNL Corporate office guidelines on procurement dated 21 June 2001 provided that utmost care should be taken to ensure that piling up of inventory was avoided. Audit however noticed that majority of the stock of GSM FWPs was lying unutilized as brought out below.

The GSM FWP instruments allotted by Corporate office were received in October to December 2008 in the test checked circles. In Jammu & Kashmir telecom circle Audit scrutiny (September 2009) revealed that the entire lot of allotment was lying in stock. In Chennai telephone district and Andhra Pradesh and Uttaranchal telecom circle the utilization was 0.01 *per cent* to 0.92 *per cent* of the allotments made to them. In Kolkata telephone district and Tamil Nadu and Himachal Pradesh telecom circles, the utilization ranged from one *per cent* to four *per cent* of the allotted quantity. Only in Karnataka and Maharashtra telecom circle the utilization ranged between 11 *per cent* and 12 *per cent* of the allotted quantity. In all, against test check of 2,39,800 GSM FWPs in the seven circles and the two districts only 10,690 FWPs were utilised apart from diversion of 8,622 FWPs to other circles. As such, out of ₹ 33.84 crore worth FWP equipments procured in the nine test checked circles/districts, GSM FWPs costing ₹ 30.47 crore were lying unutilised.

On this being pointed out by Audit the circles/SSAs stated that, there was no demand for the instruments from the customers since customers in GSM coverage area preferred mobile phones to fixed telephone.

Audit scrutiny of the records of the circles and its SSAs further reveled that:

- Diversion orders issued by the BSNL Corporate office from Uttaranchal telecom circle for 5000 FWPs to Andaman & Nicobar Islands, 500 FWPs to Assam circle, 1,200 FWPs to North East(I) circle and 7,000 FWPs to Kerala circle did not materialize as most of the units did not lift the allotted quantity.

- Efforts of BSNL Corporate office to divert (May 2009) GSM FWPs from Himachal Pradesh telecom circle to other circles did not fructify.

Thus, failure to assess requirement of GSM FWP before procurement resulted in excess purchase and GSM FWPs worth ₹ 30.47 crore remained idle for nearly two years. Its utilization in future also remained bleak as there was no demand for this product.

5.4.3 Failure to enter into Annual Maintenance Contract

The GSM FWPs include internal back up battery as standby during power failure. Non utilization of GSM FWPs for prolonged periods and lack of regular maintenance would result in non functioning of these internal back up batteries. As per purchase order, annual maintenance contract (AMC) of GSM FWP at three *per cent* of the total cost of the order, should come into effect after completion of one year warranty and should remain valid for four years. Audit noticed that the purchase order did not provide for piecemeal AMC of GSM FWPs that was issued to the customers. As a result the Company was forced to either enter into AMC for all the GSM FWPs or refrain from AMC as most of the FWPs were not utilized. Consequently, the GSM FWPs issued to the customers were not covered under the AMC and their maintenance could not be ensured.

5.4.4 Failure of marketing strategies

The GSM FWP was a new product and the circles were not aware of commercial and tariff related issues relating to this product. In December 2008, Chennai telephone district took up the matter with the Corporate office conveying inability of the circles to deploy the instruments in the absence of tariff and commercial circulars. It was further mentioned that modification in the billing system was needed for utilizing the fixed GSM phones.

When Audit sought for instructions (April 2010) issued by the Corporate office to the telecom circles it was replied (June 2010) that BSNL Board had issued detailed guidelines (October 2009) including the prevailing tariff for proper utilization of FWP. This indicated that the Corporate office took nearly a year after the supply of GSM FWP instruments to convey the tariff and commercial conditions. Also it was only in October 2009 that the BSNL Corporate office issued guidelines conveying important areas where the GSM FWPs were to be deployed, its attractive features and other benefits which were to be widely publicized by the circles. Such belated action by the Corporate office in issuing commercial conditions, tariffs and marketing efforts was one of the reasons that the sale of the new product never took off.

Thus, injudicious procurement of FWPs without proper planning, market survey and allotment of instruments in excess of requirement resulted in unnecessary piling up of inventory and idling of stock of GSM FWPs worth ₹ 30.47 crore in the test checked telecom circles of the BSNL.

On this being pointed out the BSNL Management/Ministry did not contest the Audit findings and replied that recommendations would be taken care of in future.

Recommendations

- ***Market survey should be carried out to ascertain demand and customer choice of the facility to be offered.***
- ***Assessment of field requirement should be a pre-requisite for procurement of stores.***
- ***Unrealistic procurement based only on technical feasibility should be avoided.***

5.5 Non realisation of Access Deficit Charge with interest thereon

Orissa, Punjab, Haryana and West Bengal telecom circles of Bharat Sanchar Nigam Limited failed to realise Access Deficit Charge and interest from two private service providers amounting to ₹ 63.49 crore.

Access Deficit Charge (ADC) was levied on private telecom service providers (PSPs) by Bharat Sanchar Nigam Limited (BSNL) to fill in the deficit of its large scale operation in rural areas. ADC was levied on PSPs on all incoming international calls and all outgoing calls from Wireless in local loop, Mobile {WLL (M)}.

ADC was charged by the BSNL on PSPs, viz., Reliance Communications Limited (RCOM), Tata Teleservices Limited (TTL) and Tata Teleservices (Maharashtra) Limited (TTML) for their "Unlimited Cordless" and "WALKY" services being WLL (M) service for the period November 2004 to February 2006. But these PSPs challenged the the BSNL's claim of ADC in the Telecom Dispute Settlement and Appellate Authority (TDSAT) and in the Honourable Supreme Court (SC) on the plea that their services were Wireless in Local Loop (Fixed) and not WLL (M). However, the TDSAT and then the Honourable SC dismissed their plea in April 2008 and held them liable to pay ADC as their "Unlimited Cordless" and "WALKY" services were considered as WLL (M) services. Accordingly the PSPs paid 75 *per cent* of the claim already raised by the BSNL during the period October 2005 to June 2008.

The BSNL Corporate office instructed all field units (May 2008) to raise supplementary/arrear bills of ADC as well as applicable interest on delayed payment of ADC as per Interconnect Agreements. The BSNL Corporate Office reiterated (June and December 2008) that claim bills for interest would continue to be raised. Subsequently, the TDSAT rendered the final judgement (April 2010) that balance ADC claim was to be paid by the PSPs pursuant to which detailed instructions were issued by the Corporate office in May 2010 to all circles advising them to collect the dues along with interest.

Realisation of ADC dues and interest thereon from the concerned PSPs was test checked in four telecom circles (Orissa, Punjab, Haryana and West Bengal) and it was found that though these circles raised arrear bills for ₹ 50.51 crore against the balance ADC relating to the period November 2004 to February 2006 with interest thereon calculated up to May–June 2008, the dues remained unpaid. It was also noticed that these circles did not raise interest claims for subsequent periods for delayed payment of ADC in contravention to the Corporate Office's instructions (May 2008).

On being pointed out by Audit, the circles raised (December 2009 to July 2010) interest claims for ₹ 12.98 crore on the outstanding amount of ADC for the period between May 2008 and May 2010 after a delay of over one year of issue of the Corporate office's instructions (May 2008). The total dues on account of ADC and interest thereon to be realised from PSPs worked out to ₹ 63.49 crore based on the finding of test checked circles.

The circles replied that they did not raise interest claims as the PSPs had not paid ADC and interest claims already raised on them. This was not acceptable as the corporate office had several times in the past instructed (May 2008 to December 2008) that bills for interest would continue to be raised.

Despite Honourable Supreme Court (April 2008) and TDSAT's judgement (April 2010) upholding the BSNL's right to claim ADC along with interest thereon, no breakthrough was achieved in realising the dues. This was indicative of deficient control system of the BSNL due to which the PSPs remained unresponsive to the BSNL's demand for ADC and interest thereon resulting in non-realisation of ₹ 63.49 crore (August 2010).

The matter was referred to Ministry in October 2010; its reply was awaited (February 2011).

5.6 Blocking of funds due to non-commissioning of Optical Fibre Routes

Lack of proper planning and coordination led to non commissioning of 46 optical fibre routes in two telecom circles and two telecom project circles of Bharat Sanchar Nigam Limited resulting in blocking of funds of ₹ 14.51 crore.

Fibre connectivity is provided by laying Optical Fibre Cable (OFC) in pre-lubricated polyethylene pipes (PLB). Procedure adopted by Bharat Sanchar Nigam Limited (BSNL) for timely execution of work and to provide optical fibre connectivity, catering to the demand of various users, included:

- Assessment of media requirement of telecom circle
- Identifying routes
- Obtaining prior permission from State and Central government Authorities for laying of cables
- Tendering for procurement and laying of PLB pipes and OFC
- Laying of OFC routes and completion of Acceptance Testing (AT) of cable and system
- Handing over of commissioned OFC routes to end user.

To provide fibre connectivity against projected in house requirement/ request from Army authorities, PLB and OFC were laid along identified routes under Project divisions of Northern Telecom Project (NTP), Eastern Telecom Project (ETP) and telecom circles of Uttar Pradesh (East) and Uttarakhand.

Audit scrutiny of records of two Secondary Switching Areas (SSAs) of Uttarakhand and three SSAs of UP (East) telecom circles and one project division each under NTP and ETP revealed that of the 93 routes test checked which were laid or on which work had commenced during 2005-06 to 2008-09, 41 remained non-commissioned and four routes were commissioned with delay. The delay/non commissioning ranging between 13 and 43 months was due to non availability of requisite stores like OFC systems, not obtaining prior permission from local administration for the work, delay in conducting AT or handing over routes to the party concerned and partial completion/non commencement of work. This resulted in idle investment of ₹ 14.51 crore in respect of 45 routes.

On this being pointed out by Audit, NTP stated (September 2010) that OFC connectivity would be completed on receipt of the cable and ETP replied (September 2010) that there was delay in tendering and non availability of permission from local administration. Uttarakhand and UP (East) telecom circles also acknowledged (September 2010) that the delay was due to non availability of permission, stores and non completion of AT.

Thus, lack of proper planning and coordination among SSAs, circle offices concerned and synchronization with various agencies resulted in non/delayed commissioning of 45 OFC routes in Uttarakhand, UP (East), NTP and ETP circles. This led to blocking of funds of ₹ 14.51 crore.

The matter was referred to Ministry in October 2010; its reply was awaited (February 2011).

5.7 Non-realisation of compensation charges for damages to Optical Fibre Cable and Under Ground Cable by outside agencies

Failure of ten Secondary Switching Areas (four under Bihar telecom circle and six under Orissa telecom circle) to realise compensation charges for damages to cables by outside agencies resulted in non-realisation of ₹ 5.93 crore.

In January 2003, Bharat Sanchar Nigam Limited (BSNL) Corporate office decided to charge compensation, uniformly for each damage/cut for the Optical Fibre Cable, irrespective of the location of the cable on all external agencies as well as other private operators at a rate of ₹ 1.50 lakh per damage per occasion. Further, BSNL issued instructions (October 2003) to claim copper cable damage charges at different rates on different pairs of cable, irrespective of the location of the copper cable.

Again, for the cable damage caused by Private Service Providers, BSNL in April 2004 instructed that cable damage charges be clubbed with Interconnect Usage Charges (IUC), which was to be recovered from the concerned operators. This cable damage charge was to be linked with IUC bills after 60 days in case of non-payment of charges by the private operator.

Test check of records of General Manager Telecom Districts (GMTD) Chapra and Telecom District Managers (TDMs) of Bettiah, Khagaria and Krishanganj under Bihar telecom circle and Secondary Switching Areas (SSAs) Berhampur, Rourkela, Cuttack, Dhenkanal, Keonjhar and Koraput in Orissa telecom circle revealed that four private telecom service providers damaged copper and optical fibre cables at various locations on different occasions during the period 2004-05 to 2009-10. These SSAs failed to raise the claim and/or adjust the same through IUC bills against these private service providers in accordance with the extant instructions which resulted in non-realisation of compensation charges of ₹ 5.93 crore for the period 2004-05 to 2009-10.

On being pointed out by Audit,

- Chief General Manager Telecom, Bihar circle while confirming (March 2010) the audit objection stated that bills amounting to ₹ 1.24 crore had been preferred for realization in three SSAs while claim of ₹ 0.65 crore (April/June 2008) raised by Krishanganj SSA was being pursued for recovery.

- Heads of two SSAs (Keonjhar and Dhenkanal) of Orissa circle attributed the non-claim from private service providers to non-completion of joint verification, while Cuttack SSA referred their case to circle office. Rourkela SSA stated that action would be taken for recovery. Koraput SSA replied that the demand notes for compensation issued to private operators were under dispute. The replies were not convincing since none of these SSAs complied with the extant instructions of BSNL Corporate office in effecting recovery of damage charges. They also failed to link the claims with IUC bills of these private service providers.

Hence, there was non-realisation of ₹ 5.93 crore from the four private service providers in Orissa and Bihar telecom circles. The failure was attributable solely to non-observance of instructions to bill/recover the billed amount through IUC bills.

The matter was referred to Ministry in September 2010; reply was awaited (February 2011).

CHAPTER VI: MINISTRY OF CONSUMER AFFAIRS, FOOD AND PUBLIC DISTRIBUTION

Food Corporation of India

6.1 Fixation of Incidentals on Procurement of Foodgrains

Introduction

The Food Corporation of India (FCI), setup under the Food Corporation Act 1964, is entrusted with the responsibility of execution of the food policies of the Government of India (GOI) in the areas of procurement, storage, movement and distribution of foodgrain.

The GOI fixes the procurement and issue prices of foodgrain. Difference between economic cost and sales realisation is reimbursed by the GOI as food subsidy which also includes carrying cost of buffer stock.

The FCI discharges its functions through a network of five Zonal offices, 23 Regional offices and 166 District offices spread all over the country.

The FCI procures wheat, paddy and rice for the Central Pool either independently or in association with the state Governments and their Agencies. While wheat is procured mainly from the states of Punjab and Haryana, of rice and paddy are procured from the states of Punjab, Andhra Pradesh, Haryana and Orissa. Procurement of wheat and paddy is made under Minimum support price (MSP) whereas rice is procured under levy as per levy orders issued by the state Governments.

The procurement price of the food grain, in addition to MSP announced every year by the GOI, includes incidental charges some of which are statutory (Market Fee, Arathia/ Society commission, Rural Development Cess and VAT etc.) and other non statutory such as mandi labour charges, driage allowance, storage charges, interest charges and milling charges for rice etc.

During 2004-05 to 2009-10, the following quantities of wheat and rice/ paddy were procured:

Table 1

Wheat (Quantity in lakh MTs)

Year	Punjab	Haryana	Other states	Total
2004-05	112.17	57.74	5.27	175.18
2005-06	92.10	43.96	2.41	138.47
2006-07	63.92	21.62	0.07	85.61
2007-08	56.55	31.52	7.58	95.65
2008-09	66.48	33.63	43.78	143.89
2009-2010	107.37	69.24	77.21	253.82

Table 2

Paddy and Rice in terms of paddy procurement (Quantity in lakh quintals)

Year	Punjab	Haryana	Andhra	Orrisa	Other States	Total
2004-05	1338.80	244.80	613.30	206.40	587.49	2990.79
2005-06	1255.9	305.60	586.10	227.10	817.54	3192.24
2006-07	1122.40	267.30	805.40	240.10	533.86	2969.06
2007-08	1141.6	234.00	949.40	181.30	434.43	2940.73
2008-09	1013.00	204.60	1250.00	190.70	837.64	3495.94
2009-2010	1260.00	232.70	1261.50	174.60	779.00	3707.80

In order to economise the cost of procurement, the FCI is expected to keep a constant watch on incidental charges incurred on procurements.

The graph and table below indicates percentage of incidental charges to the total procurement cost during the period 2004-05 to 2009-2010:

Graph 1

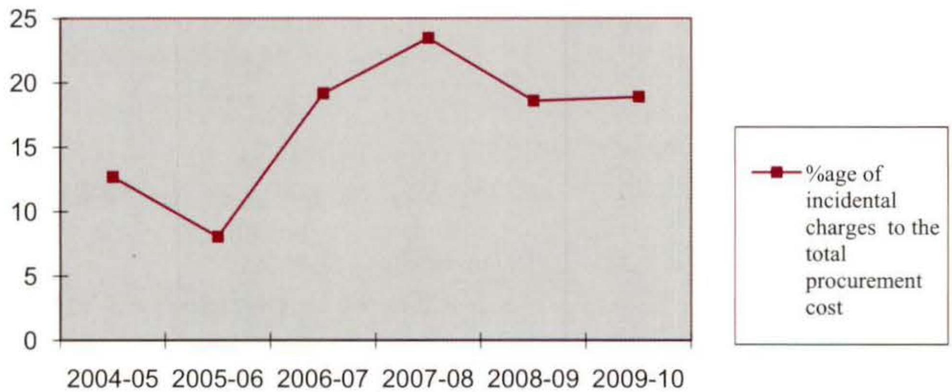

Table 3 **(₹ in crore)**

Year	Total procurement cost of wheat and rice	Incidental charges	Percentage of incidental charges to the total procurement cost
2004-05	35881.78	4552.19	12.69
2005-06	33624.48	2708.53	8.06
2006-07	29048.89	5573.46	19.19
2007-08	34634.56	8136.40	23.49
2008-09	46968.37	8736.04	18.60
2009-10	60462.70	11433.60	18.91

It may be seen that during the period of review the incidental charges varied from 8.06 percent in 2005-06 to 23.49 percent in 2007-08 which was the main consideration for taking up this thematic study by the Audit.

Audit Approach

Past Coverage

The issues relating to the procurement incidentals for the years 2001-04 were earlier reviewed during the period from June 2005 to June 2006 and the findings were included in the C & AG's Performance Audit Report on Management of Foodgrains (Report no 16 of 2006, Union Government (Civil) Performance Audit). The audit recommendations and action taken there against by the Government of India are indicated below:

Audit Findings	Action Taken
1. Statutory charges: As persuasive measures may take time to yield results, the Ministry may consider implementing the recommendation of the High Level Committee (Abhijit Sen Committee on Long Term Grain Policy) and declare a procurement price inclusive of a uniform maximum limit of allowance for State levies.	The report was discussed (November 2010) by the Public Account Committee (2010-11. In response, the administrative Ministry informed that being a state subject, the matter was taken up with state Governments which did not agree to the proposal. Ministry further informed that a study on principles to be adopted for fixation of PICs was conducted by the Chief Adviser (Cost), Ministry of Finance (December 2008). The recommendations based on the study have been sent to State Governments for their comments which are awaited.
2. Non-statutory charges: The Ministry may fix final charges for non-statutory incidentals only on the basis of audited statements of actual expenditure incurred in support of such charges. Pending submission of such statements, FCI's rates may be treated as provisional rates, subject to adjustment on the submission of actual expenditure statements.	PICs are still being reimbursed as per the provisional rates determined by the GOI based on the proposals submitted by the respective States.

Scope, Coverage and Sampling

Audit examined the policies adopted for fixation and payment of Procurement Incidental Charges (PICs) for wheat and rice. Out of total 23 regional offices, four regions for paddy viz. Punjab, Haryana, Andhra Pradesh & Orissa and two regions for wheat viz. Punjab and Haryana were selected for detailed audit. The examination in the regions included the examination of records of district offices also falling under the respective regions. The period of the study was restricted to 2004-05 to 2009-10.

Audit Objectives

The objectives of the Audit were to:

- assess whether a transparent, objective and efficient system was in place for finalization of PICs for different states.
- assess the economy, reasonableness and comparability of PICs incurred by FCI on direct procurement and those paid to state Government Agencies.
- examine the efficiency and effectiveness of the system for considering process/activity/element in arriving at PICs.

Audit Criteria

- Food policy of Government of India.
- Norms laid down by the GOI for fixation of PICs
- PICs incurred by FCI vis a vis reimbursement of PICs to SGAs
- Market price of by-products for fixation of milling charges.
- Tariff Commission Report for fixation of milling charges

Audit Methodology

Audit commenced with an Entry conference with the FCI Management in August 2010, wherein the scope, objectives and methodology of audit were discussed and the criteria were agreed upon. This was followed by field audit wherein the records and data of the FCI as well as Ministry of Consumer Affairs & Public Distribution (Administrative Ministry) were examined. An Exit Conference was held in January 2011 to discuss audit findings. The replies of the Management and clarifications made during exit conference have been suitably incorporated in the report.

Audit Findings

6.1.1 Levy of statutory charges by state Governments

Statutory charges include market fee, rural development cess and infrastructure cess, nirashat shulk, *arhatia/dami* and purchase tax/VAT payable on procurement of foodgrains. These charges are fixed as a *percentage* of the MSP by the respective State Governments. Audit observed higher incidence of statutory charges by the state of Andhra Pradesh, Haryana and Punjab, the main procuring states in comparison to the other states. The tables below indicates the total statutory charges levied by the States as a percentage of MSP.

Table 4

Wheat

Year	Punjab	Haryana	UP	Rajasthan	MP
2004-05	11.50	10.50	6.5	3.6	2.2
2005-06	11.50	10.50	6.5	3.6	2.2
2006-07	11.50	10.50	6.5	3.6	2.2
2007-08	11.50	10.50	9.00	3.5	4.52
2008-09	12.50	10.50	9.00	4.1	4.70
2009-10	12.50	10.50	7.50	3.60	3.20

Paddy

Year	Punjab	Haryana	UP	AP	MP
2004-05	11.50	10.50	7.5	11.00	3.20

2005-06	11.50	10.50	7.5	11.00	3.20
2006-07	11.50	10.50	7.5	11.00	3.20
2007-08	11.50	10.50	8.0	11.50	3.70
2008-09	12.50	10.50	8.0	11.50	-
2009-10	**Not available**				

As the statutory charges have a wide impact on the quantum of food subsidy paid out of the Consolidated Fund of India, the GOI needs to take vigorous efforts to rationalise the magnitude of these taxes in consultation with the State Governments.

The Management assured (January 2011) to take up the issue with GOI.

6.1.2 Payment of charges without supporting evidence

Procurement price of levy rice for each state is fixed by GOI every year separately before commencement of the procurement season. GOI, while communicating levy rates, stipulated that 'payments relating to statutory charges by FCI to millers would be payable only on production of the relevant official/statutory receipts evidencing payments.

Audit, however, observed that during 2005-06 to 2009-10 in Andhra Pradesh region, VAT and Rural Development Cess amounting to ₹ 61.76 crore was paid without proof of evidencing payment.

The Management promised (January 2011) to look into the issue after collecting information from their Regional office.

6.1.3 Fixation of milling charges on the basis of unreliable inputs

Milling charges are paid to the rice millers for converting paddy into rice at the rates fixed by the GOI from time to time.

GOI entrusted (December 2004) Tariff Commission under Ministry of Commerce a study to determine normative milling charges for raw and par-boiled rice. The Commission, after collecting information and data from various private mills located in seven states viz AP, Chattisgarh, Haryana, Punjab, Tamilnadu, Uttar Pradesh and Orissa, made their recommendations for fixing milling charges at ₹ 15 per qtl. and ₹ 25 per qtl. for raw rice and parboiled rice respectively. The GOI accepted these recommendations, in *toto,* and accordingly notified (October, 2005) the rates.

Audit observed that the rates of milling charges fixed by the GOI needs to be reviewed in the light of the following facts:

- The Commission in its report had stated that data/information provided by the rice mills was mostly unreliable as the financial information provided by the mills included data on activities other than custom milling operations.
- The rates were fixed based on the information/data provided by the private millers only. The same from the mills operated by State Government agencies such as Punjab State Cooperative Marketing Federation Limited (MARKFED) and Haryana State Cooperative Supply and Marketing Federation Limited (HAFED) etc were either not called for or considered for determining the rates.
- The prices of by product of paddy milling taken by the Commission for arriving at the milling charges were apparently on a lower side as compared to the prevailing market price. In order to ascertain the actual market price of the by

product, Audit obtained the relevant data from a MARKFED Rice Processing mill at Goniana (Punjab) and observed that the market price of by-products extracted out of one quintal of paddy in the year 2005-06 was ₹ 81.47 as against ₹ 33.96 considered by Commission.

- The milling charges fixed by the Government of India on the recommendations of the Commission were based on the data for the year 2003-04. Though there has been tremendous increase in the prices of by-product thereafter, the same rates were still continuing.

The Management stated that the charges were fixed by the GOI and the FCI followed the Government's directions.

6.1.4 Undue benefit to millers in procurement of rice at revised rates

Due to increase in MSP of paddy, the GOI enhanced (July 2008) procurement price of levy rice effective from 24 June, 2008. As such the resultant levy rice from paddy procured up to 23 June 2008 was to be delivered at old rates. The details of old rates and revised rates are indicated below.

Table 5 *(₹ per quintal)*

Period	**Raw rice**		**Par Boiled rice**	
	Common	**Grade A**	**Common**	**Grade A**
Upto 23-6-2008	1239.10	1286.50	1236.10	1282.90
Wef 24-6-2008	1414.20	1461.60	1408.60	1455.40
Difference	175.10	175.10	172.50	172.50

Audit observed that the various rice mills located in Andhra Pradesh had short delivered 129237 MT of levy rice in Kharif year 2007-08 against levy rice due from these mills in accordance with the AP Rice Procurement (Levy) Order, 1984. The FCI instead of making payments at the old rates, procured the same at revised rates and thereby extended undue benefit of ₹ 22.44 crore to the millers.

The Management stated that the Region had been directed to initiate action for recovering the excess amount from the State Government (January 2011)

6.1.5 Custody and Maintenance Charges

(a) Undue payment of ₹158.06 crore on procurement of paddy

The charges incurred by the SGAs for storage and preservation of paddy/wheat after procurement for a specified period are known as Custody & Maintenance (C&M) Charges. In order to compensate these expenses, FCI reimburses C&M charges in accordance with the Principles of 2003. Obviously, these charges should not be paid if the stocks are delivered directly to FCI / millers from mandis.

Audit observed that during the period under review, 7250.3 lakh qtls. of paddy procured by the SGAs in Punjab, Haryana and Andhra Pradesh was moved directly from mandis to the rice mills and the resultant rice was also delivered directly to FCI godowns. The FCI, however, paid custody & maintenance charges of ₹ 158.06 crore for this stock to SGAs.

As the SGAs neither incurred any expenditure on the custody or maintenance of these stocks nor any such charges was payable to the millers as per the milling agreement entered into by the SGAs, the payment of these charges to the SGAs was unjustified.

Audit also observed that the FCI while releasing the payment did not insist upon the SGAs for documentary evidence in support of incurring expenditure on this account.

The Management assured (January 2011) to ascertain the position from the regions.

(b) Excess payment of ₹46.23 crore on procurement of wheat

Audit observed that till 2007-08, these charges were being paid to SGAs even on the quantities of wheat delivered directly from mandis to FCI godowns. Though in May 2008, the GOI fixed (May 2008) separate rates for direct delivery of wheat from mandi after excluding the C&M charges, in Haryana region, even after receipt of these orders payment of ₹ 15.34 crore on this account was made for the crop year 2008-09 to the SGAs. The FCI also failed to recover/adjust the excess amount of ₹ 30.89 crore paid in the earlier years (2004-05 to 2007-08) on this account.

The Management assured (January 2011) to ascertain the position from the regions.

6.1.6 Excess fixation of interest charges

As per Principles decided by GOI (July 2003), the SGAs are to be reimbursed interest charges at FCI cash credit rates for procurement of food grains. It was, however, observed that in contravention of the decided principle, GOI had allowed higher rate of interest charges to the State Governments during the years 2004-05 to 2009-10. This resulted in extra burden of ₹ 188.98 crore on food subsidy.

Management stated that the higher rates of interest to the State Governments was due to the fact that the FCI had been given concessional rates because of default bank guarantee by the Government of India whereas no such system prevailed in case of State Governments.

6.1.6.1 Non achievement of procurement targets by FCI

Before commencement of each procurement season, the State Governments in consultation with FCI fix the procurement targets for SGAs and FCI. The table below indicates the targets set for FCI for procurement of paddy and wheat and actual procurement there against during 2004-05 to 2008-09:

Table 6 ***(quantity in Lakh MTs)***

Year	Paddy			Wheat		
	Target	**Achievement**	**Percentage**	**Target**	**Achievement**	**Percentage**
Punjab						
2004-05	24.00	11.49	48	33.00	21.69	66
2005-06	22.00	10.58	48	22.00	14.28	65
2006-07	21.80	2.42	11	17.00	10.67	63
2007-08	11.00	1.45	13	9.00	7.26	81
2008-09	12.50	2.15	17	11.55	10.85	94
Haryana						
2004-05	1.50	1.00	67	11.00	8.80	80
2005-06	1.50	0.95	63	12.00	6.17	51
2006-07	1.50	0.11	7	6.30	2.69	43
2007-08	1.00	0.10	10	4.50	3.50	78
2008-09	0.50	0.10	20	4.00	7.85	196

It may be seen from above that in almost all the years (except in the 2008-09 for wheat) the main procuring regions of Punjab and Haryana of FCI could not achieve the targets set for them. The shortfall in the targets by FCI were fulfilled by the SGAs. Audit observed that PICs reimbursed to SGAs were higher than those of the FCI. This led to incurring of higher incidental charges of ₹ 144.28 crore.

Management contended that mandis allotted to FCI by the State Government are generally at disadvantageous places.

The fact remained that the FCI failed to achieve the targets which were fixed in consultation with it and it resulted in extra burden to the food subsidy by ₹ 144.28 crore.

Conclusions

Audit of fixation of procurement incidentals revealed that the statutory charges fixed by the State Governments vary from state to state and the rates of the main procuring states viz Punjab, Haryana and Andhra Pradesh were significantly higher than those of the other States. As these charges impacted the quantum of food subsidy adversely, there was a need to evolve consensus among all the states to have uniform, rationalised and capped rates of state levies. Further, audit observed that reimbursement of various claims of State Government Agencies was without proof of payment, payment of milling charges to rice millers were based on unreliable and inadequate data particularly as regards value of by-products retained by the millers.

In order to address the deficiencies the following recommendations are made:

Recommendations

- ***The GoI and FCI need to take vigorous efforts to rationalise statutory taxes in consultation with the State Governments.***
- ***The FCI, while making payments, should ensure that the claims of State Government Agencies for procurement incidentals were supported by proper evidences.***
- ***The GoI while fixing the milling charges should ensure that these were based on reliable inputs.***
- ***The GoI and State Governments may deliberate upon the issue of extending default bank guarantee to have identical interest rates on bank finances availed for procurement of food grains.***

The matter was reported to the Ministry in February 2011; reply was awaited (February 2011).

6.2 *Import of food grains*

Introduction

In view of the depleting stock position in the buffer stock, the Government of India (GOI) decided (February 2006) to import wheat. The import was planned in two phases, 55 lakh MT in Phase-I in 2006-07 and 18.06 lakh MT in Phase-II in 2007-08. The import operations were to be undertaken by STC Limited/MMTC Limited/PEC Limited[♣] (importer) on behalf of Food Corporation of India (FCI) on High Sea Sales basis. In

[♣] *In Phase –I import was through STC only. In Phase-II import was through STC/MMTC/PEC*

Phase-I, 54.54 lakh MT and in Phase-II, 17.69 lakh MT of wheat was received during early 2006 to April 2008 was 54.54 lakh MT in Phase I and 17.69 lakh MT in Phase II.

The price of import during the Phase-I varied from $178.75 to $237.90 per MT and from $317.95 to $408.43 per MT in Phase-II. The importer was eligible for administrative overhead of 1.2 *per cent* of the CIF[1] cost of each cargo during Phase-I and 1.2 *per cent* of the value of import at $178.65 per MT (fixed) for Phase-II. The import was done as bulk cargo and SCH&T[2] contractors were appointed for handling at each port by the FCI.

Scope of Audit

The scope of thematic audit was to assess the role of FCI in planning, scheduling and implementation of import operations. Audit was carried out through test check of records and analysis of data at all the eight[3] ports where wheat was received.

Audit Objectives

The main objective was to examine the:

- Effectiveness of import through high sea sales basis.
- Efficiency in the performance of SCH&T contractors and transportation by road/railways.
- Economy in SCH&T contracts and imports

Audit criteria

The audit criteria were:

- Government of India (GOI) instructions, Agenda and Minutes of Board of Directors and executive body of FCI.
- Agreements with importer and SCH&T contractors.
- Claims of importer and SCH&T contractors.
- Scheduling, arrangement of logistics and actual implementation of import.

Audit findings:

6.2.1 Improper planning of berthing of vessels at ports

Out of 72.23 lakh MT wheat import throughout India, 55.10 lakh MT (76 *per cent*) was routed through Mundra and Kandla ports. During Phase-I, wheat was received in 107 vessels. Of these 43 vessels were received in Mundra and 25 vessels were received in Kandla. Similarly, during Phase-II out of the total 35 vessels, only one vessel was allocated to Chennai port and rest of the 34 vessels were berthed at Mundra (26) and Kandla port (8).

6.2.1.1 Loss on demurrage due to delay in berthing of vessels

As per agreement, FCI had to nominate the discharge port(s) and after arrival of vessel(s) it had to arrange for their discharge. The importer was required to ensure safe berthing to

[1] ***Cost, Insurance and freight***
[2] ***Stevedoring, Clearing, Handling and Transport***
[3] ***Kandla, Mundra, Chennai, Mumbai, Vizag, Kakinada, Tuticoin, Cochin***

the vessel for discharging the cargo. Any claim(s) for demurrage, damage to the vessels etc arising with regard to berthing or discharge operations were to be honored by the FCI.

Since large numbers of vessels were allocated to Mundra and Kandla ports there was unscheduled arrival of vessels. This resulted in heavy pre berthing demurrage, amounting to ₹ 24.05 crore at these ports.

6.2.1.2 Poor planning in allocation of ships.

In Phase-I and II, 6.26 lakh MT wheat was discharged from the 13 ships berthed at Chennai port. Of this, 2.34 lakh MT was moved to various states viz. West Bengal, Assam, Bihar, Chhattisgarh etc. by incurring heavy rail freight. The transportation of wheat from Chennai/Tuticorin to these states resulted in extra expenditure of ₹ 7.85 crore. The FCI could have allocated these vessels to eastern coast ports like Vizag and Kakinada where these vessels could be easily accommodated to avoid extra expenditure.

6.2.1.3 Avoidable expenditure due to transportation to southern states.

To meet the requirements of southern states wheat discharges at Kandla and Mundra ports were transported to Kerala, Tamilnadu and Karnataka by incurring heavy rail freight. A total quantity of 64,541 MT of wheat was transported to these states during Phase-II. The transportation of wheat from Kandla and Mundra ports to southern states had resulted in excess transportation cost to the extent of ₹ 5.29 crore. The FCI could have avoided excess transportation by allocation of more vessels to Chennai port during Phase-II.

6.2.1.4 Avoidable transportation by rail

Mumbai port had the facility to accommodate smaller ships up to 36,750 MT in inner berths and up to 45,000 MT in outer berths. FCI, Western Region recommended that a quantity of 6-7 lakh MT could be imported through Mumbai port. As against this, actual import made through this port was only 1.04 lakh MT in three vessels. Examination of capacity of ships berthed at ports nearest to Mumbai revealed that 10 smaller ships of less than 36,750 MT were berthed at Kandla/Mundra ports with a total bill of lading quantity of 3.29 lakh MT. Further, a total quantity of 6.62 lakh MT of wheat was transported from Mundra and Kandla ports to different centers in Maharashtra by rail. Had the smaller ships been berthed at Mumbai port, the additional expenditure of ₹ 10.51 crore on transportation by rail from Kandla and Mundra to places which were close to Mumbai port could have been avoided.

6.2.1.5 Extra expenditure due to transportation by road

Wheat through Kandla and Mundra ports was sent to various States by rail except to Gujarat. The FCI has three rail-fed depots under Gujarat Region i.e. FSD Sabarmati, FSD Bhomaiya and FSD Gandhidham and the wheat could have easily been transported to these depots by rail. A quantity of 2.56 lakh MT of wheat was transported through road to these rail fed depots during the year 2006-07 and 2007-08 by incurring extra expenditure of ₹ 12.57 crore when compared to rail freight.

Thus, planning of berthing of vessels at ports was not proper. Extra expenditure due to transportation of stock to different destinations could have been avoided.

6.2.2 Excess payment to contractors

According to clause 5 of Shipping Terms of the purchase/sale agreement between the importer and foreign sellers, "Vessels used should be geared/gearless. Suitable grabs for discharge of grain in bulk to be provided by the seller at their cost." Further, clause XX (iii) of the SCH&T contract provided that "The contractor shall make necessary arrangement for use of the ships or port gear and/or ships winches required for the discharge of foodgrains and pay any charges incurred for hiring the gear."

It was observed that 66 vessels at Mundra and 18 vessels at Kandla arrived without gear. Though the grab was to be provided by the seller at their cost or SCH&T contractor had to pay for the hiring of gear, an amount of US $4665667 (about ₹ 20.99* crore) was paid as grab charges to SCH&T contractors for discharge of which resulted in excess payment of grab charges.

6.2.3 Non recovery of dues from importer/contractors

Instances of non-recovery of losses/dues from importer/contractors were also noticed. A few instances were:

6.2.3.1 Failure to recover 'Rail Transit Losses' from the contractors

In eight ports through which the import of wheat was made during 2006-07 and 2007-08, SCH&T contract was entered into for handling and transport of stock. However, there was no provision in the contract for recovery of Rail Transit Losses (RTL) above standard allowance of 0.24 *per cent* occurring from loading point at port to the rail head where these stocks were unloaded. It was observed that FCI suffered a loss of 32523.315 MT and after standard allowance, amounting to ₹ 17.27 crore on account of RTL. FCI decided (April 2008) that RTL above 0.5 *per cent* may be recovered and responsibility fixed. In western region loss to the extent of ₹ 3.70 crore accrued but no action was taken to recover it from the contractor on account of RTL.

6.2.3.2 Non-recovery of short landed quantity

One vessel (M.V. Mairouli) arrived at Kandla port on 13 February 2008 with 47848.52 MT of wheat of Brazil origin. It had non permissible draft for Kandla port which necessitated making the ship lighter at midstream to reduce the draft for berthing. Prior to commencement to lighten the ship, a joint draft survey was conducted at midstream to confirm the quantity at par with bill of lading quantity but at the time of survey, sea swell was prevailing and the actual quantity brought by the vessel could not be ascertained. However, on full clearance of stock from wharf in April 2008 shortage of 1356 MT of foodgrains worth ₹ 1.83 crore was noticed. Since shortage was noticed only at a later date, the importer (MMTC) disowned the liability. The liability was later fixed on SCH&T contractor, since contractor was responsible for shortage at wharf. The contractor also disputed the liability referring to remarks on "sea swelling" recorded in the joint initial draft survey and leakage of grain in mid stream during lightening. Thus, absence of provisions for fixing responsibility for short landed quantity resulted in non-recovery of loss.

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* *At the rate of ₹45/$.*

6.2.3.3 Non-recovery of gunny shortages

As per contract FCI had to arrange for supplies of empty gunny bales to the contractors. The contractor was the custodian of gunny bags supplied and was liable to render account of gunnies supplied and make good the cost of gunnies lost to the FCI.

A review of gunny account and settlement of accounts with SCH&T contractors revealed that claims on losses/shortages/damaged gunnies to the extent of ₹ 6.19 crore were pending settlement as the contractors had disputed the amount.

6.2.3.4 Non recovery of godown rent and handling charges

As per para XXI (6) of contract, it was the responsibility of SCH&T contractor to hire necessary godown to accommodate stock and incur all expenditure upto loading of stock into wagons. However, during the period from 28 December 2006 to 27 March 2007 FCI hired godown facility at Central Warehousing Corporation, Kandla on actual occupation basis to accommodate the arrivals at Kandla port. FCI incurred ₹ 58.17 lakh towards handling charges and rent of godown. The expenditure incurred was not recovered from the SCH&T contractor.

Conclusion

Throughout the execution of import contract there were inefficiencies and extra expenditure especially with regard to allocation of ships to specified ports which resulted in heavy demurrage and excess road/rail transportation cost. SCH&T contracts were finalised without considering various contingencies.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

6.3 IT Audit on Non achievement of objectives of Integrated Information System for Food grains Management project in FCI

Introduction

Food Corporation of India (FCI) functions through five Zonal Offices, 23 Regional Offices, 170 District Offices and 1643 Food Storage Depots. The practice of collection of information/data for Management Information System (MIS) was time consuming and costly. As such, Government of India (GOI) approved (August, 2003) the project 'Integrated Information System for Food grains Management' (IISFM) at a total cost of ₹ 97.66 crore which was to be implemented in three phases from 2003-04 to 2005-06. The sole objective of IISFM was to install an online MIS which would give the stock position in any Food Storage Depot (FSD) at any given point of time.

A Tripartite Agreement for implementation of the IISFM project on turnkey basis was entered into amongst the FCI, National Informatics Center (NIC) and National Informatics Center for Services Incorporated (NICSI) in September 2003. As per the agreement, NIC was to act as a consultant for the project and responsible for providing application software and also update the same as per the requirements. NICSI was responsible for the supply of hardware and software for the project as per specifications prescribed by NIC. The FCI incurred an expenditure of ₹ 80.24 crore on the project till March 2010.

Integrated Information System for Food Grains Management

IISFM consists of two modules viz: district module and depot module. The system was designed to capture data related to receipts, issues and dispatches from the FCI depots. The captured data flows from the depots to the FCI's Headquarters at Delhi while being collated at various levels of hierarchy with FCI, and thus the stock related to every depot is made available at a central location i.e. the Central Server located at Head Office/NIC.

At the district level, the details of stock from all the depots within the district were consolidated and reports on stock position were placed on the IISFM website fortnightly, after authentication by Regional Office.

The scope of the project was widened in 2005-06 to include:-

- Nine major Procuring/Distributing States/Agencies
- Computerization of 'Financial Accounting Package' of FCI.

Scope of Audit

The scope of audit included an assessment of the planning, designing, implementation and operation of IISFM project to see whether the objectives of the project have been achieved. The audit was carried out through test check of records and analysis of data of two depots from each of the five Zones selected on random basis besides review of general and application controls at the level of depot, district, region and Head Office. The period of audit is the project implementation period i.e August 2003 to till date (July 2010).

Audit Objectives

The main objective of audit included an assessment of the planning, designing, implementation and operation of IISFM project to see whether the objectives of the project have been achieved. Besides, whether it was effectively performing to achieve its objective of availability of online real time data of stock position in FCI depots. For this purpose, it was seen whether -

- IISFM was planned and designed to fulfill the objectives of introducing the system
- The system was implemented economically and efficiently
- There was improvement in the existing MIS

Audit criteria

The audit criteria for assessment of the achievement of objectives of the project were as follows: -

- GOI instructions, Agenda and Minutes of Board of Directors, and Tripartite agreement with NIC and NICSI.
- Implementation schedule, arrangement of logistics for implementation and actual implementation.
- Reports generated from the system.

Audit findings

6.3.1 Planning and implementation

Planning is the foundation stone for the development and designing of any system as its success depends on appropriate planning:

6.3.1.1 IT Policy

IT policy was necessary for effective functioning of IISFM because it contains comprehensive strategy for computerization of functions at depot level without which implementation of IISFM project could not be systematic. However, audit observed that even after seven years since the project was commenced, IT policy was not finalized and documented by FCI. The FCI continued to depend on NIC for any change in the IISFM application.

It was observed that in order to monitor and oversee implementation of the project, a 'Project Monitoring Committee' (PMC), under the chairmanship of the Managing Director, FCI with members from FCI, NIC, NICSI and a representative of the Ministry of Consumer Affairs, Food and Public Distribution was formed which was required to meet at least once a month. It is however, observed that the PMC, constituted in October 2003, held only 10 meetings as against the target of 72 meetings over a period of six years (2003-04 to 2009-10). Thus, due to insufficient monitoring, the problems occurred during the implementation could not be rectified in time resulting in inordinate delay in the implementation of the project.

6.3.1.2 Delay in implementation of data transmission capability

The main objective of IISFM was to obtain on line stock position of any depot at any given point of time. Tripartite agreement signed in 2003 included the requirement of enough data to ascertain stock position at any of the depots at any given point of time. However, requirement of availability of data of online stock position was not taken care of initially as the first test version of depot application software released (1.0) in the year 2004 did not have the data transmission capability. Only the later version (2.2.2) launched in the year 2007 had the data transmission capability.

6.3.1.3 Incomplete implementation of the IISFM

It was observed that the updated stock position in any depot on any given day (instead of any given point of time) was available only in respect of 112 depots out of 1643 depots (6.82 *per cent*) (March 2010). In the latest version (3.1.0) the updated position (0 to 7 days) was available in respect of only 186 depots (11.30 *per cent*) out of 1643 depots (July2010).

Audit observed that:-

- In nearly 800 depots out of 1643 depots, hardware and software were not provided.
- The data of nearly 150 depots could not be transmitted due to lack of internet connectivity.

The scope of the IISFM project was widened (October 2005) to include computerization of State Government Agencies of nine major procuring/distributing States (Uttar Pradesh, Chhattisgarh, Orissa, Andhra Pradesh, Haryana, Karnataka, Tamil Nadu, Madhya Pradesh and Punjab). The objective of the enlarged scope was to capture complete, timely and reliable data on foodgrains stock in the Central Pool (with FCI and State Government agencies). However hardware and software were supplied to seven states except Andhra Pradesh and Punjab at a cost of ₹ 20.65 crore upto May 2010. Management informed that only Madhya Pradesh out of these states had been updating data through these modules.

Presently stock position of foodgrains with State agencies in Central Pool is being collected manually by the District Offices of FCI and fortnightly reports are sent to FCI Hqrs as was being done previously. Thus the expenditure of ₹ 16.25 crore spent on computerization of major procuring States/State Agencies (except Madhya Pradesh[♣]) remained unfruitful so far.

As per project requirement, in Regional Offices (RO) and Zonal offices(ZO) only computer and connectivity to the central server was required without servers. However, it was observed in audit that FCI purchased servers valuing ₹ 71.77 lakh for 23 ROs and five ZOs without assessing their requirement. This resulted in avoidable expenditure of ₹ 71.77 lakh.

The Management stated (November 2010) that though the depot application software was not used by ROs and ZOs, a Local Area Network (LAN) could be established with the server and client PCs supplied under IISFM for other office works of the FCI.

6.3.1.4 Disaster Recovery and Business Continuity Plan

Disaster Recovery and Business continuity planning includes taking regular backups, storage of backups in a separate location and periodic recovery exercise to ensure that backups taken are recoverable. However, it was seen in audit that no recovery exercise was undertaken and disaster recovery mechanism has not been simulated so far. In the absence of the any off-site storage and recovery exercise, recovery of the data cannot be assured thereby putting the entire database at the risk.

The Management stated (November 2010) that the point of audit for setting up a Disaster Recovery Site (DRS) and simulating it at various intervals is well taken by the department which was setting up DRS in consultation with NIC soon.

6.3.2 Process Reengineering

Test check in audit has revealed that electronic weighbridges installed at depots contain all data related to incoming and outgoing stock of foodgrains. Hence, IISFM should have been designed in such a manner that it imports stock data directly from the electronic weighbridge. It could be done by linking the system with the weighbridge. However, existing system was not designed to reduce further manual intervention thus minimizing the scope of erroneous data entry.

The Management stated (November 2010) that linkage of weighbridge required further analysis and study as well as up gradation and standardization of all weighbridges across all depots. Hence this exercise was put on hold by NIC till the computerized stock reporting could be stabilized. The weighbridge level automation may be undertaken in future as a separate project.

[♣] ***Madhya Praesh (Hardware and Software expenditure ₹4.40 Crore)***

The reply was not convincing because these difficulties were not insurmountable as most of weighbridges were upgraded to electronic weighbridges and even the upgraded electronic weighbridges were not linked to the system.

6.3.3 System Design

Following flaws in designing were also seen in audit: -

- There was no provision for capturing procurement data at 'mandies' (foodgrains markets) and data transhipment operations in the IISFM.
- No provision for capturing categories of food grains purchased under relaxed specification was available in the system under the depot module. For instance, it was observed that wheat (shrivelled and broken) purchased in Uttar Pradesh under relaxed specification, is classified under two categories viz 7.1 *per cent* to 10 *per cent* and 10.1 *per cent* to 15 *per cent*. In the absence of such provision, category wise stock position could not be generated from the system.
- Central server reports were showing negative stock balances of food grains in silo in Lucknow and Guwahati due to incomplete data feeding.
- Stock balance reports can be generated with future dates through the system which exposed the system to misrepresentations.
- System could accept any number between 0 and 9999999999 in respect of number of bags, quantity and cost per quintal in Release Order in the absence of parameters set in the depot module.
- Release order can be issued of a quantity more than the quantity available in the depot.

Management accepted (November, 2010) the flaws in the system and replied that NIC, the project consultant has been working to find solution. Further, an administrative decision was taken to keep this version in abeyance and to bring in a simplified online version IISFM Rapid Reporting Service (IRRS) which has now been launched.

6.3.4 IS Security

6.3.4.1 Physical access controls

Sensitive systems like database server and network switches in the depots of FCI were not protected by placing in dedicated (isolated) environment and were freely accessible to anyone, making the system vulnerable to physical threats.

6.3.4.2 Logical access control

It ensures that only authorized users can log on to the system. This control is secured by having a password policy, limitation in number of logon attempts, etc. However password policy was not in place. Audit also observed that:

- User IDs and passwords were shared by more than one user, thereby compromising the security of the system and making it difficult to fix responsibility.

- Idle log out time of the system can be set by system settings. It was, however, observed that the idle log out time set is 20 minutes, which is rather high and exposes the system to unauthorized access.
- Log files to assess user access were not available in the system.

The Management stated (November, 2010) the user acquaintance and comfort with the use of computers and the software was being cultivated and hence the need of tougher passwords and log maintenance was not felt. The reply further stated that IRRS had been released by NIC after proper security audit; password policy had been finalised and limitations in number of logon attempts had been incorporated in the module.

The reply of the Management was not convincing as good practices of the password management were vital for data security. Further, even limitation in number logon attempts and sharing of passwords without the existence of proper log files (user identification with time at the time of login in to the system) in the system would compromise data security and responsibility could not be fixed.

6.3.5 Performance of IISFM

Performance of IISFM as test checked in 10 depots out of 699 depots where the system was put in place. Besides, stock reports generated in central server in FCI Headquarters in respect of all depots were examined. Following deficiencies were noticed in audit:-

6.3.5.1 Non-achievement of the objective of online stock position.

The main objective of the project was to put in place an online MIS to give the stock position in any depot at any given point of time. This required data entry as and when the activity took place and prompt transmission of the data to the central server. It was, however, observed (as on May 2010) there was time lag of data entry ranging between 1 day to 823 days. Thus the stock position in any Depot at any given point of time was not available.

6.3.5.2 Incorrect MIS report generation

Reports on stock position of food grains generated by the central server were found to be incomplete, inaccurate and unreliable for decision making. The following deficiencies were noticed in the central server reports:

- Variation was seen between the stock position as per the central server reports based on depot module and district module reports. Hence the figures generated by the system were not reliable.
- Stock position of a depot as per the depot module on a given date did not match with that of the same depot as per district module. Some instances are as given below:-

Name of the depot	Commodity	Closing stock in MTs as on 30.04.2010		Difference
		As per Depot module	As per District module	
Talkatora, Lucknow	Rice	9923.45	8722.41	1201.04
	Wheat	16523.52	16499.56	23.96
Naraina, Delhi	Rice	7621.16	8607.29	986.13
	Wheat	69434.20	69076.88	357.32

Sanathnagar, Hyderabad	Rice	45846.94	45888.50	41.56

6.3.5.3 Inability of Server to handle large volume of data flow from depots

Out of six servers, two were in clustered mode and connected to SAN[♥] storage. The Random Access Memory (RAM) of the servers was 4 GB. Capacity of the central server was not commensurate with the volume of data generated in the depot leading to delay in uploading of data transmitted by the depots to the central server.

The Management stated (November, 2010) that due to changed circumstances and increase in multiple web based application running on central server setup, the load on the Central server increased manifold and proposal for upgrading the central server was already in pipeline.

Conclusion

The main objective of availability of online stock position of any depot at any given point of time could not be achieved due to incomplete implementation and absence of connectivity. Reports generated by the system were not reliable because position of stock for the same depot for the same date were different in depot module and district module. Further, the system had problems related to security and control of data. The FCI kept in abeyance the old version of IISFM depot module 3.1.0 and launched a new version known as IRRS in August 2010. However, the fact remained that that the objective of online stock position of any depot at any given point of time had still not been achieved.

Recommendations

- ***Application software should be linked to upgraded electronic weighbridges installed in depots.***
- ***IT controls need strengthening to improve reliability of reports.***
- ***Comprehensive IT policy may be formulated for efficient functioning of the IISFM project.***
- ***Action needed to be taken to increase capacity of the central server.***
- ***Disaster recovery management may be improved by periodically creating simulated emergencies and testing the recovery of data backup.***

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

6.4 Extra expenditure on Mandi transportation

Fixation of different *per* quintal *per* kilometer rates for transportation of foodgrains from mandis to storage points resulted in extra expenditure of ₹ 24.34 crore during 2005-06 to 2009-10 in Punjab region.

Food Corporation of India (FCI) as well as State Government agencies procured foodgrains for the Central Pool from the mandis established by the State Marketing

[♥] ***Storage Area Network***

Boards. For transportation of foodgrains from these mandis to the storage points, Mandi Transportation Contractors were appointed.

The Director Food & Supplies and *ex-offcio* Special Secretary to Government of Punjab intimated FCI (July 1998) that in order to have uniform rates in all mandis/procurement centres committees had been constituted at district level to finalise appointment of labour and transport contractors for transportation from different centres to storage points. Each committee had Deputy Commissioner as its Chairman, District Food & Supplies Controller as Member Secretary and Labour Officer of the district along with District Managers of the procuring agencies as its Members. While fixing transportation rates, it was stressed that Deputy Commissioner might ensure that for equal distance, the same rate be fixed. Every year, contracts were awarded in the district wise meeting chaired by the Deputy Commissioner.

It was observed in audit that in Punjab Region the contracts for transportation from mandis to storage points were awarded on adhoc basis by allowing a certain *per centage* enhancement over the previous years rates. Though it was to be ensured that the same rate was fixed for equal distances different *per* quintal *per* kilometer rates were fixed by the Committees. These rates were adopted by FCI. Examination of rates in five Districts[1] in Punjab region revealed that the rates for same distance ranged[2] from ₹ 6.25 to ₹ 36.05 *per* quintal *per* kilometer during 2005-06 to 2009-10. Fixation of different *per* quintal *per* kilometer rates for same distance resulted in extra expenditure of ₹ 24.34 crore[3] in five districts only for transportation of 23.52 lakh MT of foodgrains during 2005-06 to 2009-10.

The Management contended that;

- The mandi transportation charges were finalized by the District Committee headed by the Deputy Commissioner.
- The system adopted by the Punjab region for fixation of rates was logical and did not require any change.

The contention of the Management was not convincing as

- The District Manager of FCI was also member of the District Committee. The FCI should have ensured fixation of same rates for same distance.
- In the neighbouring Haryana region, basic 'Schedule of rate' was fixed for transportation of foodgrains from mandi to storage point allowing fixed *per* quintal *per* kilometer rates to the transporters.

Thus, extra expenditure of ₹ 24.34 crore was incurred during 2005-06 to 2009-10 in the five districts of Punjab region due to fixation of different *per* quintal *per* kilometer rates for transportation of foodgrains from mandis to storage points. It is recommended that

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[1] ***Sangrur, Patiala, Bathinda, Jalandhar and Hoshiarpur (out of 13 Districts).***

[2] ***2005-06- ₹7.34 to ₹26.39, 2006-07-₹8.75 to ₹28.63***
2007-08-₹6.25 to ₹31.20, 2008-09- ₹11.38 to ₹33.69
2009-10-₹9.30 to ₹36.05.

[3] ***Compared with lowest per quintal per kilometer rate in the mandi.***

basic 'Schedule of rate' be fixed for mandi transport contracts in Punjab region for uniform *per* quintal *per* kilometer rates to the transporters.

The matter was reported to the Ministry in June 2010; reply was awaited (February 2011).

6.5 *Irregular payment of VAT to the Millers*

Without ensuring applicability of VAT element, irregular payment of ₹ 7.04 crore was made to Yanam millers.

As per Memorandum of Understanding (1983) between Government of Andhra Pradesh (GoAP) and Yanam[♦] Administration, the rice millers of Yanam were permitted to procure paddy from the farmers of Andhra Pradesh (AP) with a condition *inter-alia* to deliver the levy rice as per the levy order of GoAP to Food Corporation of India (FCI) or on its behalf to the AP State Civil Supplies Corporation. Accordingly, Yanam millers were procuring paddy from AP State and delivering the levy rice to FCI in AP.

For every marketing season Government of India (GOI) fixes the procurement price for levy rice. Among other items it included an element of Central Sales Tax (CST) or Goods and Services Tax (GST) or Value Added Tax (VAT) of the respective State.

After enactment of AP State VAT Act 2005, the procurement price of levy rice paid to AP rice millers included VAT at the rate of four *per cent* (October 2005). The price paid to rice millers of Yanam was also the same. From July 2007, the Puducherry VAT Act, 2007 came into effect, according to which food grains including rice and pulses were exempted from VAT. However, FCI made payment of ₹ 7.04 crore as VAT element to Yanam millers against delivery of 13.13 lakh MT of levy rice from July 2007 to March 2010. Since, no VAT was payable in Yanam on the levy rice delivered by Yanam millers and the Yanam millers did not remit any VAT to the Commercial Taxes Department of AP as they did not come under their jurisdiction, the payment of VAT element to Yanam millers was irregular.

The Management stated (November 2010) that it was obligatory on the part of FCI to pay VAT element to Yanam millers as per costing sheet given by GOI.

The reply is not acceptable as FCI should have ensured applicability of VAT before making payment of VAT element to Yanam millers.

The matter was reported to the Ministry in September 2010; reply was awaited (February 2011).

[♦] *Union Territory of Puducherry*

CHAPTER VII: MINISTRY OF DEFENCE

Bharat Electronics Limited

7.1 Loss in manufacture and supply of satellite radio receivers

Contract manufacturing of Satellite Radios and supply without agreement with the collaborator resulted in a loss of ₹ 16.39 crore.

Based on an indication by M/s. Eton Corporation, USA (ETON) of long term requirement of E1-XM Satellite Radio Receivers (radios) with a business potential of US$ 108 million spread over five years and ETON's desire to shift its manufacturing activity from China to India, Bharat Electronics Limited (Company) took up (May 2005) contract manufacturing of the radios at its 'mass manufacturing facility at Bangalore Complex' (SBU) to supply the same to ETON for marketing in USA and Europe. The unit price of radio agreed to was US$ 173.67. ETON placed an order with the Company for manufacture and supply of 19,110 radios. However, the Company did not enter into any contract/agreement with ETON with specific terms and conditions detailing, inter-alia, obligations and responsibilities of the buyer.

The radios were to be manufactured based on the design owned by ETON and its design agency. During execution, ETON's design agency modified the design of the radios. Out of 17,748 radios launched for manufacture, the Company manufactured and dispatched 11,748 radios to ETON during June 2005 to June 2006 as per modified design after complying with all test procedures, quality checks and clearance by agency designated by ETON. However, the radios failed in the field due to battery leakage, display failure, *etc.* ETON recalled the radios and returned 3,718 radios to the Company during June 2006 to September 2008 for rectification. ETON did not make full payment even for the 8,030 radios retained. Even after rectification by the Company, ETON did not lift the radios on the ground of slump in the market and introduction of 'Regulations on Hazardous Substances' (ROHS) in July 2006 in USA and Europe which made the sale of radios impossible in USA and Europe as they were not compliant with ROHS. Thus, besides raw material, the Company ended with an inventory of 3,774 finished radios, 5,944 semi-finished radios. The radios could not be put to alternate use as the Company did not have license and necessary back up required for effective usage in India.

In the absence of an agreement with ETON, the Company could not force the former to compensate it for the radios manufactured and not lifted and loss incurred by the Company due to defects in the design prescribed. As a result, the Company had to incur avoidable loss of ₹ 16.39 crore as indicated below:

- The price quoted by the Company was based on projections for long term requirement of radios by ETON and the benefits envisaged due to large scale production. However, the same could not be achieved.
- The Company had to absorb ₹ 6.17 crore being the difference between cost of production (₹ 12.29 crore) and the agreed sale value (₹ 6.12 crore) in respect of

8,030 radios accepted by ETON. Reasons for wide variation between the cost and the selling price were not on record.

- The Company ended up with unusable inventory and made a provision of ₹ 7.09 crore in its accounts for 2008-09 towards non-realisable value of the finished radios (₹ 2.87 crore), semi-finished radios (₹ 1.42 crore) and raw materials (₹ 2.80 crore).
- The Company was also of the view that an amount of due ₹ 0.70 crore (net) due in this deal from ETON was doubtful of recovery.
- In the absence of any agreement with ETON, customs duty and interest thereon (₹ 2.43 crore) had to be paid by the Company in July 2008 and March 2009 due to failure in fulfilling export obligation.

The Management stated (October 2010) that:

- The Company ventured into the project due to business potential of US$ 108 million with an expected contribution of around ₹ 56 crore over a period of five years, especially in the light of the fact that the SBU had not earned any profit in several projects taken up by it;
- Entering into a long term agreement would not have made any major impact as both the parties were clear about their responsibilities and risks involved;
- The actual cash loss was only ₹ 9.66 crore without considering the cost of labour and overheads.

Reply of the Management was not acceptable as in the absence of a formal agreement, the Company could not protect its financial interests and incurred a loss of ₹ 16.39 crore. Further, the contention that the overheads and labour were excluded from loss as they would be absorbed in overall profitability of the SBU was not correct as it diluted the accountability of the Project Management. Labour and overheads were consumed in the project and were considered for the valuation of inventory in the respective years as confirmed by Management (October 2010).

The matter was reported to Ministry in November 2010; reply was awaited (February 2011.)

BEML Limited

7.2 Sale of Dealer Model Equipment

Introduction

BEML Limited, Bangalore (Company) was incorporated in May 1964 as a fully owned Government undertaking under the Ministry of Defence for manufacturing earth moving equipment, defence aggregates, trucks, engines and rail coaches. Marketing activities of the Company for equipment (except rail coaches) and spares are managed by Marketing Division, headed by Executive Director (Marketing) and supported by Chief General Manager (Marketing). The Company had also established 10 Regional Offices and 17 District Offices throughout the country for marketing its products.

The Company had identified small end construction equipment mainly used in infra structure development activities like road building, irrigation projects and other construction activities, which are generally purchased by small/individual contractors as Dealer Model Equipment (DME). The product range of the Company in this segment consists of Hydraulic Excavators, Bulldozers, Backhoe Loaders, Wheel Loaders and Graders.

DME were marketed both directly by the Company and also through appointed dealers. Separate section headed by Assistant General Manager in the marketing division of the Company was responsible for marketing activities relating to DME.

Scope of Audit

This thematic review broadly covers the marketing and sales activities relating to DME of the Company for the period 2006-07 to 2009-10 focusing mainly on marketing strategy, sales performance, pricing, appointment and performance of dealers.

Audit Objectives

Audit was carried out to assess:

- Whether target fixed for sales of DME was based on requirement and realistic
- Whether marketing activities in respect of DME were effective
- Whether dealer Management techniques and dealer appraisal system were in existence in the Company and were efficient
- Whether the Company had a system for collection and analyzing customer and dealer level information for promotional and operational decision
- Whether the pricing of DME were as per the policy
- Whether the Company ensured efficiency in quality of products and after-sales services

Audit Criteria

The following criteria were adopted for judging performance:

- Policies and guidelines issued by the Board of Directors (BOD) and the Management of the Company regarding sales of DME.
- Policy/procedure relating to appointing, appraisal of the performance of the dealers and policies relating to pricing, sales commission and service charges.
- Targets and achievements of sales of DME.

Audit Methodology

Audit methodology involved review of documents relating to DME, analysis of statistical information and discussion with the Management, data relating to DME sales, inventory and debtors for the period 2006-07 to 2009-10, review of sale order files and other general files relating to the equipment.

Audit observations

7.2.1 Market share of dealer model equipment

Though the Company had been in the business of mining and construction equipment since 1964 and enjoyed 12 *per cent* market share in respect of construction equipment, the Company's market share in respect of DME (small end construction equipment) was around one *per cent* only till 2009-10 and was facing severe competition from both domestic and international suppliers in this segment. Significant among the competitors are JCB (India), Telcon, L&T Komatasu, Caterpillar, and Volvo, who had established their presence and brand image significantly. JCB (India) was holding a market share of around 70 *per cent* in Backhoe loaders. Telcon and L&T Komatsu between themselves shared the lead in respect of Excavators. The Company and Caterpillar (India) Private Limited shared the market in respect of Dozers.

The Management stated (October 2010) that, it was concentrating on high end products catering to institutional buyers like mining companies *etc.* and considering potential for growth in construction/infrastructure activities, the Company entered this segment in the last 3 to 4 years.

The reply was not acceptable as the Company could not improve market share during the last 3 to 4 years as discussed in paragraph 7. The competitors of the Company used this opportunity to establish their brand image and consolidated their market share.

The problems encountered by the Company in this segment are discussed in the subsequent paragraphs.

7.2.2 Strategy of the Company to improve market share

To establish brand image and get reasonable market share, the Company decided (July 2006) to establish wider dealership network throughout the country to have maximum access to the customers located in interior areas.

A review of dealership network of the Company in Audit revealed the following:

7.2.2.1 Market assessment

The Company did not conduct any market survey before it took the major step to establish dealership network throughout the country.

The Management stated (October 2010) that the Company conducted market assessment through Regions/District Offices and through published research reports. However, the documents in support of Management's reply were not on record.

7.2.2.2 Appointment of dealers

The dealers were initially appointed by inviting open tenders for a period of three years. During the period from 2006-07 to 2009-10, of the 30 dealers appointed by the Company, 16 dealers were either terminated/under termination due to non-performance, or had resigned before the term of agreement due to non-viability as indicated below:

Year	At the beginning of the year	Appointed during the year	Terminated/ resigned during the year	At the end of the year
2006-07	-	15	-	15
2007-08	15	9	3	21

2008-09	21	-	2	19
2009-10	19	6	4	21
2010-11 (up to September 2010)	21	-	7	14

The Management stated (October 2010) that the infrastructure available with the dealers, their capabilities to generate business and expertise in the area were generally considered before selection.

The reply of the Management was not acceptable in view of the fact that the dealers performed poorly and amounts due from dealers were outstanding for a long period.

In September 2010, the Company was having only 14 dealers and some of the bigger States like Tamilnadu Uttar Pradesh, Bihar, Chattisgarh, and Orissa were not covered under dealership arrangement. Some of the bigger states like Andhra Pradesh, Gujarat and Rajasthan were having one dealer each for the entire State.

The Management stated (October 2010) that efforts were on to establish dealers in prospective areas not covered presently.

Recommendation

Selection process of dealers needs to be strengthened and viability of dealers ensured.

7.2.2.3 Dealer appraisal

The system to appraise the performance of dealers was not in place.

The Management stated (October 2010) that the performance of DME was being monitored by Regional/District Offices and by Corporate office by conducting various meetings of dealers at regional level and on annual basis centrally.

The reply of the Management was not acceptable as records to evidence the existence of a dealer appraisal system in the Company was not produced to audit, in the absence of which the method of evaluation of performance of the dealers, reasons for non performance, quality of service rendered by dealers, constraints, feedback of regional offices/dealers and action taken by the Management to improve performance could not be ascertained in Audit.

Recommendation

Dealer appraisal system to assess performance, effectiveness and quality of service is essential to evaluate performance of dealer and improve sales.

7.2.2.4 Assessment of financial viability of maintaining dealers:

The Company admitted (September 2010) that the expenses incurred towards establishing dealer net work like tendering, appointment of dealers, termination of dealers and other administrative expenses like travelling, *etc.* were not accounted for separately and expenses relating to DME sales transaction could not be tracked. In the absence of this, whether the investment on establishing dealers delivered results and increased the revenue could not be ascertained in Audit.

7.2.3 Sales Performance

7.2.3.1 Targets and achievements

Targets fixed for the Company as a whole for sale of DME and targets for sales through dealers vis-a-vis actuals during the years 2006-07 to 2009-10 were as under:

(Value ₹in crore)

Year	Sales of DME for the Company as a whole				Sales by dealers			
	Target		Actual		Target		Actual	
	Quantity	Value	Quantity	Value	Quantity	Value	Quantity	Value
2006-07	1,054	289.96	318	128.69	298	102.12	129	46.45
2007-08	1,037	303.51	542	210.80	1,332	422.85	336	119.96
2008-09	2,057	606.25	210	82.06	1,857	537.27	127	40.49
2009-10	752	247.83	299	137.22	775	282.61	128	43.27
Total	4,900	1,447.55	1,369	558.77	4,262	1,344.85	720	250.17

The Company had not fixed targets for direct sales separately. The difference between Company's targets and targets for dealers was considered as target for direct sales by the Company.

It would be seen from the above table that:

- At the time of BOD approval (July 2006) for wider dealer network, sale of 945 equipment was planned for the year 2006-07, but the target fixed was for only 298 equipment and the achievement was much less at 129 equipment.
- Targets fixed for sales through dealers in the years 2007-08 and 2009-10 were more than targets fixed for the Company as a whole.
- The Company was not able to achieve the targets in any of the years under review. Targets set for years 2007-08, 2008-09 and 2009-10 were ambitious without regard to actual achievement in previous years.
- There was decline in sales by dealers over the period except in the year 2007-08 when the achievement was ₹ 119.96 crore.

The Management stated (October 2010) that higher targets were fixed to motivate the marketing team to achieve higher turnover. Though promotional activities like customer meet/ advertisement *etc.* were conducted the targets could not be achieved due to recessionary trends prevailing in the country coupled with competition from established players in the market.

The reply of the Management was not acceptable as:

- Fixing of targets arbitrarily for the dealers without any realistic chance of achievement cannot be expected to motivate them; and
- Recessionary trend was only during 2008-09 and not relevant for the entire period covered by audit.

7.2.3.2 Inefficient Sales Management

Further, the actual sales indicated above have to be viewed in the light of the following:

(i) The Company resorted to marketing of DME through advance supply of equipment to dealers without considering the operational and financial risk.

During the years 2008-09 and 2009-10, advancing of 76 equipment valuing ₹ 32.06 crore was noticed.

The Management stated (October 2010) that payment had been realised in most of the cases.

The reply of the Management was not acceptable as it was noticed that sales in respect of 10 equipments valuing ₹ 3.94 crore accounted for in 2007-08 were reversed in 2009-10 indicating advance recognition of sales to achieve targets.

(ii) Cases of delay in dispatch of equipment for which dealers sales were recognized earlier were also observed. During 2008-09, 102 such cases valuing ₹ 34.31 crore which accounted for 38 *per cent* of the dealer sales of 2008-09 were noticed. The delay in dispatch of equipment ranged from 8 to 228 days.

The Management attributed (October 2010) delay to non availability of transport and snag rectification but did not justify the reply with documents.

(iii) The dealer sales portion constituted only 3.40 *per cent* of the total sales made at the Regions.

The Management stated (October 2010) that, total turnover of the region included high value equipment, and hence, dealer sales looked meagre.

7.2.3.3 Poor customer financing options

Following factors contributed to the poor sales performance of DME:

(i) Financing the purchase

Over 85 *per cent* of the domestic purchase of the DME by the customers was by obtaining finance through banks/financiers. Competitors of the Company were able to secure finance relatively easily to the prospective customers.

The Management stated (October 2010) that established brand like JCB was able to secure finance. Considering the options available, the aesthetic looks *etc.* and feed back from the customers based on performance the Company's equipment were rated as category 'C' by the financiers. For category 'C' equipment, a customers would get loan up to 70-75 *per cent* of the value of the equipment, which was not attractive.

The reply of the Management was not acceptable as, though Company had arrangements with some of the banks and financiers, there was no visible improvement in business mainly due to the above reason. To attract customers, the Company needed upgradation of its equipment to category 'A' by technical up-gradation, improving the aesthetic look of the equipment *etc.* to enable customers to obtain loan of around 85-90 *per cent* value of the equipment.

Recommendation

The Company should make efforts in the direction of facilitating finance for the customer like its competitors to enhance sale of its products.

(ii) The resale value

Resale value of Company's equipment was low when compared to that of competitors due to low brand value. Due to this, financial institutions were reluctant to finance

Company's equipment. To improve the resale value, the brand image of Company's equipment needed improvement.

It was also observed that around 65 *per cent* of the customers were plant hirers in respect of backhoe loaders. Though the Company offered this equipment at a price lower than that offered by the market leader JCB, the Company's share in this segment was insignificant mainly due to lack of brand image.

The Management stated (October 2010) that JCB's main product was backhoe loader and their distribution network for the product was much wider compared to the Company.

The reply of the Management was not acceptable as one of the dealers in Chennai region indicated that customers were reluctant to invest in the equipment of the Company as more sophisticated and technically superior equipment were available in the market.

Thus, the poor achievement in dealer sales indicated lack of promotional support, information feedback, control by Corporate/Regional Offices and lack of initiative by dealers. Regional offices were concentrating mainly on the institutional customers. Sales manpower at regional offices needed to be strengthened to market small end construction equipment.

7.2.4 Credit Policy

Agreements with the dealers were silent about the credit allowed to the dealers. In many cases payments were outstanding for longer period. There were no reasons on record for not including a clause in the dealership agreement specifying the credit period.

An examination of outstanding debtors as at March 2010 revealed that out of the total debtors of ₹ 30.23 crore, (i) ₹ 9.28 crore was pending collection from dealers for more than two years, (ii) ₹ 7.30 crore related to dealers whose dealership were either terminated or under termination. Analysis indicating reason for these debts pending for long period and action taken to realize the payment were not available with the Company.

The Management stated (October 2010) that (i) credit policy was not mandatory to be covered in the agreement and (ii) efforts are continuously made to liquidate the outstanding amount.

7.2.5 Pricing of DME

In respect of DME, Management fixed minimum sale prices. It was observed that in respect of Backhoe Loaders and Excavators, the minimum price fixed itself was less than the cost of sales.

The Management stated (October 2010) the prices were approved based on the competition and the market condition.

On a review of sale order files, the following was observed:

- The equipment sold by dealers were at much lower prices than the minimum price fixed by the Management. A review of 30 sale order files for the period from 2007-08 to 2009-10 relating to equipment sold by dealers revealed that the Company incurred a loss of ₹ 3.02 crore on account of difference between minimum selling price fixed by the Company and actual price at which the equipment, were sold.

- During the year 2009-10, in respect of sale of DME, the Company incurred a loss of ₹ 38.03 crore due to sale of equipment at a price less than the cost. In fact, in respect of 83 equipment, the Company could not recover even the cost towards material and labour amounting to ₹ 3.25 crore.

The Management stated (October 2010) that (i) though cost could not be recovered fully, over a period of time they would be able to cover this gap through spares and services; (ii) it had an element of high labour cost and the factor was linked to volumes; (iii) the Company was trying to achieve the volume and profit in this segment in course of time.

Recommendation

The Company should try and reduce the cost of production to remain competitive in the market and increase viability of DME.

7.2.6 Quality and customer support

It was observed from correspondence between dealers and Regional office that:

- Quality of the DME supplied by the Company was poor and failed frequently during operations. Customers also complained about the poor painting /finishing/ aesthetic look.
- One dealer at Chennai region indicated that orders worth ₹ 4 crore were lost due to quality problems like breaking of fan belts, leaking from swivel joints, increased heat of engine, and cracks in rubber surface etc. in the earlier supplies. At Chennai region, five equipments valued ₹ 2.04 crore were returned by the customers due to poor quality and these equipments were lying with the Company.
- Further, 3 loaders valued ₹ 49.20 lakh supplied from Sambalpur region during January 2007 failed and were returned in June 2009 due to multiple failures and were lying with the Company. Similarly, two wheel loaders valued ₹ 35.70 lakh sold in Mumbai region were not lifted by the customer due to quality issues faced by the customer in the previous supplies.
- The Company (Chennai Regional office) did not provide efficient after sales services, delayed attending to the customer during warranty period, responded poorly in meeting the requirements of the customers and delayed supplying spare parts.

The above clearly indicated that the Company had not been paying due attention to supporting and attending to the requirements and complaints of the customers. The poor quality of the equipment and poor customer service earned negative image for Company's equipment. The review of correspondence also indicated that there were very few depots storing spare parts resulting in delay in supply of spares to the customer.

Recommendation

Considering the high market potential, Company should make all out efforts to enhance the quality of its products, after sales service, availability of spares and strengthen dealership network thereby improve its brand image.

7.2.7 Inventory of DME

It was observed in Audit that as of March 2010, 266 DME valuing ₹ 70.81 crore were lying unsold as indicated below:

Sl. No.	Model	Quantity	Value (₹ in crore)
1	BD50 - Dozer	5	1.23
2	BD65 - Dozer	17	6.17
3	BD80 - Dozer	6	2.86
4	BE200 - Excavator	16	7.21
5	BE220 - Excavator	42	18.53
6	BE300 - Excavator	9	5.50
7	BL9H – Backhoe Loader	61	8.45
8	BE71 - Excavator	28	5.74
9	BEML 636 – Wheel Loader	82	15.12
	Total	**266**	**70.81**

Above inventory included 22 equipment valuing ₹ 5.86 crore lying in stock for more than 2 years.

During visit to Regional Offices, it was noticed that 78 equipment valuing ₹ 25.89 crore pertaining to period earlier to 2009-10 were lying with Regional Offices/dealers. Further, out of 44 DME valuing ₹ 11 crore dispatched to Regional Offices during the year 2009-10, eight equipment valuing ₹ 2.04 crore were lying in stock at Regional offices.

The Management stated (October 2010) that sales performance was badly affected due to recession and that it was hopeful of disposal of inventory in the near future.

This clearly indicated that the Company had been producing DME and setting targets for sale of DME without valid orders and without considering the market realities. Piling up of huge inventories resulted in blocking up of funds.

Conclusion

- Despite growth in construction/ infrastructure activities in the recent years, the Company failed to capitalize on the potential for small end equipment.
- Quality of DME supplied by the Company and after-sales service was poor resulting in return of equipment by the customers. This created negative image for the Company's products.
- The Company had dispatched equipment to dealers without valid orders and also not considered the market realities resulting in piling up of inventories and consequent locking up of funds.

The matter was reported to Ministry in October 2010; reply was awaited (February 2011).

7.3 Failure to safeguard interest of the Company in selection of a Joint Venture partner

Failure to ensure business and financial credentials of the JV partner resulted in unfruitful investment of ₹ 6.94 crore besides impending threat of invoking Corporate Guarantee of ₹ 19.15 crore

As part of diversification activity, BEML Limited (Company) decided (January 2005) to form a Joint Venture Company (JVC) for entering into the contract mining business. Out of the seven firms which responded to the Expression of Interest (EOI) called for (January 2005) by the Company, four firms, including M/s Midwest Granite Private Limited, Hyderabad (MGPL), were found to be meeting the requirement of EOI. A Sub-committee of the Board of the Company formed (March 2005) to evaluate the capabilities of the short listed firms rejected the proposals of three firms other than MGPL on the grounds that, *inter alia,* they did not possess mine mapping capabilities. The Sub-committee also observed that MGPL did not have experience in large scale 'coal mining and overburden removal' but recommended (April 2005) that it could be the JV partner, provided its EOI submitted as consortium partner of the Company for Mahanadi Coalfield project mining gets through. BEML-MGPL Consortium could not secure the contract, but the Board approved (July 2005) MGPL as the JV partner with 55 *per cent* equity holding and balance 45 *per cent* by the Company subject to approval by the Government of India (GOI). Before seeking approval from GOI, a shareholders agreement was entered into (September 2005) with MGPL stipulating formation of JVC by September 2006. In response to approval sought for (February 2006) by the Company, the Ministry of Defence (MOD) replied (October 2006) that being a Category I Mini Ratna Company, BEML was competent to decide on the matter, but cited certain unresolved issues such as ability of MGPL to sustain high investment considering its low turnover, profitability, net worth and credit rating for taking necessary action by the Company. Formation of the JVC with MGPL and Sumer Mitra Jaya Limited (SMJ)[♣] as JV partners was approved (January 2007) by the Board and a JVC named as BEML-Midwest was incorporated (April 2007) with its head office at Hyderabad.

Review of records relating to formation of the JVC and the Company's exposure in its functioning revealed the following:

7.3.1 Selection of the JV partner

a) Absence of wide publicity

The press notification calling for EOI from prospective partners did not disclose the name of the Company as a JV partner and was limited to Southern India editions of newspapers only. As major mining activities are spread throughout the country, restricting the notification to southern editions and that too without disclosing the name of the Company as a JV partner denied the Company benefit of responses from compatible and experienced firms in the field of coal mining for forming a JVC.

[♣] *An Indonesian company.*

b) Adoption of incorrect data for evaluation of JV partner

Eligibility parameters prescribed in the EOI included, inter alia, (i) annual turnover of around ₹ 150 crore, (ii) staff strength of 1,000 personnel and (iii) experience in the field of 'overburden removal/coal and spread operation' in not less than 2 to 3 states. Against this, MGPL had (i) turnover of ₹ 36.30 crore, (ii) staff strength of 24 persons (14 mining engineers/foremen and 10 engineers without certificates) and (iii) no experience in coal mining/overburden removal *etc.*

The Company justified (June 2010) MGPL's selection stating that turnover of MGPL's group companies was taken into account in the evaluation process and the Committee's recommendation did not preclude it from formation of a JVC.

The contention of the Company is not acceptable as (i) the Company intended to form JVC with MGPL and not with MGPL group of companies. In the absence of such benefit given to other bidders, it amounted to conferring undue favour on MGPL and (ii) the recommendation of the Committee, though not precluded MGPL had considered the inexperience of MGPL in mining.

c) Ignoring the suggestion of the Ministry

MOD, in response to Company's proposal had communicated the need for proper credit rating to ensure financial soundness of the proposed JV partner. MGPL's ICRA credit rating was "IrBB+" which indicated inadequate credit-quality and high risk. Board was informed (January 2007) that to overcome the financial weakness indicated by the low credit rating, MGPL would set apart an amount of ₹ 16.5 crore in a Fixed Deposit (FD) to show its financial ability to fund capital and would also give an undertaking endorsed by the bank that 'without the consent of the Company the said FD cannot be encashed.' However, no such FD/undertaking was obtained by the Company.

Reply (June 2010) of the Management that ICRA rating does not relate to the capability of MGPL to invest in JVC is unacceptable due to the fact that operational efficiency, competence and effectiveness of Management, hedging of risks, cash flow, liquidity and financial flexibility form the standard parameters for ICRA credit rating for which a high risk "IrBB+" was awarded to the proposed JV partner. Further, the DPE guidelines (October 1997) on 'Financial and operational autonomy for profit making Mini-Ratna Category I companies' prescribed that all proposals whether they pertain to capital expenditure, investment or other matters involving substantial financial or managerial commitments should be prepared with the assistance of professionals and experts. It was, however, observed that the proposal was approved by the Sub-committee of Directors of the Company and no evidence was produced to Audit to substantiate that the assistance of professional(s) was sought/obtained.

d) Lack of experience of JV partner in mining

Board initially approved (July 2005) formation of JVC with MGPL as the JV partner with 55 *per cent* equity holding and balance 45 *per cent* by the Company. As MGPL did not have prescribed experience in 'overburden removal and mining of coal', the Company decided to include (September 2006) SMJ, as a second partner in the JVC with a revised shareholding pattern of 45 *per cent* by BEML, 26 *per cent* by SMJ and 29 *per cent* by MGPL. SMJ was selected by a team consisting of Chief General Manager (Marketing) BEML, Director (Technical) Coal India Limited and Chairman MGPL, deputed by the Company to Indonesia for the purpose without going through any selection process. However, the JVC was finally incorporated (April 2007) with BEML and MGPL as promoters holding shares of 45 *per cent* and 55 *per cent* respectively leaving the discretion to MGPL to allot 26 *per cent* shareholding to SMJ. Composition of the Board of Directors of the JVC was thereby restricted to four from MGPL and three from the Company, with Chairman of the Company as its Chairman and no representation from SMJ who held 0.01 *per cent* shares allotted to it by MGPL.

7.3.2 Company's exposure in JVC activities

a) Loss in contract mining

Even before the incorporation of the JVC, the Company, in order to help MGPL gain contract mining experience, obtained (November 2006) work relating to contract mining from MOIL Limited♥ on nomination basis and subcontracted to MGPL. However, out of the work of eight lakh BCM (Bank Cubic Metre) sub-contracted, MGPL could complete only 1.11 lakh BCM. Further, to facilitate mining experience for the JVC after its incorporation, balance mining work on the contract was allotted to the JVC, but it could execute only 2.14 lakh BCM and the remaining work (out of the balance 6.89 lakh BCM) could be executed in extended time forcing the JVC to outsource the work to a Nagpur based private company at an extra cost of ₹ 1.41 crore. Thus, the solitary mining contract executed by the JVC resulted in a loss.

The reply (June 2010) of the Management that it will try to bring new partners with global standing and with sufficient contract mining exposure is a tacit admission of the fact that the present JVC partner lacked contract mining exposure and global standing.

b) Trading activity by JVC

With no further orders on contract mining, the Company persuaded (January 2008) the JVC into trading of iron ore which was neither one of the objectives of its formation, nor an activity for which it had any previous experience. As per the agreement entered into (January 2008) with the JVC for this purpose the Company was entitled to 3 *per cent* of net profit on the sale of iron ore. Funding for the activity was done by the Company by providing an advance of ₹ 112.61 crore which was repaid with interest during 2008-09. Further, the Company also provided a Corporate Guarantee of ₹ 19.15 crore to the JVC against credit facilities including packing credit and bills discounting which lacked justification considering the fact that the trading activity was funded by the Company and no other major contract was being executed by the JVC. Subsequently, the JVC availed of packing credit of ₹ 13.41 crore of which ₹ 11 crore was misappropriated by a nominee Director of MGPL and incurred forward cover loss of ₹ 18.66 crore. The Company filed (September 2008) a petition in the Company Law Board (CLB) seeking relief from the unauthorized and illegal activities of the nominee Director of the JVC. Thereafter the activities of the JVC came to a standstill (September 2008). After almost ten months, the Company filed (June 2009) a criminal complaint against three Directors (from MGPL) on the Board of JVC alleging manipulation of records. Hearing in the case at CLB was under progress (December 2010). Though the Company recovered the advance of

♥ ***A Central Government Company in the field of mining business.***

₹ 112.61 crore paid to the JVC, with interest, the former spent ₹ 1.52 crore (2007-08 to 2009-10) to meet day-to-day expenses of the JVC not in operation. Justification for such funding of the day-to-day expenses and approvals were not on records produced to Audit.

The Management stated (June 2010) that they were confident that the decision of the CLB would be in their favour and the liability towards packing credit would fall neither on the Company nor the JVC. The Management added that the interests of Company are fully safeguarded as the petition had been filed before CLB, police complaints had been lodged before the Central Crime Station, Hyderabad and private complaints had been filed before the Chief Metropolitan Magistrate, Hyderabad.

However, the fact remained that despite Chairman of the Company being the Chairman of the JVC and three Directors of the Company were on the Board of JVC, they could not ensure (i) establishing of proper internal control procedures to prevent the misappropriation, (ii) immediate lodging of criminal complaint against the delinquent officials and (iii) financial accountability of the JVC for not preparing accounts even for a single year till December 2010.

Thus, failure of the Company to ensure business and financial credentials of the JV partner resulted in unfruitful investment of ₹ 6.94 crore (₹ 5.42 crore equity plus ₹ 1.52 crore maintenance expenses) in the JV Company besides impending threat of invocation of Corporate Guarantee of ₹ 19.15 crore given by the Company to the JVC's banker who has declared the debts as a non-performing asset.

The matter was reported to Ministry (September 2010); reply was awaited (February 2011).

Hindustan Aeronautics Limited

7.4 IT Audit on Implementation of Industrial Finance System with specific thrust on Material Management module

Hindustan Aeronautics Limited implemented Industrial Finance System (IFS) an ERP-package with the objective of implementing uniform procedure and practices, on-line information for decision making, integration and inter-operable systems amongst divisions eliminating isolated islands of automation. A review of IFS implementation with specific thrust on Material Management Module in Engine division, Bangalore and Nashik division was taken up. Delays in implementation were noticed due to absence of Business Process Re-engineering combined with inexperience of the implementer. Flaws in system design, non-mapping of various business processes, non-cleansing of data before migration, absence of validation checks combined with manual interventions resulted in incomplete and unreliable data and further led to non-achievement of the intended benefits as per Project Quality Document.

Introduction

Hindustan Aeronautics Limited, Bangalore (Company) decided (April 2003) to implement Industrial Finance System (IFS), an Enterprise Resource Planning (ERP) package and awarded (June 2004) the contract to Company's joint venture Company viz.

British Aerospace and Hindustan Aeronautics Limited (BAeHAL), with the objectives of facilitating:

- Implementation of uniform procedure and practices,
- On-line information for decision making at the division, complex and corporate level, and
- Integrated and inter-operable system amongst divisions eliminating isolated islands of automation.

The Company planned (June 2004) to implement IFS in all the divisions in phases in 25 months i.e. by July 2006 at a total cost of ₹ 42.30 crore. It was also decided (July 2004) to implement the system initially at three pilot sites[1] by June 2005 and the implementation at other divisions being contingent on the success at these sites.

Organization

The Information Systems (IS) department was headed by Additional General Manager in Nashik Division and Chief Manager in Engine Division, Bangalore, assisted by executives in charge of various modules and system/user Management.

Work order for IFS was issued by Engine Division, in March 2006, where the system run on HP integrity RX 6600 server with Oracle version 10g and the 'go live' was signed in December 2006. In Nashik division, where the system run on IBM p560Q series Server with Oracle 10, the work order was issued in March 2006 and the 'go live' was signed in June 2007.

Scope of Audit

The scope of audit was to review in general the implementation of various modules[2] of IFS with specific thrust on the material management module at Engine Division, Bangalore and Nashik division.

Audit objectives

The objective was to review the performance of IFS in Engine and Nashik divisions with a specific thrust on material management module and to assess the:

- Effectiveness of planning and implementation;
- Effectiveness of general application controls in the system/modules;
- Correct mapping of the business rules of the Company; and
- Integrity, completeness and reliability of data.

Audit criteria

The IS audit was conducted based on the corporate rules, regulations, Government guidelines and the best practices in IT System for control and security.

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[1] Corporate Office, Aircraft and Helicopter division

[2] Financials, customer services and marketing, manufacturing, maintenance and repair/overhaul, payroll, human resources, material management

Audit methodology

IS Audit methodology included:

- Entry conference detailing the scope and expected responses from the Management
- Information collected through questionnaire issued to Management, audit enquiries and requisitions
- Data extraction and analysis from the reports, query and data entry screen using Computer Assisted Audit Techniques
- Exit conference discussing the findings of the IS Audit

During the discussion in the exit conference, the Company emphasized on the challenges involved in IFS implementation owing to the complex nature of its business. The Company however, assured to look into approvals and authorization procedures and take appropriate action on the discrepancies pointed out by Audit.

The implementation at pilot sites was reviewed in 2007 and the discrepancies pointed out were reported in C&AG's Audit Report (Commercial) No.10 of 2008. The action taken by the Ministry/Management on the report is yet to be received from the Ministry.

Audit findings

7.4.1 Implementation issues

7.4.1.1 Poor planning of implementation phases

The Company failed to analyse the feasibility of the project before taking up the implementation and did not carry out any business process re-engineering, thus, depriving the benefits of improving the business processes. Contrary to its decision of implementing in phases based on the success in pilot sites, it was observed that:

- Though implementation at pilot sites was completed with a delay of two years in May 2007, roll out of Phase I and II were ordered in March 2006 and March 2007 respectively and
- Even before completion of work at roll out sites, implementation in 10 other divisions was awarded.

7.4.1.2 Delay in implementation

There was an overall delay exceeding five years in completion of the project and integration at Corporate office was yet to be achieved. The delay was attributed by the implementer to:

- problems in data preparation
- cleansing and migration
- new customization and no re-usability of reports created in earlier implemented sites

The inexperience of the implementer also contributed to the delay as indicated below:

- lack of proper scientific assessment of hardware and software requirements which led to mid-course correction at an additional cost of ₹ 31.01 crore;

- overlooking the future expansions and huge infrastructure requirement;
- poor response of system during peak hours and
- limited traceability, congestion and low reliability of hardware due to very slow back up process.

*7.4.1.3 **Conflict of interest***

It was also noticed that the Company compromised on independence in assessment and selection of ERP package since the implementer was initially appointed as IT consultant and as member of the core group for selection of ERP package. Thus, the implementer's business interest prevailed in the entire process against the good practice of Corporate Governance.

*7.4.1.4 **Data Transformation Services***

Project Quality Document (PQD) provided for a Management Information System (MIS) by utilizing the concept of Information Access Layer[1] using the IFS Data Transformation Services (DTS) tool. The Company could not generate the required reports through the system necessitating hiring the support services of the implementer. This indicated flaws in system design and non-mapping of various business processes. Later, due to problems in report designing through IFS, the MIS for top Management was provided using Oracle business information software (BIS), an external software, incurring additional expenditure of ₹ 0.11 crore. Thus, the information is still transferred outside IFS and consolidated involving manual intervention with risk of inaccuracy of information, time lag and also consuming considerable man hours. Further, the project management, a tool for the Management to watch the progress, delays and reasons attributable to such delays, was yet to be implemented.

*7.4.1.5 **Benefits as envisaged in Project Quality Document***

Though the user requirements were reviewed and included in the PQD, the Company failed to insist on the implementer to create the agreed outputs before signing the go live[2]/handholding[3] certificates. These lapses resulted in the non-achievement of the following illustrated benefits as envisaged in the PQD:

- On line information for purchase processes, costing, material accounting, price lists, advance tracking, job progress and notification of changes in production plan;
- Alerts for delay in delivery, work order completion etc.;
- Alerts on stock outs, non moving items, life expiry items;
- On line generation of Trial Balance, Profit & Loss Account and Balance Sheet;

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[1] A storehouse for the processed transaction data of each division

[2] Go-live was defined as the date when HAL users begin to use IFS System with live data.

[3] Successful handover would take place after completing handholding period from date of IFS Go Live. During the handholding phase, BAeHAL was responsible for ensuring printing reports run smoothly and no transactions were held up in IFS due to the system itself before a successful hand over takes place.

- Budget monitoring and performances; and
- Automatic adjustment of allowances, TDS deduction and accounting, depreciation calculation with updation of fixed assets ledger.

The Management replied (October 2010) that in the absence of experienced implementer in the country and the Company being the only Aerospace Industry in the country, the Joint Venture was resorted to where British Aerospace (BAe) who had domain knowledge was one of the JV partner.

The reply was not convincing as even after a lapse of five years and with investment of ₹ 73 crore on ERP implementation, the envisaged objectives of integration and self reliance were yet to be achieved.

Recommendation

Ensure complete implementation in all respects as per PQD and periodically review the time frame of action for implementation of IFS

7.4.2 Non utilisation/implementation of modules

It was observed that the implementation was partial and several features available in the system were neither enabled nor utilized due to non mapping of the general business practices into the system as envisaged in the PQD as detailed below:

- Implementation of Financials and Human Resources (HR) modules was partial and certain sub modules such as attendance, overtime and incentive were not implemented.
- In the absence of automatic flow of information from payroll and attendance on labour bookings, the system could not generate cost ledger automatically.
- Due to non-linking of Bill of Material (BOM) with the material drawn from Indian Air Force (IAF) the related Sales invoices could not be raised directly.
- Service tax was not mapped in the system.
- Non automation of procedures in respect of transfer of inspected materials into inventory, Liquidated Damages (LD) calculation, adjustments of advances/liabilities, etc., necessitated manual interventions.
- A referential price list using historical data was not maintained in the system to help users while preparing quotations for purchases.
- Non issue of Material gate pass (MGP) through the system necessitated manual intervention and resulted in non updation of the movement status as under transit even after delivery.
- Data analysis showed that 14287 materials continued to be shown as 'under despatch' for a period ranging from 9 days to 763 days as on 20 May 2010.
- It was also noticed during certification audit that two major items valued ₹ 1.60 crore, moved out of the Engine division were incorrectly included as closing stock in the financial accounts for the period 2009-10.

The Company (October 2010) accepted the facts and stated that periodic review of the system would be undertaken. It further stated that sales invoicing and transfer of inspected inventory were now being automated.

However it was observed that the action taken was incomplete and manual intervention still existed in transfer of material after inspection. It is suggested that automatic recording of the movement of materials through the system may be enabled to ensure non-occurrence of such incidents affecting financial accounts.

Recommendation

Ensure complete implementation and proper utilization of automated features

7.4.3 General controls

Following deficiencies in general controls were noticed:

7.4.3.1 IT Policy and Security Policy

Though the Company adheres to the IT plan approved by the Board in 2001 for IT implementation strategies, the Company had not formulated and documented IT Policy including IT Security Policy, which were very critical.

The Management stated (October 2010) that the draft IT Security Policy was under finalisation.

7.4.3.2 Business Continuity Plan and Disaster Recovery Plan

The Disaster Recovery (DR) site of Engine division was located within the factory complex and was subject to same vulnerability of loss of operations as of original server. No DR site existed for Nashik division. Thus, the risk of disruption of the business continuity in the event of disaster still existed.

The Management stated (October 2010) that a Data Centre would be established at a geographically different location and on completion, the offsite DR site would also be planned.

7.4.3.3 Change Management

Despite the audit recommendations in the Audit Report Commercial No.10 of 2008, the Company was yet to initiate action to acquire the source code and continued to depend on the implementer for changes to be carried out in the system. At the divisional level, only operational issues were being handled based on user requests. Further more, the changes made in the system were not documented and in the absence of which, the audit trail of problems and solutions relating to implementation was absent. The risk of unauthorized changes and continued dependence on selected individuals existed.

The Nashik division agreed (June 2010) to record user requests and the action taken on it. Management stated (October 2010) that source code was proprietary of IFS and the implementer would not share the information with the Company.

However it is suggested that a third party escrow account for the source code, which would serve in the event of any threat or discontinuance of support from implementer may be explored.

7.4.3.4 Physical and logical access controls

It was noticed that:

- Due to insufficient storage capacity, the logs of physical access control system (CCTV) were maintained only for 5 days. Thus the logs could not be used for review of damage to the system due to lapse in physical access controls beyond the backup period.

The Management stated (October 2010) that permanent backup of log as suggested with regular monitoring would be examined.

- The changes in roles of users necessitated due to change in incumbency were done by rewriting the earlier identity. However, it was observed that no logs of creation and deletion of user ids were maintained in the system for audit trail. The logs of successful/unsuccessful attempts to user's account were also not being maintained.

The Management has since initiated (October 2010) action to maintain the logs.

- Various stages of placement of purchase orders (PO) such as 'planning, release, approval' and arrival/receipt of material were authorized with same user id in 5907 POs out of 6610 POs issued during 2009-10 indicating absence of proper segregation of duties. This lack of preventive controls required for authorizing the transactions increased the risk of errors remaining undetected.

The Nashik division replied (June 2010) that on making amendment to POs during material receipt would result in display of same identity at all stages and assured of necessary corrective steps.

The reply indicated flaws in the system design and this discrepancy needed to be rectified. The Management (October 2010) further assured to exploit the utilization of on line features.

- The instructions regarding the password policy were not enforced through the system. Thus the risk of gaining un-authorised access to system data could not be ruled out.

The Management (October 2010) assured to review the system.

Recommendations

- ***Formulate IT Policy and Security Policy and establish DR site at the earliest.***
- ***Obtain the customized source code or explore the possibility of an escrow account.***
- ***Create permanent backup of the log.***
- ***Incorporate proper segregation of duties at all levels through the system.***

7.4.4 System design/customization deficiencies

As per the Accounting Policy of the Company, the finished goods were to be valued at cost or net realizable value, which ever is lower. However, due to non-configuration of Fixed Price Quotation (FPQ) prices in the system, the finished products were being valued based on the weighted average rate without correlating to the realizable value.

This resulted in overvaluation of inventory and overstatement of profit as on 31 March 2010 by ₹ 4.52 crore.

The Management stated (October 2010) that such flaws in the valuation had since been corrected.

However, since only accounting entries were corrected, the system design remained to be corrected in consonance with the Accounting Standard/Accounting policy.

Recommendation

Ensure valuation of Inventory as per Accounting Policy

7.4.5 Relational Integrity

The relational integrity between two related data should ensure automatic updation of the changes made in the corresponding data. Instances where relational integrity was not ensured are discussed below:

7.4.5.1 Status of Purchase Orders

After completion of inspection/ acceptance of the received materials and payment, the PO should be closed in the system. Data analysis, however, showed that the status of 1876 items relating to 348 POs issued by Engine division during 2009-10 was displayed as 'items received' even after acceptance of all materials ordered therein and payment thereon. The age-wise analysis of such POs revealed that 157 POs were in the 'received status' for more than four months to one year and 141 POs were more than one year.

Hence, the system required to be configured to change the status of PO in relation to the change of status corresponding to RR and payments.

The Management (October 2010) replied that the relational integrity was ensured in the system.

The reply of the Company could not be accepted in the light of the facts mentioned above and the need for review of the system is reiterated.

7.4.5.2 Goods in Transit

It was observed that even after inspection, acceptance, finalization of RR and consumption of the materials, materials valued at ₹ 3.31 crore were still shown under Goods in Transit (GIT) resulting in overstatement of GIT, evidencing lack of relational integrity between material management and financials modules. Necessary corrective action was carried out by Engine division during certification audit of 2009-10.

The Management attributed (October 2010) the error to migration issues and further stated that the same had been rectified.

Necessary controls in the system have to be employed to automatically update the status of the material from GIT to inventory for smooth work flow automation.

7.4.5.3 Customer Orders and Sales Orders

- The customer orders fed in the system had to be approved and after approval only further relating processes such as creation of work orders, sales order and commencement of production process were to be carried out. However, it was observed that 30232 customer orders of Nashik division pertaining to 2009-10 were not approved through the system even though their status was indicated as closed. Thus, the processing of the orders was allowed by the system without proper initial authorization through the system and indicated manual intervention in this regard.

The division agreed (June 2010) that the approval was not part of the customer order cycle. However, a necessary system check for authorization was essential for future scope of work flow automation.

- Status of the orders were being indicated as 'released', 'delivered', 'closed' etc against the respective orders in the system. A comparison of the status of sale orders with the corresponding customer orders in respect of 1725 cases out of 10381 pertaining to Nashik division of the period 2009-10, showed that the status indicated were different. This indicated absence of integration between the orders through the system.

The Management stated (October 2010) that the necessary corrections were being carried out. However, necessary inbuilt controls in the system were required to be provided.

7.4.5.4 Production Orders

It was noticed that the processing status of work order was displayed as 'started' even before release of such order. This indicated system allowing processing of the work orders before authorizing the same through the system.

Management agreed (October 2010) that necessary checks would be employed to avoid such occurrences in future.

Recommendation

Ensure work flow automation and relational integrity of the data stored in the system by employing appropriate controls in the system

7.4.6 Referential integrity

Referential integrity is a database concept that ensures that relationships between tables remain consistent and changes made to the linked table are reflected in the primary table.

7.4.6.1 Receipt of materials in excess of tolerance limit

The ordered quantity in PO and receipt quantity in Receiving Report (RR) needs to have referential integrity between them. The allowable tolerance level of excess/shortage in measurement of each material depending upon factors such as minimum order level, weights, etc. were also required to be considered while incorporating the referential integrity of these two related items. However, data analysis showed that the receipt quantity as per RR in 2543 cases out of 3409 cases relating to Engine division for the period 2009-10 exceeded the ordered quantity specified against the corresponding PO beyond the tolerance level of 10 *per cent.*

The Management replied (October 2010) that receipt quantity depends on the tolerance level, excess supplies and the receipt quantity should reflect actual receipts.

However, it was insisted that since receiving materials in excess of the tolerance level of the ordered quantity required higher approvals, appropriate authorization should be incorporated in the system.

7.4.6.2 Excess purchase of materials

The Engine division initiates the procurement activity based on the confirmed orders received from customer for carrying out the Repair and Over Haul (ROH) jobs of various engines. Since the customer order details were not fed into the system, the Material Procurement Request (MPR) was not linked to the quantity specified in these orders resulting in lack of control on the quantity in MPR and PO with that of the customer requirement. Thus, due to absence of proper in built control, the system allowed excess procurement over and above the actual task/requirement for Artouste engines during 2006-2009 by incurring an additional expenditure of ₹ 5.85 crore.

The Management stated (October 2010) that the procurement activity was initiated based on forecasted orders and that there were changes in the actual/firm orders and that the extra procurement had to be utilized against future orders.

However, it was insisted that immediate corrective measures may be taken through built in controls in the system.

Recommendation

Ensure referential integrity to avoid the risk of incorrect data being processed and accounted.

7.4.7 Non mapping of business rules

7.4.7.1 Preparation of Financial Accounts

- As pointed out in the Audit Report Commercial No.10 of 2008, the system was used to derive trial balance and these values were manually fed to generate balance sheet as per the Company's format, due to non availability of facility in the system for grouping the details as required by the Company. Even though this aspect was envisaged during PQD and included in the expected benefits from IFS implementation, failure to configure the system for online generation of balance sheet resulted in manual intervention in the key area with risk of manual errors and manipulations.

The Management accepted (October 2010) the observation in principle.

- Contrary to the Company's accounting policy on depreciation where in the fixed assets were to be depreciated to one rupee as net value, due to non-mapping of the accounting policy into the system, it allowed assets with zero residual value.

7.4.7.2 Accounting of transfer of stock

As per the accounting instruction on 'accounting of inter-divisional transactions', the materials received from inter divisions, were to be accounted based on delivery and acceptance of the main equipment (aircraft/helicopter). Accordingly, the engines delivered through inter division transfer orders, were accounted as 'stock in trade' (SIT) in Engine division till the aircraft/helicopter were delivered to the customer. However, engines accounted in financial module under 'SIT' were shown as 'delivered' in material management module. Thus, SIT could not automatically flow from the system evidencing non-integration of two related modules, resulting in passing of manual entries.

The Management assured (October 2010) to incorporate this process in the system.

Recommendation

Map the Business Rules in the System to indicate the status in consonance with the accounting instructions to avoid manual intervention establish integration amongst divisions for proper flow of SIT.

7.4.8 Data migration

7.4.8.1 Migration error

The Materials valued at ₹ 36.25 crore issued to production/work orders were migrated as inventory and to that extent material consumption was not accounted during the year 2007-08. On being pointed out in accounts audit for the year 2007-08, Company passed necessary adjustments in the accounts.

7.4.8.2 Non-cleansing of data

- The comparison of data on long outstanding liabilities towards procurement in Engine division with the actual PO files revealed that there was no actual liability for an amount of ₹ 3.31 crore. The outstanding liability was displayed due to improper cleansing of data, partial upload/ non availability of payment details, non feeding of details of rejected materials, non matching of payments with receipt details, non-adjustment of advances and LC payments, non-clearance of exchange rate variations during migration etc.

On being pointed out by audit, rectification entries were passed in the accounts of 2009-10.

- Examination of accumulated provision for doubtful claims receivable from vendors (old GIT) of ₹17.55 crore in Nashik division revealed that the provision was created to clear old uploaded data wrongly shown under GIT even after receipt, acceptance and settlement of claims of materials during migration.

The Management agreed to review the same during 2010-11.

Thus non-cleansing of data before migration to IFS system resulted in overstatement of assets and liabilities and fictitious charging of provision to Profit & Loss account affecting the profitability of the division. Management assured (October 2010) to take up data cleansing.

Recommendation

Review the migrated data and initiate appropriate action for data cleansing.

7.4.9 Input controls

7.4.9.1 Incomplete data

- The system accepted data input without value or rate against 282 items out of 15815 items pertaining to POs issued by Engine division for the year 2009-10. Further analysis revealed that in 14 items, though rate was shown as zero, the value was available indicating absence of input controls to ensure complete and accurate data.

The Management attributed (October 2010) the error due to formatting of downloaded data.

The reply was not acceptable as the data was directly taken from the IFS. Hence action was required to be taken by the Management to arrest such occurrences.

- In the absence of range check or reference check, system accepted manual data entry of a higher number* under exchange rate for Euro.

The Management related (October 2010) the issue to typographical error and stated that at the time of P.O. generation system recognizes current exchange rate only.

However, system has to be equipped with such control to disallow such incorrect inputs.

7.4.9.2 Stock levels and Material classification

The system accepted blank/zero quantity against safety stock, re order point, minimum and maximum lot size to be produced in the production planning details in respect of 180344 items of Engine division. It was further noticed that system indicated manual control over the planning in respect of safety stock and ordering point etc. In the absence of such details in the system, system based inventory control could not be established.

Further, it was noticed that duplicate ABC classification existed in respect of two materials with same part number and same material codes (534) had been allotted to different materials (1712) with different material description ranging from 2 to 34. Thus, due to non-mapping of system requirements, no ABC classification rules had been incorporated into the system to ensure proper procurement planning process.

The Management stated (October 2010) that due to nature of business of the Company, such parameters were being considered on case to case basis and hence not enforced in the system.

The reply could not be accepted since the business processes could have been mapped into the system for better decision-making through system.

Recommendation

- ***Configure the system to automatically relate the exchange rate with the master table and ensure correct updation of exchange rate master table***
- ***Incorporate proper input controls to ensure complete and correct data***

7.4.10 Validation checks

7.4.10.1 Vendor Master and material codes

- The System allowed entry of duplicate vendor codes for the same vendors in same location in Engine division with the risk of irregularity in placement of orders and corresponding follow up of payments.

The Management noted (October 2010) the observation for compliance.

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* *674,625.0000*

- Duplicate part number even against engines and blank part number were observed due to absence of proper validation checks required to ensure non blank, unique and feeding of valid data in vital fields.

The reply of the Management (October 2010) that inventory part master did not allow any duplicates/blank part numbers was not tenable as the actual data observed in the system by audit was commented upon.

- There was no uniformity in the pattern of codification of part numbers, resulting in difficulty in differentiating engines from spares/part of the engines. In the absence of uniformity in codification of part numbers, analyzing the stock for proper planning and status reporting would be difficult.

The Management stated (October 2010) that part numbers provided by the licensors were being used.

Reply was not acceptable as uniformity should be ensured in system for easy access.

7.4.10.2 Material Procurement Requests

- System permitted creation of 698 POs valuing ₹ 17129.04 crore during 2007-10 in Engine division without the Material Procurement Requests (MPR) i.e. without validation checks in this regard.

The Management stated (October 2010) that these were dummy POs created based on Hawk contract.

It was suggested that in respect of POs created based on any contract should have the corresponding reference.

- The lack of validation checks on dates and non employing of specific date format, allowed input of PO date earlier to MPR date, PO date later to delivery due date and even later to the receiving report date (2492 cases out of 22128). Also 'invalid date time' was observed as displayed under inspection offer date of production planning, while the date of entry of the customer enquiry into the system was shown as earlier to the customer enquiry date itself.

The Management assured (October 2010) to review the cases.

7.4.10.3 Inspection of materials

It was observed that the date of inspection was earlier to that of 'offered for inspection' date, date of 'offered to stores' was earlier to date of approval of charges, date of shifting to store was earlier to date offered to stores in 7 out of 42 RRs of Engine division of April 2009.

The Management stated (October 2010) that these date columns were only for internal monitoring purposes.

It was reiterated that such validation checks with regard to dates would ensure better internal monitoring.

7.4.10.4 Fixed Price Quotations

The prices of the products/supplies for repair and overhaul jobs undertaken by HAL to IAF and Army were governed by the FPQ with effect from 01 April 1995. Though the

FPQ prices were captured into the system, it was not linked with procurement cost. It was observed that the purchase price was more than agreed FPQ, resulting in under recovery of ₹ 8.46 crore in various Artouste engines parts procurement and this prevailed continuously from 2006-07. Thus, in the absence of such validation, the system could not be effectively used to monitor the procurement cost against the corresponding realizable FPQ prices for initiating timely action to take up the cost escalation with the customer.

The Management assured (October 2010) to explore the linking of FPQ and purchase prices.

Recommendations

- ***Ensure integration of FPQ prices with purchases***
- ***In built controls to authorize PO Process with necessary forewarning***
- ***Avoid duplicate /non-blank entries and ensure relevant controls over date columns***
- ***Avoid manual intervention and duplication of work in all modules.***

7.4.11 Integration between Material Management and Financials modules

Due to non-integration of material management module with financials module automatic cost could not be arrived at, resulting in manual interventions and abnormal variation in cost booking, thereby, the data could not be relied upon. As observed in Nashik division, since the system was not configured to allocate proportionately the entire cost of materials towards the delivery of two Sukhoi aircraft during 2008-09, there was unrealistic and unjustifiable material cost booking against these two aircrafts. Further, wide variation in material consumption for identical production evidencing irregular material cost booking was observed wherein the material cost booked for one aircraft was at ₹ 98.24 crore and while the other was at ₹ 48.59 crore.

The Management assured (October 2010) to employ strict control on issue of materials against correct work orders.

Recommendation

Ensure complete integration of relevant modules

Conclusion

The major objectives of implementing ERP envisaged in the PQD were reduction in cost of production, reduction in inventory levels, reduction in cycle time, reduction in stock outs, improved on-time deliveries/services, increased manpower productivity, on-line information availability for quick decision making.

However, failure on the part of the Company to ensure complete mapping of business rules and control designing resulted in non-integration of modules, dependence on legacy system and other utilities, manual intervention and duplication of work. Further, due to the lack of input, validation and proper supervisory controls over the input and processing of transactions, the system is prone to entry of incomplete, redundant, irrelevant and unauthorized data. Thus, the very objective of work automation from implementation of ERP system is defeated and the desired objectives could not be achieved.

The matter was reported to the Ministry in June 2010; reply was awaited (February 2011).

7.5 Setting up dedicated manufacturing facilities without firm commitment

The decision of the Company to set up dedicated facilities for undertaking export orders without firm commitment or equity participation with P&WC was injudicious, resulting in blocking up of funds to the tune of ₹ 53.57 crore and infructuous expenditure to the tune of ₹ 46.97 crore.

Pratt & Whitney, Canada (P&WC), the manufacturer of Aero-Engines, expressed their interest (February 2006) for outsourcing critical rotating components[♣] to Sukhoi Engine Division, Koraput (the Division) of Hindustan Aeronautics Limited (Company). The Division agreed (July 2006) to manufacture these components by setting up of dedicated facilities and for undertaking export orders to P&WC. The Board approved (September 2006) the above proposal and sanctioned ₹ 74.99 crore towards capital commitment for procurement of machines.

The proposal inter-alia envisaged that:-

- the project would generate an export sale of ₹ 2234.45 crore (US$ 507.83 million) and a profit of ₹ 278.42 crore (US $ 63.28 million) over a period of ten years with a margin of 14 *per cent*, commencing from 2008-09 to 2017-18;
- the prices of these components would be valid for an initial period of three years;
- the Division was to procure the machines from the sources designated by P&WC to ensure quality and conformity with the proven parameters; and
- man power requirement would be around 152 personnel for execution of the export order.

Consequently, the Division entered into a Long Term Purchase Agreement (Agreement) with P&WC (February/ March 2007). Thereafter, the Division initiated procurement action from the sources designated by P&WC for imported machines worth ₹ 71.75 crore. However, the Division did not ensure that the investment in the project was either shared by P&WC, so that P&WC had stake in the project or there was firm commitment from P&WC for export orders so that the investment was recovered. The Agreement contained a clause for cancellation of orders by P&WC and payment for inventory and work-in-progress but not recovery for investment.

During July 2009, that is, after 27 months from the date of signing agreement, P&WC cancelled the orders placed on the Division on the pretext that their personnel were not comfortable with regard to manufacturing of critical rotating parts outside their direct supervision and the sustained concerns of their senior Management regarding their personnel security.

[♣] ***Turbine Discs (51 numbers), Compressor Discs (13 numbers) & Compressor Hubs (10 numbers) of Aero – Engines.***

As of 31 March 2010, the Division had procured all the machines/equipments required for dedicated facilities worth ₹ 88.79 crore[1] and these were installed and commissioned, except two machines valuing ₹ 21.74 crore. The Division apart from transferring 48 personnel to this project also recruited 46 personnel and incurred ₹ 35.02 crore towards manpower cost. The Division also incurred ₹ 11.95 crore towards interest on borrowed funds. By the time, the order was cancelled, 17 components were ready for trial operations.

Subsequently, the Division preferred a claim (May 2010) of ₹ 125.44 crore towards compensation for canceling the order. P&WC, however, did not respond to the claim. Consequent upon cancellation of order, eight CNC machines and one Broaching machine procured at ₹ 35.22 crore were being diverted to SU-30 project and the balance equipments including tooling, consumables and spares worth ₹ 53.57 crore were lying idle. Audit observed that the Division did not include a clause in the agreement that in case of cancellation of order there would be payment of compensation by PW&C to safeguard the Company's interests.

The Management in its reply (September 2010) contended that the facilities set up for P&WC were of general purpose and these would be used for all future programs; hence Division neither obtained any advance payment nor any financial commitment for these capital expenses from P&WC.

The contention of the Management was not convincing in view of the fact that dedicated facilities were created for undertaking export orders to P&WC and later these have become redundant.

Thus, the decision of the Company to set up dedicated facilities for undertaking export orders without firm commitment or equity participation by P&WC was injudicious which resulted in blocking up of funds to the tune of ₹ 53.57 crore and infructuous expenditure to the tune of ₹ 46.97 crore[2] till end of October 2010.

The matter was reported to the Ministry in September 2010; reply was awaited (February 2011).

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[1] ***Imported machinery ₹71.75 crore; indigenous equipment ₹6.10 crore; Tools costing ₹8.54 crore; and Consumables & Spares ₹2.40 crore.***

[2] ***Manpower cost- ₹35.02 crore; Interest cost on borrowed funds- ₹11.95 crore.***

CHAPTER VIII: DEPARTMENT OF FERTILIZERS

National Fertilizers Limited

8.1 Marketing of products

Introduction

National Fertilizers Limited (Company) incorporated in 1974 had an annual installed production capacity of 32.30 lakh metric tonne (MT) of urea as on 31 March 2010 in its five production units located at Nangal, Panipat, Bhatinda and two at Vijaipur. The Company ranked as the second largest producer of urea in the country with a market share of 16.8 *per cent* of total urea production. Turnover and profit of the Company were ₹ 5091 crore and ₹ 259 crore respectively for the year 2009-10.

Marketing Operations

Marketing of fertilizers is looked after by the Central Marketing Office (CMO) of the Company. The CMO co-ordinates and oversees sale of fertilizers through its wide marketing set up of three Zonal offices at Chandigarh, Bhopal and Lucknow which cover the 15 States of Northern and Western India. Under the Zonal Offices there are State Offices, Area Offices and District Offices.

The Company's main product is Nitrogenous fertilizer i.e. urea. It also produces Industrial Products viz. Methanol, Ammonium Nitrate, Nitric Acid etc. and trades in other nutrient fertilizers namely Muriate of Potash. The Company sold 33.77 lakh MT of urea during 2009-10. Dispatch of fertilizers is made by the units as per movement plan given by Department of Fertilizers and the requirement of States. The Company marketed its products in 2009-10 through a combination of private dealers (77.10 *per cent*) and institutional buyers (22.90 *per cent*).

Audit objectives

The study was conducted to examine whether:

- marketing/sales functions were carried out with economy, efficiency, and marketing/sales cost was contained within the norms fixed by Fertilizers Industry Co-ordination Committee; and
- marketing operations like handling and transportation, warehousing, dealers' appointment and functioning were carried out as per the prescribed policies of the Government of India and in terms of Marketing Manual.

Scope of audit

Audit test checked the marketing operations of the Company involving handling and transportation of urea, warehousing, functioning of dealers and pricing scheme for grant of subsidy for the last three years upto 2009-10. Checking of the entire operations of CMO and functioning of 505 out of 5063 dealers and 33 out of 335 handling and transportation contracts of Chandigarh, Bhopal and Lucknow Zonal offices were carried out. Audit was conducted during the period 21 April 2010 to 31 May 2010 and 12 July 2010 to 30 July 2010.

Audit findings

The Company through its extensive network had achieved sales at 100 *per cent* of its installed capacity. The Company could improve its performance and achieve better results by taking corrective action on the audit findings discussed in the succeeding paragraphs:

8.1.1 Marketing/sales functions: Efficiency and cost effectiveness:

8.1.1.1 Under recovery of marketing cost

As per New Pricing Scheme of Fertilizers Industry Co-ordination Committee (FICC), effective from 1 October 2006, selling expenses were reimbursed subject to a ceiling of ₹ 138 per MT for eighth pricing period. Audit observed (March 2010) that the Company's marketing expenses ranged between ₹ 151.94 and ₹ 155.82 per MT on sale of urea during 2007-08 to 2009-10 against the FICC norms of ₹ 138 per MT at which it could get re-imbursement. An analysis of the marketing expenses on sale of urea revealed that increase in rake handling expenses by 6.6 *per cent* and 5.5 *per cent* during 2008-09 and 2009-10 and increase in warehouse handling expenditure by 7.16 *per cent* during 2008-09 as compared to 2007-08 contributed to the increase in marketing expenses.

Thus, failure of the Management to monitor and control operational expenses during 2007-08 to 2009-10 resulted in under recovery of ₹ 15.04 crore on dispatch of 99.42 lakh MT urea.

The Management stated (June 2010) that the increase was on account of increase in salary and wages and that operational expenditure was regularly monitored and efforts were made to optimize the expenditure. Also marketing cost re-imbursement was fixed in the year 1997 and was not revised since then.

The Management's reply is not convincing as there was under recovery of actual marketing expenses to the extent of ₹ 15.04 crore even after excluding non-controllable expenditure of salary and wages (Basic, Dearness Allowance, City Compensatory Allowance, House Rent Allowance and Provident Fund) which are claimed separately as a part of retention price. Thus, inefficiency in control of marketing expenses led to non-containment of the same within the FICC norms. Further, the marketing cost re-imbursement rate was based on the cost data of 1999-2000 and not 1997 as stated in the reply.

8.1.1.2 Unviable import of Muriate of Potash

With a view to strengthen its product line by transforming from single product to multi products, the Company decided to procure Muriate of Potash (MOP) for the Rabi season 2009-10. MOP is also covered under Fertilizer Monitoring System (FMS) and its movement is determined on a monthly basis. The proposed quantity of 50,000 MT MOP was to be procured at Kandla Port through two vessels of 25,000 MT each. The Company adjudged timely arrival of material during October 2009 as crucial while issuing NIT. Delay in receipt of material at port beyond October 2009 was not to be compromised. Accordingly the Company imported 61115.73 MT of MOP in two vessels at Kandla port during October and November 2009 and the entire stock was distributed from the port itself by rail/road during October 2009 to February 2010. The Company sustained a loss of ₹ 86 lakh against the projected gain of ₹ 122 lakh i.e. ₹ 244/PMT.

Scrutiny of records revealed that decision of the Company to import MOP was not prudent as normative interest income on the unavailed credit period was treated as operative income while projecting gain. Also delay in imports resulted in carrying over, cost of unsold inventory beyond November because requirement of MOP was largely in October/November in the major part of Northern India.

The Management stated that the total profit earned was about ₹ 2.07 crore including the exchange rate benefit of ₹ 1.60 crore and remaining was operating profit. The Management's reply was not acceptable as the above profit also included ₹ 1.33 crore as prepayment discount which did not form part of operative income. Thus, Management's lapse in not evaluating the profitability based on prudent financial practice resulted in a loss of ₹ 86 lakh. The Management further added that the entire stock was marketed across the country during 2009-10 depending on geographical need. The Management's reply was not acceptable because the major demand of MOP in North India was in October/November, whereas the same could be disbursed completely only by February 2010.

8.1.1.3 Extra expenditure due to change in sales terms

At the start of a season (Kharif/Rabi), standard sales terms covering dealer's margin, payment terms, cash rebate, interest on delayed payment, security and secondary freight for sale of urea are communicated by CMO to all the Zones. Within these standard terms, the field offices send proposals for sales terms, for sale of urea to private traders and institutional traders of different states under each zone for a particular month for approval by the competent authority for that month only. A test check of records for sales to private dealers and institutional dealers for both 'Rabi and Kharif' seasons during 2007-08 to 2009-10 revealed that:

- Ex-post facto approval was accorded to Markfed in Chattisgarh State for allowing average credit period of 110 days instead of the earlier approved average credit period of 60 days. This was beyond the approved parameters of credit period for institutions resulting in excess financial burden of ₹ 25.62 lakh on sale of 30,050 MT urea. Further, Markfed, Chattisgarh was allowed higher credit period of 105 days during March 2009 on sale of 15,000 MT of urea, resulting in extra expenditure of ₹ 23.04 lakh.
- As against the sales terms of urea to institutions (April 2009) for the States of Haryana, Rajasthan, Himachal, Jammu & Kashmir during Kharif 2009, the Company allowed handling charges, special rebate, storage charges, freight and cash rebate for Kharif 2009 to Hafed in Haryana State. This resulted in extra expenditure of ₹ 67.08 lakh.

The Management stated that proposals for changes in sales terms were given ex-post facto approval by the highest authority in order to increase sales.

The Management's reply is not acceptable as changes in sales terms were made frequently in violation of approved parameters and it did not result in increase in sale of urea during the year.

Thus, offering better sales terms beyond the approved parameters caused extra financial burden to the Company amounting to ₹ 115.74 lakhs without any increase in sales.

Recommendation
The Company should ensure that the standard sales terms parameters for each season are complied with and frequent amendments to the same are avoided.

8.1.1.4 Sale of industrial products below cost of production

The Company produces and sells Industrial Products (IP) which are cost plus items like Methanol, Ammonium Nitrate, Nitric acid etc. Products like Liquid Oxygen, Liquid Nitrogen and Sulphur do not have a cost of production and are by-products, which are also marketed. The cost plus items are sold against the parameters falling within the price range as approved from time to time. For some products annual contracts are drawn up for the sale of quantity produced like Sulphur, Liquid Carbon-dioxide etc. Prices of industrial products are generally fixed for a certain period comprising six to nine months which are reviewed quarterly in view of frequent changes in the market rates of the products. Audit observed that products like Ammonium Nitrate (Lumps), Ammonium Nitrate (Melt), Methanol, off grade Methanol and Nitric Acid (60 *per cent* for distant market) were marketed at a rate which was below the cost of production of these products.

Thus, the Company sustained a loss of ₹ 7.06 crore on sale of 19,266 MT of Ammonium Nitrate (Lumps) (₹ 4.42 crore), 2710 MT of Ammonium Nitrate (Melt) (₹ 0.68 crore) and 30,969 MT of Nitric Acid (60 *per cent*) (₹ 1.96 crore) during 2007-08 to 2009-10.

The Management stated that the cost of production of IP products was considerably high due to higher fixed cost but there was positive contribution. Further, after changeover of feedstock from oil to gas, production of all IP products would be discontinued except Nitric Acid, Ammonium Nitrate (Lumps and Melt) and Sodium Nitrate/Nitrite.

The Management's reply is not acceptable as the Company had to reduce selling price of IPs in order to compete with stiff competition from low cost producers in the market. Hence, the Company was unable to realise full cost of production and incurred a loss of ₹ 7.06 crore.

8.1.2 Marketing operations:

8.1.2.1 Grant of credit in excess of credit limits

As per clause 6.5 of Marketing Manual one time maximum credit limit for each dealer is fixed as per laid down procedure. The sales terms for urea specify that material would be supplied against cash payments or 100 *per cent* secured credit limits only. Security can be either a bank guarantee or demand draft. Scrutiny of records relating to Lucknow, Bhopal and Chandigarh Zones of the Company for the months of March 2009, August 2009 and January 2010 revealed that the Company allowed excess credit to 27 parties resulting in an outstanding amount of ₹ 1.79 crore, out of which ₹ 1.17 crore could not be recovered as these cases were sub-judice. The Company not only allowed credit to the parties in excess of their credit limits but also allowed credit to the parties who had not provided any bank guarantee or Central Stockist Scheme security.

The Management while accepting the facts replied (June 2010) that excess credit was sometimes allowed to the parties when urea rakes were placed at the end of the month for disposal/sale of urea to dealers from the rake point itself.

The Management's reply is not convincing as excess credit granted without any security resulted in blocking of ₹ 1.17 crore.

8.1.2.2 Expenditure on secondary freight

The Government of India, Department of Fertilizers, introduced (July 2008) a new "Policy for Uniform freight subsidy" on all fertilizers under the New Pricing Scheme Stage III, to be implemented retrospectively w.e.f. 1 April 2008, under which secondary freight as admissible under the old scheme was discontinued. A review of freight subsidy revealed that the Company incurred secondary freight expenditure of ₹ 8.34 crore which was allowed to 1396 out of 1603 dealers during 2008-09 (July 2008 onwards) and to 692 out of 1893 dealers during 2009-10, for which no subsidy was allowed as per the New Policy of Uniform Freight Subsidy. Approval of the field unit proposals for retaining the secondary freight element in the sales terms in violation of new policy guidelines resulted in non-recovery of ₹ 8.34 crore.

The Management stated that secondary freight was allowed to avoid inventory-carrying cost due to limited availability of storage capacity at railheads and efforts were made to reduce the secondary freight.

The Management's reply is not acceptable as the secondary freight allowed was in contravention of Government's new policy for uniform freight subsidy.

8.1.2.3 Irregularities in appointing handling and transportation contractors

Handling and transportation are important elements of marketing operations to ensure fertilizers are made available at consuming centers in time. Material is moved either by road from production units, or by rakes up to rake point and subsequently by road. To move the material from rake points within the stipulated time allowed by the Railways, the Company appoints handling and transportation (H&T) contractors at rake points/storage points in the marketing territory of the Company. Scrutiny of H&T contracts of Chandigarh and Bhopal Zones for the years 2007-08 to 2009-10 revealed the following irregularities:

- As per the new uniform freight policy, movement of material as per the least cost module only was re-imburseable. Audit observed that there were deviations from the least cost module resulting in movement of 56,082 MT of urea at extra freight expenditure of ₹ 31.67 lakh during 2009-10. The Management accepted that least cost module could not be followed strictly due to certain constraints for which all the fertilizer Companies had submitted their freight data for arriving at normative lead distance and PMT freight rate.
- In eight contracts, the quantity of urea as per the movement plan proposed for award of handling and transportation was more than the actual quantity handled by H&T contractors, which resulted in less handling of urea by H&T contractors ranging between 23 *per cent* and 84 *per cent*. Thus, fixing of higher movement quantities of urea, than actually being handled, resulted in diminishing competition among H&T contactors as those who were capable of handling lesser quantities had not quoted in these cases. This resulted in extending favours to

certain contractors who could handle higher quantities, as it was observed in audit that bidding was done by same contractors every year.

- Review of 37 H&T contracts in Chandigarh Zone revealed that more than 10 *per cent* of the contracts were awarded on a single tender basis and the same were renewed for two to three years without inviting fresh tenders.
- Review of award of H&T contracts in two zones (Chandigarh and Bhopal) revealed that the Company could not award regular H&T contracts prior to its expiry at many rake points in time. This resulted in ad-hoc H&T contracts being awarded for short durations of two to three months usually with higher financial implications. As an illustration, H&T contract for Sangrur expired on 30 September 2007, but could not be finalized during 2008-09. Due to delay in finalizing the tenders relating to Sangrur and Dhuri rake points, freight rate of the contract at Nabha had to be increased from ₹ 119.58 to ₹ 136.83 per MT. This resulted in additional financial burden of ₹ 6.61 lakh.

The Management stated that contracts were awarded to a single party as only one party responded to the tender. Further, there were very few pre-qualified parties at the above mentioned rake points as the truck unions were very strong and they did not allow any individual transporter to operate at these rake points. Regular H&T contracts could not be finalised timely as rates quoted were on very high side and hence tenders were cancelled and fresh tenders were invited. Also, supply of material through rakes was reduced at the stated rake points, being uneconomical.

The Management's reply is not acceptable as sufficient efforts were not made by the Company to pre-qualify parties on a regular basis through open advertisements in order to attract new parties to break the cartel formed by truck unions and obtain reasonable rates for transportation of urea. Further, the Company resorted to award ad-hoc H&T contracts to cover-up delays in finalization of H&T contracts prior to their expiry. Also, the Company should have accordingly changed the contracted quantity for H&T contracts as per their planned movement.

8.1.2.4 Non- lifting of contractual quantity by dealers

The Company appoints dealers for wholesale trade, retail or both and dealers are classified under two categories i.e private or institutional. Targets were fixed for each dealer depending on the total sales in market, number of dealers, existing market share and total sales target of the Company etc. The Company fixed 250 MT as minimum annual off take for each dealer under Central Stockist Scheme and dealers were required to lift a minimum of 10 *per cent* of the annual off take during each month.

Dealers performance report revealed that out of 686 dealers (Bhopal zone: 262, Lucknow zone: 156 and Chandigarh zone: 268), annual off take of urea of 211 dealers (Bhopal zone: 158, Lucknow zone: 20 and Chandigarh zone: 33) was 'nil' during 2009-10. Even then, the Company renewed Fertilizer Registration Certificates (FRC) of 121 dealers for the year 2010-11, after excluding the reserved category dealers.

The Management stated that FRC of underperforming dealers were renewed on the specific recommendation of field staff or in case of reserved category dealers. Nil lifting was basically due to constraints of dealer network, non-availability of full rake loads etc.

The reply is not acceptable as the Management should have arranged for alternative mode of transport in case demand was low in view of "constrained dealer network".

Conclusion

Though the Company ranks as the second largest producer of urea in the country with a market share of 16.8 *per cent* of total urea production, there is still scope for improvement. Efficiency and cost effectiveness was not visible where marketing and sale of its products was concerned as marketing expenses on sale of urea led to under recovery of ₹ 15.04 crore during 2007-08 to 2009-10, while untimely import of Muriate of Potash led to a loss of ₹ 86 lakh with stocks remaining unsold till February 2010. Also sale of industrial products below their cost of production led to a loss of ₹ 7.06 crore during the period under review. Further, where marketing operations like handling, transportation, warehousing etc. were concerned the Company continued to incur secondary freight expenditure in violation of the New Policy of 'Uniform Freight Subsidy' which resulted in non-recovery of ₹ 8.34 crore. Also, allowing credit in excess of limits and without obtaining security resulted in blocking of funds. Non-renewal of handling and transportation contract on a regular basis resulted in delay in award of contract and award of contracts on a single tender basis.

In all these areas, the Company may like to improve its marketing/sales functions in order to streamline its functioning.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

Rashtriya Chemicals and Fertilizers Limited

8.2 Project Implementation

Introduction

Rashtriya Chemicals and Fertilizers Limited (Company) was incorporated on 6 March 1978 on the reorganisation of erstwhile Fertilizer Corporation of India (FCI) into five companies. The operations started with the take over of all Mumbai based divisions of the FCI relating to manufacturing facilities at Trombay and Western and Southern marketing divisions of the FCI. The Thal manufacturing unit was added during 1985.

The Company is manufacturing fertilizer viz., Urea, Suphala 15:15:15 and 20:20:0 and Industrial Products viz., Methanol, Nitric Acid, Sulphuric Acid, Ammonium Nitrate, Phosphoric Acid, Microla and Argon gas. Apart from its own products, the Company also markets imported fertilizers.

Working Results

Projected turnover as per revenue budget and actual turnover of the Company for the five years ending 31.3.2010 are as follows.

Table 1

(₹ in Crore)

Sl. No.	Details	31.3.2010	31.03.2009	31.03.2008	31.03.2007	31.3.2006
1	Projected turnover (BE)	6178.55	5119.23	3917.68	3115.76	2892.81
2	Actual turnover	5642.11	8365.98	5140.27	3487.99	3046.83
3	Profit before tax	344.21	325.70	242.07	241.46	215.67

4	Existing Capacity of a) Fertilizers (in lakh MT) b) Industrial product (in lakh MT)	 23.37 1.10	 20.07 1.10	 20.07 1.10	 20.07 1.10	 23.68 1.10
5	Capacity utilisation (in %) a) Fertilizers. b) Industrial product	 120.25 154.25	 134.26 154.43	 131.71 140.11	 134.75 152.02	 101.30 141.93

The Company had not carried out any major expansion or created production facility after setting up of Thal unit in 1985. However, the Company was carrying out upgradation and revamping, to sustain production for longer operation life of the plant and to create additional facilities to produce bye products from the existing fertilizer and chemical plants.

System of Project Implementation

The Company is having a dedicated Projects Department (PD) headed by Chief General Manager. The PD gets the basic engineering and detailed engineering prepared through consultants. Further, the PD prepares Notice Inviting Tender (NIT), scrutinises, evaluates and negotiates on technical and commercial matters, places purchase orders and follows up erection and commissioning of plants. After completing guaranteed test run, the plants are handed over to the divisions concerned for operation.

The PD conducts regular review of implementation of the projects and reports the current status to Management and Board periodically. The Company constituted (July 2006) Project Review Committee (PRC) (originally Project Investment Committee) with three members. The Committee is headed by Government nominee director and assisted by one independent director and one functional director (Director Technical), to study all ongoing as well as future projects and to advise the Board.

Audit Objectives

The audit objectives were to see that:

- Investment decision on new products was preceeded by market survey;
- Observance of due diligence in the selection of vendors for the supply of equipment;
- Existence of uniform criteria for evaluation of vendors and contract clauses to protect the financial interest of the Company; and
- Adequacy of monitoring through setting up milestones for different activities.

Audit Scope

Audit examined the projects implemented during last three years 2007-08 to 2009-10.

Audit Criteria

The following criteria were adopted:

- Decisions of the Board of Directors (Board) for the approval of the projects
- Projections in the Detailed Project Report (DPR)
- Cost estimates made for approval of the project

- Terms and conditions in the Notice Inviting Tenders

Audit Methodology

During the audit DPR, Board papers, contracts and purchase orders placed for implementation of projects, printed annual reports, cost records and production records were examined and information was also collected from web. The preliminary audit observations were issued to the Company and discussions at appropriate level of Management were held to form audit opinion on various issues raised in this study paper.

Audit Findings

Delays were observed at different stages of the project starting from tendering to award of contract in each of the contract and resulting in cost over run. Besides there were deficiencies in the selection of the vendor, non-evaluation of capability of vendor, non-conducting of market study, non-identification of viable associate, non-compliance with Board directive on tendering and unproven technology. These shortcomings noticed in the execution of individual projects are discussed below

8.2.1 Capital Budget

The capital budget and the actual expenditure for the five years ending 31.3.2010 were as detailed below:

Table: 2

(₹ in Crore)

Sl. No.	Details	31.3.2010	31.3.2009	31.3.2008	31.3.2007	31.3.2006	31.3.2005
1	**Capital budget**	311.08	653.14	314.78	304.78	344.88	159.59
2	**Actual expenditure**	141.02	241.83	118.57	127.91	210.01	143.89
3	**Percentage of capital expenditure to budgeted expenditure**	45.33	37.03	37.67	41.97	60.89	90

It could be seen from the table that the ratio of capital expenditure to the budget allocation of the Company ranged between 37 and 61 *per cent* during the five year ending 2009-10 as against the expenditure of 90 *per cent* for the year 2004-05. The gap between the budgeted and the actual capital expenditure indicated that the financial projections were not integrated adequately with milestones in project activities.

8.2.2 Monitoring by Board

The Board approved (July 2006) the constitution of a committee to monitor the progress of all ongoing and future projects to the Board. Audit observed that the committee met only five times from July 2006 to March 2009 and there was no meeting during 2009-10.

The capital expenditure incurred on projects were not brought under the scope of Internal Audit and this deprived the Company of an independent assessment.

8.2.3 Execution of individual projects

8.2.3.1 Argon Gas Project-Selection of vendor without assessing their financial capability

The Board approved (October 2004) Argon Gas Project at an estimated capital outlay of ₹ 70.98 crore, with a direction to put the project on fast track. It was envisaged that Argon gas escaping along with tail gas of purge gas be recovered which could result in net profit of ₹ 5.94 crore, ₹ 8.40 crore and ₹ 0.85 crore at a capacity utilisation of 60, 80 and 100 *per cent* respectively.

Audit observed the following deficiencies:

- The Company selected Bharat Heavy Plates & Vessles Limited (BHPV) who was financially unsound due to not meeting Notice Inviting Tender (NIT) condition (could not furnish solvency certificate). In terms of the purchase order the Vendor was expected to complete mechanical supplies by 30 September 2006 and sustained load test by 5 January 2007. To tide over the financial difficulties of BHPV, the Company took pro-active steps to avoid delay in execution of the project by making direct payment to the vendors (for materials procured by BHPV) and customs duty on imported goods through an escrow account. Despite such measures, the supply of equipment was delayed and the plant was commissioned in January 2009 with a time over run of 23 months and a cost over run of ₹ 9.69 crore.
- The project was conceived with an anticipated price of ₹ 26 per kg. during 2009 and 2010, which could not be realised when the plant was commissioned. As against a cost of ₹ 21.43 per kg. incurred by the Company during 2009-10, the average price realised was only ₹ 12.07 per Kg. resulting in loss of ₹ 9.17 crore on production of 7553.52 MT of Argon Gas.
- The terms and conditions of agreement did not contain any clause for recovering the cost of utilities like supply of power, fuel etc or cap on the quantity of such utilities to be supplied by the Company to the contractor, beyond the stipulated date of commissioning. In the absence of an enabling clause, the Company could not enforce recovery of ₹ 7.28 crore towards the cost of utilities consumed by them during the period of over stay solely attributable to the contractor.

The Management agreed (February 2010) that there was no specific clause in the contract for recovering the cost of utilities during the period beyond stipulated delivery date.

8.2.3.2 Revamping of Methanol Plant-Non-evaluation of capability of vendor

The Board approved (December 2005) Methanol Revamp (MR) Plant at Trombay at an estimated cost of approximately ₹ 108.43 crore on the basis of Techno Economic Feasibility Report (TEFR) prepared (October 2005) by PDIL. The project envisaged increase in methanol production to 242 MT PD from the existing 172 MT PD and bring down the energy consumption from 8.89 MKcal/MT. to 7.94 MKcal/MT. During the tendering stage (January 2007 to March 2007) the cost of the project was revised to ₹ 215.20 crore, with the realistic cost estimates based on the offer of ₹ 57.69 crore for synthesis gas compressor (SGS) and ₹ 83.88 crore for primary reformer, as against the estimated cost of ₹ 19.06 and ₹ 23.57 crore. The Company did not have the vital data for making a realistic estimate of the project.

The Company however, reviewed the project cost based on the above quoted price and decided to go in for small reciprocating synthesis compressor (RSGC) in place of SGS to bring down the cost to ₹ 135crore. Due to change in scope, technical specifications were revised resulting in delay in placement (November 2007 to October 2008) of POs. The scheduled implementation of the project was April 2008. Further, it was decided to synchronize RSGC in Phase II.

The Company received all equipments as per delivery schedule up to December 2008 except CO_2 compressor package, which was received only during January 2010. First phase of the project was completed in March 2010 (as against April 2008). Phase-II was still in progress (October 2010).

The following deficiencies were observed in audit:

- Cost estimate for methanol was prepared during October 2005, when the market for machinery and equipment manufacturers was in downward trend. When the tender enquiry was floated (January 2007 to March 2007), equipment manufacturing units were over booked resulting in increase in price of equipments and longer delivery period.
- The procedure of getting solvency certificate and evaluation of financial capability of the vendors before placement of order was not complied with.
- The Company did not evaluate production capacity of the supplier {M/s. Bharat Pumps and Compressors Limited (BP&CL)} in respect of compressor. There was delay of 12 months in supply of CO_2 compressor (cost ₹ 6.71 crore) by BP&CL. Thus, the project could be commissioned only on completion of erection of CO_2 compressor.
- The initial estimates were not realistic and the midway change in the selection of another option resulted in time over run.

The Management while agreeing with the audit findings stated (July 2010) that:

- Pre-qualifications criteria were not applicable for the list of pre-qualified vendors given by the detailed engineering consultant, M/s. PDIL. Hence, solvency certificate was not asked for from BP&CL.
- The annual reports submitted by BP&CL revealed that BP&CL was a loss making PSU in 2004-2005. However, they had booked profits in the subsequent two financial years. Hence, it was observed that at the time of placing order, BP&CL had enough capacity and gained financial stability to supply CO_2 compressor worth ₹.6.70 crore.

Reply of the Management was to be viewed in light of the following:

- The mere fact that a sick Company had started making profit was not an indication of its capacity to execute all orders within the given time. When BP&CL was having five orders worth ₹ 90.60 crore to be executed from March 2008 to February 2009, placement of order on BP&CL by the Company for delivery in December 2008 was not prudent.

Thus, incorrect estimate of the cost of project resulting in change of design and delay on the part of the contractor in supply of CO_2 compressor resulted in delayed implementation of the project and non-achievement of the envisaged benefit of reduction in energy consumption to 7.94 Mkcal/MT from the existing 8.89 Mkcal/MT.

8.2.3.3 Chickton Project-Non conduction market study

Chickton project was approved during March 2007 at a cost of ₹ 43.50 lakh on the basis of preliminary cost estimate and was to be completed by December 2007.

The project was conceived mainly to make optimum utilisation of the existing facilities and manpower to produce Chickton 1000 litres/day. The project cost was revised (June 2008) to ₹ one crore. The Company procured (March/April 2009) equipment costing ₹ 88.43 lakh and the plant was commissioned in June 2009. Regular commercial Chickton production was yet to be commenced (December 2010).

Audit observed the following deficiencies:

- The Company did not carry out any market survey to ascertain the viability of this project. The Company found that the product could not be launched into the market as there was no demand for the product. Thus the plant created at a cost of ₹ 88.43 lakh remained idle since June 2009.
- The Company had not made any provision in the capital budget of 2007-08 for execution of the project. Hence, funds were diverted from Argon Project. The diverted funds were not sufficient due to increase in the project cost. Provision for the same was only made in the budget for the year 2008-09.

The Management in their reply stated (November 2010) that they were hopeful of running the plant continuously on establishment of market and attributed the delay to the limitation in the production of the Formic Acid, which was one of the raw materials for making Chickton during 2007 to 2008.

The above reply was not borne out by facts as it was observed that the delay in placement of purchase order was due to non-provisioning of funds rather than to the stoppage of production of Formic Acid. The Company placed order for ancillary equipments during November 2007 to March 2008 by diverting funds from Argon project. The main equipment was ordered (August 2008) after provisioning the same in the capital budget for the year 2008-09.

In the absence of realistic estimate about the market potential for the product, the objective of investment remained unrealized.

8.2.3.4 Non-identification of viable associate- Clean Development Mechanism (CDM) Project

The Board approved (October 2005) Clean Development Mechanism[1] (CDM) project, which was taken up (February 2005), for reduction of Nitrous Oxide (N_2O) by installation of equipment (for measuring the emission before and after implementation) and catalyst[2] (chemical to capture the emission and destroy) in New Nitric Acid Plant at Trombay. It was envisaged that technology, equipments and catalyst were to be supplied by the Project Participant[3] (PP) and mutually agreed portion of Certified Emission Reduction[4] (CER), earned by the Company were to be shared. The project was conceived with a basic objective of containing green house gas emission and translating the same

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[1] ***CDM project aims at reducing emission in developing country. Kyoto Protocol provides that developed Annex I countries can fund eligible emission reduction projects in the developing countries and use the resulting certified emission credits (CERs) to help in meeting their national reduction commitments of emission.***

[2] ***Substance, which causes change in rate of chemical reaction.***

[3] ***Developed countries funding the eligible emission reduction projects.***

[4] ***A CDM project is undertaken in a developing country with no emission reduction targets. Each tonne of the carbon dioxide emission saved/reduced would result in one Certified emission reduction.***

into carbon credit. It was estimated that with the investment made by the technology provider, the project would result in reducing emissions of N_2O by 0.58 million MT from the existing level of 0.73 million MT per year in Nitric Acid Plants at Trombay. Under Kyoto Protocol[1], the above reduction in emission would entitle the Company to earn a CER worth US$ 2.61 million (approximately ₹ 1148 lakh) per year.

As the attempts made (October 2006 and July 2007) by the Company to bring in an associate through consortiums did not materialise, the Board approved (July 2007) implementing the project by funding through internal accruals.

The Company placed work order/purchase orders for the project during December 2007 to November 2008 for consultant, validation[2] and procurement of equipments and catalyst. The Company registered the project and started the campaigning period (abatement of N_2O) during November 2009 for nitric acid plants.

Audit observed that the Company procured (December 2008) the catalyst before registration with the UNFCCC[3] in November 2009 resulting in blocking of funds of ₹ 3.74 crore for 10 months.

The Management stated in July 2010 that the interest loss on account of so called advance procurement on hindsight could be construed as avoidable but difficult to anticipate and predict in advance.

The reply of the Management needs to be viewed in light of the following:

- The project design document (PDD) submitted to UNFCCC during July 2009 for registration was under preparation at the time of placement of intent/purchase order for catalyst (September/November 2008 with delivery schedule of 10 weeks/November 2008).
- Further, the fact remained that validator was an independent agency working under the guidelines of UNFCCC and there was no timeline prescribed by UNFCCC for completing validation process. In the circumstances, the Company could have placed PO for catalyst after submission of PDD for registration to UNFCCC (July 2009) and avoided advance procurement of catalyst.
- The Company was yet to receive CER (November 2010).

8.2.3.5 Non-compliance with Board directives on tendering-Ammonium Nitro Phosphate (ANP) Granulation Project

The Board accorded (August 2006) 'in principle' approval for taking action in refurbishing of Complex Fertliser Ammonium Nitro-phosphate (ANP) Plant namely Suphala 20:20:0 (complex fertilizer brand), at a cost of ₹ 125 crore in two phases through limited tenders on lump sump turn key (LSTK) contract basis. Phase I envisaged installation of a new 900 Metric Tonne Per Day (MTPD) granulation process within a period from 15 months from August 2006 i.e., in November 2007, at an indicative price

[1] ***Kyoto protocol to United Nations Framework Convention on Climate Change adopted contains legally binding emission target for developed countries for the post 2000 period.***
[2] ***Validation is the process of determining that the project is eligible to be registered as a CDM project, by confirming that the project meets the requirements of the CDM.***
[3] ***United Nations Framework Convention on Climate Change***

of ₹ 65 crore and Phase II aimed at taking parallel action for execution of wet process improvement of plant at an indicative project cost of ₹ 60 crore. The project objectives were

- technology upgradation of the plant
- minimizing the cost of production
- ensuring safe operation
- manufacturing new product/grade and
- Simplifying the product quality control.

The Company invited (October 2006) global tenders and due to poor response was re tendered (May 2007). The Company took 15 months to finalise the tender and a Letter of Intent was issued (January 2008) on M/s. Hindustan Dorr-Oliver Limited for ₹ 82.11 crore (INR 70.85 crore+US$1.42 lakh+Euro 0.98 lakh) and with a time schedule for completion in July 2009. The Company started commercial production in November 2009 but could not stabilise the production to its capacity of 900 MTPD even after nine months (August 2010).

The following deficiencies were observed in the execution of the project:

- Despite clear direction by the Board to invite bids from three well known Indian parties having tie up with international technological suppliers, the Company issued global tenders. This delayed the project schedule and coupled with other slippages in the supply, civil and erection work by the vendor ranging from 2 to 6 months resulted in project completion by November 2009 against the scheduled completion of November 2007.
- The work in respect of wet process, which was taken up in Phase II by the Company departmentally was yet to be completed (July 2010).

The Management inter-alia stated in July 2010 that:

- Since the revamp project was unique in nature, it needed attention from international technology suppliers and hence they advertised simultaneously in the international trade magazine and Indian newspapers for good coverage and achieving competitive bidding.
- No technically acceptable party had responded against NIT of Wet Process even after re-floating and was being undertaken departmentally.
- The first batch of ANP 20:20:0 was produced in November 2009 and the plant so far produced almost 31,000 MT and the production was being streamlined.

The reply of the Management had to be viewed in light of the following:

- The response to the global tender was received only from parties identified by the Board and the process only resulted in delay and additional cost of ₹ 12.97 crore.
- The actual production of ANP 20:20:0 was far below the envisaged capacity as it ranged between 41 and 293 MTPD against the planned capacity of 900 MTPD.

- As against the expected contribution of ₹ 30.83 crore per year on 100 *per cent* utilisation of the plant, the contribution for the year 2009-10 (November 2009 to March 2010) was - ₹ 3.95 crore.

The intended objectives of the project thus remained to be achieved till the implementation of wet process.

8.2.3.6 Unproven technology-Rapid Wall Project

Board approved (March 2006), Rapid Wall* project at a cost of ₹ 62.91 crore, revised to ₹ 75 crore to be completed in August 2008. The project was envisaged to produce 14 lakh square meters wall panels and appropriate quality Plaster of Paris using phospho gypsum (PG) a waste product of Phosphoric Acid (PA) plant.

The Company entered (May 2007) into an agreement with Rapid Building Systems Pvt Ltd (RBS) for a fee of Australian $9281400 (₹ 32.19 crore approx) on the basis of Memorandum of Understanding (MOU) (October 2005) with RBS for supply of technology. The Company placed purchase orders for critical and non-critical equipment from December 2007 to February 2009. These equipments could not be erected immediately, since the plot selected (Feb 2006) did not meet the requirements of Explosive Inspectorate. Hence, the plot had to be changed. This resulted in delayed completion by 7 months of plant building (schedule date June 2008)

The Company had incurred expenditure of ₹ 74.08 (March 2010) crore against the approved cost of ₹ 62.91 crore and was yet complete the project.(December 2010)

The following points were observed in Audit:

- The technology supplier (RBS) was using natural Gypsum (NG) for its rapid wall manufacture and was yet to scale up the production of wall paper panel using PG. It was observed that the Company encountered the problem of lump formation as moisture content in PG was 10 to 18 *per cent,* further going up to 20 *per cent* during monsoon season.
- The site for the project was chosen without evaluating its suitability preferably with outside expertise.
- The Company could not market wall panels produced due to lack of load bearing capacity.

The Management while noting the audit findings, replied (July 2010) as under:

- Only after necessary testing and study of the PA plant gypsum with regard to its suitability for manufacturing Wall Panels by RBS, agreement was signed. Due to use of different types of Rock phosphate by PA plant, formulations for making Wall Panels were to be decided depending upon the quality of gypsum.
- Using the in-house expertise, the original plot was selected by Corporate Project department for Rapid Wall Project.
- Various commissioning difficulties were encountered on account of equipments and formulation for Wall Panel production. However, main delay in completion

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* ***Ready made walls from the phospho gypsum, a solid bye product from Phosphoric Acid Plant.***

of the project was due to delays in civil works (change in plot location and earth filling) and supply of material handling equipment.

- As on date, more than 400 wall Panels had been produced and issues related to quality were being resolved. Some panels were given for trial and as per the test result of IIT Chennai, the wall panels were not fit for load bearing. Hence, new formulas were being tried to make load bearing wall panel.
- It was a new concept and a new product; it would take some time for sales to pick up. Mixing Plant was producing Wall Plaster as per the requirement of marketing.

Reply of the Management was to be viewed in light of the following:

- Detailed testing of PG for manufacturing load bearing wall panel was not conducted at the beginning resulting in alternate formulas being tried after completion of erection of the plant.
- The site selected for the project had to be changed due to not consulting specialist/RBS for selection of suitable site, resulting in cost and time overrun.
- Regular commercial production of wall panel had not started (August 2010) due to modification work which was completed during August 2010.

The Company initially had neither analyzed the suitability of PG thoroughly for manufacturing load bearing wall panel nor had it foreseen the problems in the process of PG, due to its high moisture content. This had resulted in modification of plant, which was completed during August 2010. Also, the site was selected without consulting experts leading to delay in civil construction by 7 months. As such, the Company could not commence (October 2010) commercial production resulting in blocking up of capital amounting to ₹ 74.08 crore.

Conclusion

Despite creation of a dedicated cell to monitor the progress of projects, Audit observed delay in completion of projects. The delay had resulted in cost over run of ₹ 68.35 crore (March 2010). Moreover slippages in project schedules also affected marketability of the products. The expected savings in cost due to energy saving measures also did not accrue to the Company. Thus, the project deliverables envisaged during conceptual stage could not be realised due to inadequate monitoring.

The matter was reported to Ministry in September 2010, reply was awaited (February 2011).

Recommendations

- ***The Company may conduct market study on demand for products to assess viability.***
- ***Projects should be undertaken only after firming up the technical process and not to commit investment on projects with unproven process technology***
- ***Incorporate clauses in Lump Sum Turn Key (LSTK) contracts to recover the cost of utilities and damages arising out of non-performance on the part of the contractor.***

- ***Monitoring of project should start from the time of approval of the project by the Board.***
- ***PRC meetings should be held regularly to study all ongoing projects, so as to initiate timely corrective action, whenever required.***
- ***Mandate internal audit to review project implementation so as to get first hand independent assessment.***

CHAPTER IX: MINISTRY OF FINANCE (DEPARTMENT OF FINANCIAL SERVICES-INSURANCE DIVISION)

General Insurance Corporation of India

9.1 IT Audit on SAP-Reinsurance Module

Introduction

General Insurance Corporation of India (Company) has been catering to the reinsurance* needs of Indian General Insurance Industry. The Company was designated as 'Indian Reinsurer' in November 2000, assumes reinsurance business from foreign insurance companies and leads the reinsurance programmes of several insurance companies in neighboring South Asian Association for Regional Cooperation (SAARC) Countries, South East Asia, Middle East and African continent. The Company has its registered and corporate office in Mumbai and overseas offices viz. representative office at Moscow and branch offices in London and Dubai.

IT systems were managed by IT Management Group (ITMG) housed in their Head office in Mumbai. General Manager heads the ITMG who report to the Chairman-cum-Managing Director of the Company.

Objectives of introducing ERP system

The Company implemented (August 2006) a comprehensive, integrated Enterprise Resource Planning (ERP) system using SAP R/3 covering all major functions such as reinsurance, investment operations, treasury operations, human resources and accounting with the objective of redesigning the Company's computerized framework in line with global standards.

Benefits of introducing SAP-Reinsurance

Some of the significant anticipated benefits were:

- Integrated system
- Detailed data capturing
- Automatic calculations of Commission etc.
- Loss Module with automatic generation of Statement of Accounts
- Check on Annual Aggregate Limit/Annual Aggregate Deductibles/claim payment with differential shares through the policy period
- Statistics for 100 *per cent* of premium and liability of original insurer and GIC share thereon

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* ***Contract made between an insurance company and a third party to protect the insurance company from losses.***

Objectives of Audit

The main objectives of audit were to:

- Assess whether benefits envisaged and planned by the Company were truly achieved
- Evaluate the security system, business continuity and disaster recovery procedure.
- Evaluate and comment upon the weakness in controls relating to SAP FS-RI Module so as to enable the Company to eliminate inaccurate, unauthentic and unreliable information for improved decision making
- Ascertain the existence of audit trail between underwriting, claims, accounting and actual collections/disbursements.

Scope of Audit

This IT Audit includes review of business process re-engineering, hardware and software procurement, customization and implementation of SAP R/3 with the prime focus on SAP Financial services-Reinsurance (FS-RI) Module viz. Basic System and Risk Manager and its link with accounting activities, security features in an ERP environment and training. The review covers the period from 2006-07 to 2009-10.

Audit Criteria

The criteria used for audit were:

- Companies Underwriting Manual and Claims Manual
- Business Process Document and Business Blueprint accepted by the Company

Audit Methodology

IT Audit methodology included correspondence, discussions with ITMG and data extraction using SAP query, SAP reports and analyzing the same using Computer Assisted Audit Techniques.

SAP Financial Services – Reinsurance System

SAP system was procured (December 2004), customized and implemented in August 2006 by engaging the services of WIPRO. SAP project implementation was carried out in a planned manner. The system implemented consisted of five modules viz. SAP-Financial Services-Reinsurance (FS-RI), SAP Financial Services – Collection and Disbursement (FS-CD), SAP Investment Management & Investment Control (IM-IC), SAP Financials & General Ledger Accounts (FICO-FIGL), SAP Human Relations including Payroll Administration and Payroll and SAP Net Weaver (including Business Intelligence and Business Warehouse). The Company spent ₹ 6.59 crore for implementation of this project and further incurred ₹ 7.46 crore towards data migration, maintenance and support and additional development as on 31 May 2010.

FS-RI consists of two sub modules viz. Basic System and Risk Manager. Basic system deals with treaty[1] reinsurance contracts and Risk Manager deals with policy administration of facultative[2] reinsurance contracts. Loss Management and reinsurance

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[1] ***Treaty is a reinsurance contract which covers all the insurance policies coming within the scope of that contract, usually for a period of one year or more.***

[2] ***Facultative Reinsurance is specific reinsurance covering a single risk.***

programme functions were included in Basic sub-module.

Audit findings

The findings of Audit were as under:

9.1.1 General IT Controls

General IT controls encompassing project planning, business process re-engineering, involvement of senior level Management and structured steps in implementation were adopted by the Company. The acquisition and maintenance of hardware and software was carried out keeping in line with CVC guidelines. An inventory of IT Assets and physical access security to IT assets was in place.

9.1.2 IT Security Controls

The Company has framed IT security policies and procedures (December 2006) and the updated (December 2009) Policy was also communicated to all the officers and staff. An Information Security (IS) Audit comprising review of physical security, vulnerability assessment and penetration testing and review of information security management system in place was conducted (November 2009) by M/s. Appin Security Group. Recommendations of M/s. Appin Security Group were accepted and corrective actions were taken by the Management. However, audit has observed the following:

- At the time of installation of SAP certain standard users were automatically created with default passwords, which are commonly known or can be known from a search through internet. Such default passwords for Users viz. 'SAP*' and 'Early Watch' were not changed exposing the system to unauthorized access and high risk. On being pointed out by the Audit, the Company changed the default passwords, which was also verified by Audit.
- Eight user identifications were not deactivated despite their having been unused from the date of creation. The Audit point was accepted by the Company and users were locked at the instance of Audit. The Ministry while concurring with the Company's reply stated (December 2010) that a system has been introduced for review of unused identifications regularly.
- The passwords of the users were not changed after every 60 days as per the IT security policy of the Company. Necessary rectification actions were taken by the Company at the instance of audit. The reply of the Company was endorsed (December 2010) by the Ministry.
- The Company initiated steps in respect of off-site storage, Business Continuity Plan and Disaster Recovery. However, Business Continuity Plan and Disaster Recovery Procedure were yet to be communicated to all users and awareness enhanced. The Ministry replied (December 2010) that the availability of disaster Recovery System as well as the Business Continuity Plan had since been communicated to all.

9.1.3 System design

9.1.3.1 Non-linking of financial authority

In order to accept the business offer as well as for claim settlement, Company has defined financial standing authority. However, Company did not ensure to capture the financial standing authority in the SAP system and link the same to underwriting/claims authorization through the system. The claim settlement process was kept out of the system and SAP system implemented does not reflect the actual business process.

The Company while accepting (September 2010) the audit observation stated that they would address the issues in the proposed functional upgrade of SAP system to derive maximum benefits from SAP. The Ministry concurred (December 2010) with the Company's reply.

9.1.3.2 Automatic calculations by system

Under proportional type of facultative arrangements, once the 100 *per cent* premium and liability was entered into the system along with coinsurance share of the cedent and Company's share of participation, the system ought to have calculated Company's share of premium and liability. However, in three cases, it was observed that premium was not calculated automatically resulting in differential (undercharged) premium amounting to ₹ 1008.01 (one case), AED 39,608 (one case) and Bahraini Dinar (BHD) 8905.68 (one case).

The Company in its reply (September 2010) accepted audit points and stated that the same would be considered. The Ministry endorsed (December 2010) the views of the Company.

9.1.3.3 Non-Mapping of Business Rules

Treaty status (such as create, declined, business not materialised, business materialised, business not taken up, cancelled by cedent etc.) in customized SAP system allow tracking of entry of offers and the progress of offers/proposals/quotations in various stages. Accounting of the business transactions ought to take place in accordance with the treaty status. However, the following instances of inconsistency of data were noticed due to non- updating of treaty status and due to improper validation.

No. of cases	Observations
153	The status of Treaties were displayed as 'create or copy' (signing of treaty slip and finalization of treaty were pending) mode as on 25 February 2010 although treaty period had expired.
02	Though the status of the treaty no. 35328 was shown as "create mode" for the period from 1.7.2008 to 30.6.2009 accounting transactions were made against and in respect of treaty no. 42020, the status was " create mode" for the period from 1.1.2007 to 31.12.2007, premium, commission and losses paid amounted to USD 139435.71 were accounted. The accounting transactions in respect of such un-materialized treaties were incorrect.
01	In respect of a retrocession treaty (33626), starting year and ending year was indicated as 5 May 5002 and 4 May 5003 while the status of treaty was indicated as 'business materialized'.
149	Although treaty period had expired in these cases, modifications to the treaty (such as date effective from, first account date, date of cancellation of treaty etc.) were allowed to be carried out. The system ought to have restricted any modifications after the treaty period had expired.
30	Brokerage amounting to ₹ 27.04 lakh was paid even though the business was

	directly assumed without involving broker. In seven treaties the broker code was blank and in 23 treaties dummy broker codes were allotted. This indicated improper customization and absence of linking between the broker-master to Treaty details.

The Ministry while agreeing with the above observations stated (December 2010) that it was not unusual for multinational companies to have breaking alliances and that based on the specific request from the subject Cedants, brokerage had been paid to them. They however added that the instances pointed out were due to erroneous feeding of data and would be corrected.

9.1.4 *Input Controls*

Input Controls are vital to the integrity of any application system. Input controls were reviewed with a view to ensure that the procedures and controls reasonably guarantee that (i) the data received for processing were genuine, complete, accurate and properly authorised and (ii) data entered were accurate and free from duplication.

The Company generally cannot underwrite any risk, unless it communicates to cedent[1] its response to proposal received from cedent about the risk. The willingness to underwrite risk is conveyed to cedent by way of communicating 'Written[2] (share) Line'. Once the treaty/policy terms and conditions are finalized the actual *per cent*age of share or specific amount is agreed between the cedent and the reinsurer[3], a treaty slip is signed by both the parties to agreement. This share is considered as Signed[4] (share) Line. Subsequently, a formal agreement is inked by both the parties to the contract. Keeping this business procedure, input controls and validations were subjected to check and following deficiencies were noticed.

9.1.4.1 Absence of validation in Written Line and Signed Line input

The following instances indicated absence of proper validation checks in the system:

- In 25 cases, Signed share was captured and business was shown as 'materialised' in the system though the Written Line was captured as zero.
- In respect of four facultative proportional[5] policies shown as 'materialised' in the year 2007-08, it was noticed that both the written line and signed line were not captured. System also indicated Company's liability to the extent of ₹ 19.08 crore in three cases and in another case involving USD 15,00,000.
- In five cases, though the status of policy was shown as "Business not materialized", the details regarding Signed Line was captured with Company's liability to the extent of ₹ 26.22 crore, 18.62 crore Taiwan Dollar and of 60 lakh USD.

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[1] ***Cedent means the original or primary insurer; the insurance company which purchases reinsurance***

[2] ***Written share generally mean a per centage of original share or a specific amount of risk which the reinsurance company is ready to underwrite***

[3] ***Reinsurer is the insurer which assumes all or a part of the insurance or reinsurance risk written by another insurer.***

[4] ***Share signed in the Treaty slip***

[5] ***Proportional means a form of pro rata reinsurance indemnifying the ceding company for an established per cent or per centage of loss on each risk covered in the contract in consideration of the same per centage of the premium paid to the reinsurance company.***

- In two cases (Loss number 18358 and 4209) relating to loss accounting through the participation of Company was indicated as nil, payment of claim as well as outstanding amount have been indicated against those losses.
- Actual liability accounted by the Company cannot exceed the signed share liability. However, in 49 cases involving various currencies the system allowed accounting of liability more than the signed share of liability.
- In 20 cases the premium accounted differed from the signed share premium.
- Although, Annual Aggregate Limit (AAL)[*] of ₹ 12.50 crore was defined in Treaty No. 43023, the loss amounting to ₹ 125 crore was entered in to the system erroneously. This error was rectified later.
- No liability can accrue to the Company without receipt of premium under facultative business. In 10 cases, Company's Facultative liability was indicated to the extent of ₹ 1707.31 crore (five cases), Taiwan Dollar 1.14 crore (three cases) and Arab Emirates Dirham 42 crore (two cases) although premium was indicated as zero.
- The loss mode was required to be defined in underwriting sub-module as either 'Accounting year basis' or 'underwriting year basis'. Upon selecting accounting year basis, system ought to have restricted claims occurring after the treaty period. It was noticed that in six cases amounting to ₹ 5.68 lakh although the loss mode was selected as accounting period, system did not restrict claims which had occurred after the treaty period.

The Company clarified (March 2010) that due to human error the loss mode was wrongly selected as 'accounting year basis' instead of 'underwriting year basis' under which the claims were payable.

- It was also noticed that in one case, the treaty was created on 9 October 2009 (Treaty No. 46769) whereas the accounting for the treaty was done prior to the date of creation of treaty i.e. on 1 July 2009.
- In one obligatory treaty no. 40815, system allowed booking and cancellation of brokerage to the tune of ₹ 9.03 crore on two different occasions although such treaty did not contain details of broker and brokerage.

9.1.4.2 Absence of maker-checker system

Data entry is done in off-line mode chiefly after processing of papers manually. The system did not indicate that data so fed in the system was subject to check by another official than the maker before saving. This is corroborated from the following illustrative cases:

- In the case of treaty no. 32139 the period was erroneously stated from 01.04. 0200 to 31.03.0201 at the time of creation of treaty. Instead of modifying or cancelling this entry, a fresh entry with correct dates was made. This indicates that data entered in the system was not subject to any date validation and that a maker-

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[*] ***Annual Aggregate Limit means cumulative of losses in a year that is agreed to be paid as maximum limit under that particular treaty.***

checker method was absent before saving data. Similar error was also noticed in treaty no. 35014.

- Para 4.2.6 of Business Blueprint provides that 'Profit Commission is calculated year-wise, company-wise as per the terms agreed in the treaty slip and that the profit commission is paid to cedent after the treaty books are finally closed'. It may be deduced from the above, that profit commission invariably was a 'Result Dependent Condition'. However, in treaty No. 47218 for 2009-10, the profit commission was included under the tab 'Result Independent Condition' due to incorrect data entry and absence of further supervisory checks.

The Company in its reply (September 2010) accepted the audit points and stated that these would taken up in the proposed functional upgrade of SAP system to derive maximum benefit from SAP. The Ministry concurred (December 2010) with the Company's reply and stated that the Company had initiated action to get the data entry corrected in the system.

9.1.5 Migration issues

9.1.5.1 The status of treaty no. 31952 was indicated as "Copy" from 1977-78 to 1984-85 and not as materialised. The status was not updated as on date.

9.1.5.2 It was seen that the cancellation date was indicated as '01-01-1900' in respect of 11286 migrated materialized treaties. It was further noticed that in some of the treaties migrated the details relating to premium, commission, loss paid, incurred claims, net balance and accounts booking were not available. In view of the above, accuracy and completeness of data migrated from the erstwhile system to SAP system was not being ensured.

The Company in its reply (September 2010) accepted the audit points. The Ministry endorsed (December 2010) the Company's reply.

9.1.6 Output Controls

In order to ensure that the accounting of premium is accurate, MIS reports on estimated premium income vis-à-vis actual premium booked by the Company was called for. However, it was noticed that that the Company could not utilize some of the MIS reports since many important fields were blank as the same were not made mandatory. During the course of certification of accounts for the year 2009-10, it was brought to the notice of the Company that due to this deficiency Company failed to account premium to the extent of ₹ 165.47 crore which was accepted by the Management.

The Company in its reply (September 2010) stated that they would revisit their requirement during SAP functional upgrade. The Ministry concurred (December 2010) with the Company's reply.

9.1.7 Training

Data input errors pointed above amply indicate that the training imparted was ineffective and had defeated the purpose of introduction of SAP system. Further, a system of obtaining feedback from the officers/employees immediately after the in-house training was not available and hence effectiveness of training could not be commented.

The Company replied (September 2010) that audit point is noted and a system of obtaining feed-back from the participants would be made compulsory in future. The Ministry endorsed (December 2010) the Company's reply.

9.1.8 Post Implementation Review

The Company had not carried out a post implementation review (functional audit) of SAP although the system was stated to have been stabilized in 2008-09.

The Company replied (September 2010) that they were contemplating a functional upgrade of SAP in the beginning of next fiscal year and as a pre-requisite for the said exercise, they would be undertaking a full-fledged functional audit. The Ministry concurred (December 2010) with the Company's reply.

Conclusion

Re-designing the Company's computerization framework in-line with global standards cannot be considered as fully accomplished in the absence of (i) a real-time environment in implementing SAP system and (ii) configuring the approval of proposals, claim processing and settlement online by linking it to Financial Standing Order (FSO), despite incurring expenditure of ₹ 15.19 crore as on date. The input controls, validation checks were inadequate resulting in incomplete and incorrect data capturing in the system apart from manual intervention. Level of user awareness was inadequate to minimize errors during input stage of data. Further, awareness about Disaster Recovery Procedure was yet to be communicated to all the employees.

The Company replied (September2010) that efforts would be taken up for initiating Real-time environment including online approval of proposals, claim processing and settlement; adequate validations, input controls and automatic calculations as suggested would be incorporated during the functional upgrade of their system. The Company also stated that a comprehensive training encompassing majority of employees was being carried out and Disaster Recovery Procedure was being finalized and documented.

Recommendations

The Company need to:

- ***Introduce real-time SAP environment while upgrading the system***
- ***Strengthen input controls and process controls to ensure accurate, reliable and completeness of data.***
- ***Raise the level of user awareness and minimize errors of input data.***

The Company accepted (September 2010) the recommendations and assured to take up the same in order to reap the benefits from the ERP system of SAP in future and particularly during the proposed functional upgrade of the system.

The matter was reported to the Ministry in December 2010; reply was awaited (February 2011).

National Insurance Company Limited

9.2 Excess settlement of claim due to violation of Standard Policy Conditions

National Insurance Company Limited settled a claim in excess by ₹ 236.68 crore in violation of standard policy conditions of Industrial All Risk Policy.

As per Industrial All Risks Insurance Required (IAR) Policy, the cover in its widest form will include (a) Fire and all Special Perils, (b) Burglary, (c) Machinery Breakdown/Boiler Explosion/Electronic Equipment Insurance and (d) Business Interruption (Fire and all Special Perils). The Machinery Loss of Profit (MLOP) cover is optional and can be included by deleting Special Exclusions 1.4,1.5,1.6, and 1.7 to Section II of IAR Policy.

A Delhi based Divisional Office of National Insurance Company Limited (Company) issued an Industrial All Risk Policy to Satluj Jal Vidyut Nigam Limited (SJVN) for the period 28 March 2005 to 27 March 2006 for the sum insured Fire- ₹ 5029 crore, Machinery Breakdown- ₹ 1791 crore and Business Interruption (FLOP) ₹ 1420 crore covering its 1500 MW Nathpa Jhakri Hydro Electric Project (Project) consisting of six turbine generators of 250 MW each in Himachal Pradesh including common auxiliaries, accessories and civil works.

An incidence of water leakage occurred in unit No. 4 of the Project of SJVN on the night of 4 September 2005 and the Management found that labyrinth pipe and checkered plates were blown away. Subsequently, the Project was submerged with water and as a result of flooding, all the generators, accessories, unit control system and instrumentation suffered extensive damage.

Audit observed, that the Company settled the claim for Material Damage at ₹ 71.19 crore and Business Interruption at ₹ 236.68 crore under Fire Section instead of ₹ 71.19 crore only under Machinery Break Down Section, as the proximate cause of the loss was detachment/failure of the blind flange at the T junction of the pressure equalizing pipe (labyrinth leakage pipe), which was "Machinery Breakdown". Thus, no claim was payable for Business Interruption since the same was caused due to machinery breakdown and MLOP was not covered in the Policy as the insured had not opted for such cover.

The Management stated (August 2010) that in the initial stage of survey and during approval of 'on account' payment the joint surveyors relied upon circumstantial evidence and the reports of 'High Power Committee' and 'Internal Investigation Report' on the cause of loss.

The Ministry stated (January 2011) that technical expert was appointed to ascertain the proximate cause of the loss since the claim was highly technical in nature. Technical expert opined that the proximate cause of the loss was flood since failure of the flange would not and could not have resulted in flooding and the insurer cannot avoid liability under "Business Interruption section". The claim was settled on the basis of the Joint surveyor's final report and technical expert's finding which mentioned that detachment/failure of Blind flange at 'T' junction was the cause, was successive but not concurrent in their operation and 'Flood' was not the first or the last or the sole cause of the loss, and it was the dominant or effective operative cause.

The Management/Ministry's reply is not acceptable as the entry of water was caused by detachment/failure of Blind Flange at the T Junction pressure as reported by the Joint Surveyors in their report dated 19 November 2005. Further, as per findings (October 2005) of the High Power Committee appointed by Government of India and Internal Investigation, the cause of flooding of Power House was failure of blind flange at the T junction of the pressure equalizing pipe and dislodging of flange due to poor quality of welding as well as improper design. The above reports were based on laboratory tests. The Management disregarding all these three reports appointed another surveyor/technical expert one and a half years after the Joint Interim Loss Adjustment Report of the joint surveyors. Technical expert's report (January 2007) led the joint surveyors to change their initial report of November 2005 wherein they had clearly stated that water entry into the power house had been proximately caused by detachment of the blind flange, which was machinery breakdown and instead came up with a final report in April, 2008 wherein loss was then shown as caused by water which came under "Fire section" of the policy. Proximate Cause was Machinery Breakdown and water entered subsequently as admitted by the Ministry also that flood was not the first or the last or the sole cause of loss. Rather flooding was caused by dislodging of flange and so Machinery breakdown would remain as the proximate cause of loss.

Thus, the Company settled the claim in excess by ₹ 236.68 crore in violation of standard policy conditions of Industrial All Risk Policy.

9.3 Loss of rent

Failure to incorporate term on mutual evaluation of prevalent market rent in the agreement led to loss of rent of ₹ 7.85 crore

National Insurance Company Limited (licensor) owns the Royal Insurance Building at Churchgate, Mumbai. The total built up area is 57680 sq.ft [8240 sq.ft x 7 (ground + six)]. The licensor's own occupancy is 21604 sq.ft and remaining 36076 sq.ft is let out to either Government or private parties or lying vacant (July 2010).

In respect of an area admeasuring 11027 sq.ft (first floor 2787 sq.ft + third floor 8240 sq.ft) which was in the possession of M/s. Syngenta Group of Companies (the licensee), the following offer was made (August 2003) by the licensee to the licensor:

- Monthly rent at the rate of ₹ 60 per sq.ft with effect from 1 April 2003.
- Lease for a period of ten years.
- Provision of increase of rent at the rate of 25 *per cent* on completion of every five years, subject to mutual evaluation of the then prevalent market rent.

The licensor's Regional Office at Mumbai, in spite of independent valuation at the rate of ₹ 78/- per sq ft of the said premises in December 2002, proposed (September 2003) monthly rent of ₹ 60 per sq. ft. and the lease period as 10 years subject to approval of its Head Office. However, in respect of enhancement of rent while proposing 25 *per cent* increase after 5 years, failed to incorporate the term on mutual evaluation of the prevalent market rent. The Head Office approved (March 2004) the proposal with the period of leave and licence agreement (LLA) divided into 4 terms of 30 months each.

Based on the above, the licensor and licensee signed (April 2004) the *LLA* for the initial term of 30 months (April 2003-September 2005). But for the second term of 30 months (October 2005 to March 2008) no *LLA* was executed due to some area dispute, which was later, settled (December 2007). Subsequently, the licensee was allotted (February 2006) further area admeasuring 8240 sq.ft on the second floor of Royal Insurance Building at the same rate of ₹ 60 per sq. ft. per month.

The *LLA* for the third term was executed with the licensee for all the three floors (December 2008) covering the period April 2008 to March 2011 (leave and licence period enhanced from 30 months to 36 months). The rent was fixed at ₹ 75 per sq.ft per month, 25 *per cent* more than the original rate of ₹ 60 per sq.ft per month.

Audit observed that though the *licensor* had got the market rent of the building (fourth floor) assessed (May 2008) by a Govt. Registered valuer at ₹ 257.77 per sq.ft. could not enforce the same while going in for the lease after 5 years in December 2008 due to failure to incorporate the term on mutual evaluation of prevalent market rent in the first *LLA* signed in April 2004. Thus, there was short realisation of rental income amounting to ₹ 7.85 crore during the period April 2008 to July 2010.

In the December 2008 *LLA*, however, the licensor included the term saying that 'the parties hereto may mutually agree upon the renewal of the arrangement herein granted, on such terms and conditions as may then be agreed to between the parties'. The inclusion as above clearly revealed the lapse on the part of licensor in inclusion of the term on mutual evaluation of market rent in the LLA of April 2004 though the licensee had offered the same.

Ministry replied (November 2010) that the rate agreed to was realised and added that the provision regarding market rent was omitted as it was an extension of item relating to increase in rent by 25 *per cent* after completion of 5 years.

The reply was not convincing as the Company failed to incorporate the offer of the licensee on increase in rent subject to mutual evaluation of market rent due to which it could not enforce the market rent of ₹ 258 per sq.ft in the renewal after 5 years for the period April 2008 to March 2011.

Thus, lack of due diligence resulted in failure to incorporate the relevant term in the offer and in subsequent LLA leading to loss of rent of ₹ 7.85 crore to the Company.

Recommendation

The Company may strengthen the internal control mechanism to ensure that due diligence exercise is comprehensive while entering into LLAs.

The New India Assurance Company Limited

9.4 Excess settlement of claim

Settlement of a claim ignoring the policy conditions resulted in excess settlement of ₹ 10.65 crore.

Divisional Office 510700 under Kolkata Regional Office of the New India Assurance Company Limited (NIA) (insurer) issued a Standard Fire and Special Perils Policy covering building and stocks to Hotel Trident (unit of EIH Limited-insured) for the period from 01 April 2008 to 31 March 2009 for a sum insured of ₹ 780.92 crore. Another policy was also issued for the same period covering Consequential Loss with an indemnity period of 12 months, for a sum insured of ₹ 232.85 crore. The relevant fire policy had a terrorism extension coverage, subject to an excess of 0.5 *per cent* (i.e. ₹ 5.07 crore) of the combined Sum Insured in respect of both 'Material Damage' and 'Loss of Profit' for each and every loss.

There was an act of terrorism in the Hotel on 26 November 2008 causing damage to the building and contents. It took 25 days to repair the damage. The hotel became fully operational and was reopened on 21 December 2008. Tentative loss assessed by the surveyors for Material Damage and Business Interruption for 25 days was ₹ 16.50 crore (₹ 50 lakh for material damage and ₹ 16 crore* for consequential loss). The net admissible amount worked to ₹ 11.43 crore after adjusting policy excess of ₹ 5.07 crore. The insured reported (April 2009) a business interruption of 12 months after the occurrence and a claim for ₹ 91.17 crore on the plea that their working results could not be normalised within the insured indemnity period of 12 months. So, the surveyors revised their estimated loss to ₹ 55 crore and then to ₹ 66 crore. Final report of the surveyors was yet to be finalised (December 2010). On the recommendation of the surveyors in December 2008 and in April 2009, ₹ 3 crore and ₹ 15 crore respectively were released to the insured as 'on account' payment.

It was observed in Audit that:

- The preamble of the Consequential Loss (Fire) policy had clearly laid down that the benefits under the policy would be available only to the extent the business was interrupted in consequence of the damage or destruction to the insured property arising from the occurrence of the perils covered under the fire policy.
- The properties insured were building and its contents. The damage to the said properties was completely repaired and the hotel became fully operational in 25 days. Once the earning capacity of the insured properties damaged by the insured peril was restored, the damage ceased to interrupt the business. The insurer was not liable for the revenue shortfall on account of other factors such as loss of goodwill, global economic slowdown etc; as they were either non-insurable interests or uninsured perils.
- The maximum indemnity available under the policy was only ₹ 7.35 crore. However, ₹ 18 crore was paid to the insured by way of 'on account' payment resulting in excess payment of ₹ 10.65 crore.

The company in their reply (July 2010) admitted that the interruption period would end for all practical purposes on restoring the property damage. It however added that till the time the results of business had been affected in consequence of this damage and there was achievement of normalcy of business results, the insured would be indemnifiable. In the instant case, according to the Company, even after the re-opening of the hotel on 21

* ***₹232.85 crore x 25/365 =₹15.95 crore***

December 2008, it took several more days for the normalcy in business results to return due to factors such as lingering fears in the minds of the clientele, global economic slowdown, cancellation of confirmed booking by Corporates etc. Thus, the Company viewed the 'on account' payment of ₹ 18 crore made in line with the policy coverage.

Ministry concurred (October 2010) with the Company's views and stated that (i) policy given to the insured was an Industrial All Risk policy under which terms & conditions were quite different from standard fire and special peril policy (ii) interruption would continue till the normalcy of the business results were attained as per the provisions of the policy under BI (Business Interruption) and (iii) the loss assessment was done on provisional basis for releasing on account payments.

The reply of the Management/Ministry was not convincing as:

- The policies in question were (i) a standard fire and special perils policy with terrorism extension and (ii) a consequential loss (Fire) policy relevant to the standard fire and special perils policy. Hence the terms and conditions were in no way different.
- The claim for business interruption beyond the date of restoration of property damage would be admissible only if the business results would not have been affected had there been no property damage. In other words, the insured need to establish that the interruption (revenue shortfall) beyond the date of restoration of the property damage was solely attributable to property damage. In the instant case, the insured themselves anticipated and clarified that the normalcy in room occupancy would not be achieved during the indemnity period because of the impact of terrorism. Thus, the business interruption after the date of reopening of the hotel was not in consequence of property damage but on account of the impact of terrorism and global slowdown which were extraneous causes as far as the scope of the consequential loss policy was concerned. This point was made clear to the Company by the surveyors themselves in their letter dated 29 September 2009, wherein they stated that a distinction would have to be drawn between 'in consequence of the damage' and 'in consequence of the incident i.e terrorism' and that the interruption in consequence of fear of terrorism would not be covered.

Thus, the settlement of the claim beyond the scope of the policy not only entailed loss of ₹ 10.65 crore but also the Company would be obliged to settle similar claims in future for 'Loss of Profit' in consequence of the incident quoting this case as a precedent.

The Oriental Insurance Company Limited

9.5 Claims Management and settlement in Northern Zone

Introduction

Insurance is a contract in which an individual or entity receives financial protection or reimbursement (indemnity) against losses from an insurance Company. Thus, an insurer settles claims against policies issued by him. The efficiency of the claims management and settlement process has a direct impact on a Company's ability to retain customers.

Audit objectives

The theme audit was conducted to assess:

- the system of processing and disposal of claims;
- the system of appointment and efficiency of service of surveyors in settlement of claims; and
- monitoring mechanism to ensure timely recovery from co-insurers.

Scope of Audit

The Northern Zone has seven Regional Offices, of which it was decided to cover two Regional Offices[1] and Seven Divisional Offices[2]. Audit test checked 2702 claims (out of 13508) settled during 2008-09 to 2009-10 during May 2010 to August 2010. Since, 'Health Service Insurance' was examined during 2009-10 and its audit findings stand included in Report No. 10 of the Comptroller and Auditor General of India (CAG) for the year 2010-11, these claims were not covered.

Audit methodology

Audit reviewed the records maintained for appointment of surveyors, surveyors' reports, settlement of claims at operating offices & service centres and various reports generated under management information system besides discussions with the unit heads and other officers of the Company.

Audit criteria

The following criteria were used:

- Insurance Act, 1938;
- IRDA's regulations;
- guidelines issued by the Company for processing, and settlement of the claims;
- various reports and returns prepared under MIS;
- records relating to appointment of surveyors, surveyors' reports;
- functioning of service centres set up exclusively for centralized settlement of claims; and
- review of money due to/from other persons or bodies carrying on insurance business.

Audit findings

The details of the policies issued, premium collected, number of claims settled (including claims reported and outstanding) by Oriental Insurance Company Limited (Company) and its Northern Zone for the period from 2007-08 to 2009-10 is given in ***(Annexure-IV)***.

An analysis of the details given in above Annexure revealed that there was a considerable increase in number of claims settled during the year 2009-10 indicating the Company's resolve to settle claims faster, there was no significant progress in settling claims

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[1] ***Delhi Regional Office – I (DRO-I) and Delhi Regional Office –II (DRO-II)***

[2] ***Divisional Office (DO) – I, II, VI, XVIII & XX under DRO-I and DO – XIII & XXII under DRO -II***

outstanding for more than six months during the period. Total claims outstanding for more than six months constituted 73.67 *per cent* and 51.78 *per cent* of total claims outstanding as on 31 March 2010 in respect of the Company and Northern Zone respectively. As against this, the percentage of claims outstanding for more than six months was 54.16 *per cent* of total claims outstanding in respect of DOs reviewed in audit. Audit observed that performance of the Company could further improve by strengthening its system and ensuring compliance thereof as discussed below.

The Management stated (September 2010) that in view of high percentage of pendency in various offices, a claim review committee was constituted in DRO I & II and within a period of three months there would be sizeable reduction in number of claims outstanding.

9.5.1 System deficiencies

9.5.1.1 Appointment of surveyors: The IRDA[1] Regulations require insurers to appoint surveyors to assess the loss within 72 hours of receipt of the claims. It was noticed that there were delays in appointment of surveyors in 151 out of 2702 claims reviewed.

The Management stated (September 2010) that efforts would be made to follow the guidelines of IRDA and Regional Offices (DRO I & II) were issuing fresh directives to all the controlling offices.

9.5.1.2 Delay in receipt of survey reports from surveyors: Surveyors are required to submit their reports within 30 days of appointment. It was noticed that this timeframe was not adhered to in 987 cases out of 2702 claims reviewed.

The Management stated (September 2010) that the Regional Offices (DRO I & II) were instructing all surveyors that in case of delay in submission of reports, an interim report should be submitted as per IRDA guidelines.

9.5.1.3 Delay in settlement of claims: IRDA Regulations require that the claimant be offered a settlement within 30 days of receipt of the survey reports. However, there were delays beyond this period in 684 cases out of 2702 claims reviewed.

The Management stated (September 2010) that they were making strenuous efforts to make up the delay by drawing the attention of the operating offices and reiterating the provisions of IRDA regulations applicable to the settlement of claims and both the Regional Offices (DRO I & II) were instructing their DO in-charges accordingly.

9.5.1.4 Non-settlement of claims through in-house surveyors: In line with IRDA's regulations as well as Insurance Act, 1938, the Company's guidelines stipulate that 'In case of claims of less than ₹ 20,000, survey by a licensed surveyor is not mandatory. Such losses may be surveyed by the Company's officials (in-house survey) if survey is required'. Following this some of the DOs have incorporated a clause in tender document (DO-I customer IOCL[2]), risk Management programme (DO-VI customer Bharti Airtel) and in policy terms (DO-II customer Bennett & Coleman Ltd) waiving the survey in case of losses upto ₹ 20,000. However, review of records of the selected divisional offices revealed that the licensed surveyors were appointed even in cases where the services of

[1] ***IRDA: Insurance Regulatory and Development Authority***
[2] ***IOCL: Indian Oil Corporation Limited***

in-house surveyors should have been utilised. This resulted in avoidable payment of survey fee of ₹ 10.45 lakh in 638 claims settled for ₹ 31.86 lakh.

The Management stated (September 2010) that in most of the cases where the surveyor was deputed, the estimated loss was more than ₹ 20000 but the final assessment was less than ₹ 20,000 and the services of in house surveyors will be utilised where the estimated loss would be less than ₹ 20000. The reply is not tenable as the audit considered the cases where the reported loss was less than ₹ 20000 and claim settled was also less than ₹ 20,000.

The above four issues were brought out earlier also in CAG's Report No.15 (para 4.6) of 2008. Effective internal controls were yet to be implemented in all operational offices of the Company with periodical monitoring at highest level to reduce delays in settlement of claims at different stages.

9.5.1.5 Evaluation of survey work: Though, the Company prescribed evaluation of surveyors' performance through average qualitative ratio based on time taken for submission of report, assessed and settled amounts, it was observed that the service centers both at DRO-I and DRO-II rated all the existing surveyors as 'Excellent' for the period under review. The rating was not justified in view of the fact that there were many delays in submission of reports and variations in assessed and settled amounts.

The Management stated (September 2010) that both the Regional Offices (DRO I & II) had constituted a Committee to review performance of the surveyors and would submit their report on quarterly basis to their DGMs. Steps need to be taken to review the performance of surveyors at all operational offices in the Company.

9.5.1.6 Establishment of Service Centers: To improve upon client satisfaction, the Company took a pioneering initiative during the year 2008-09 in establishing 'Service Centers (SVC)' in Regional Offices for centralised settlement of claims excluding health. The service centre, being a specialised office is expected to settle claims faster for the offices attached to it. The position of establishment of SVCs at DRO-I & II is given below.

Name of Office and date of starting SVC	Total DOs functioning	DOs attached to SVC	Type of claims attached as on 31 March 2010
DRO-I SVC March 2008	15	12	Motor OD claims of all 12 DOs and all types of other claims relating to five DOs
DRO-II SVC February 2009	13	11	Only Motor OD claims

Audit observed that in the 21 SVCs which were running across the country the average turnaround time of settlement of claims was 30 days and 29 days during the years 2008-09 and 2009-10 respectively in respect of motor own damage (OD) claims. As against this, the average time taken by SVCs at DRO-I and DRO-II was 43 and 44 days respectively during the year 2009-10. Though the Management created different types of MIS for Management analysis of functioning of SVC, it was observed in audit that only the position relating to outstanding claims was monitored by the Management.

The Management stated (September 2010) that corrective measures had been taken and the position would improve in 2010-11.

The purpose of establishment of service centers was that the operating offices would be freed from non-marketing activities and devote more time for sales. However, as the job of settlement of claims was being done both at service centre and at operating offices concerned the purpose of utilising the resources efficiently was not achieved. All the claims were not attached to the SVCs for settlement along with existing manpower of operating offices. This resulted in lower share of SVC i.e. only 28.18 *per cent* in settlement of claims in the selected DOs during the year 2009-10 even after two years of conceptualisation of establishment of SVCs.

The Management stated (September 2010) that the reason for low share of SVC was that, two DOs were not attached to SVC, one DO for all claims and others for motor claims. Initially motor claims would be attached to SVC and after stabilisation other claims would be attached. Accordingly in the 21 SVCs running across the country other claims would also be attached. Reply is not acceptable as Audit did not consider data of DOs that were not connected to SVCs. The percentage of settlement was with reference to total claims settled by DOs including SVC indicating that the job of settlement of claims was being done both at SVC and at operating offices without utilising the resources efficiently.

Recommendation

The Company may expedite attaching all the departments to the service centres for expeditious settlement of claims.

9.5.1.7 Outstanding share recoverable from Co-insurers on settlement of claims: As per Company's guidelines the principal insurance company will process the claim on behalf of all the coinsurers. The coinsurers shall settle their share of the claim within 15 days from the date of receipt of such intimation from the leader without any delay.

A review of records revealed that in 105 out of 276 cases settled during October 2007 to March 2010 relating to DO I & DOVI of Delhi RO I an amount of ₹ 1.13 crore recoverable from co-insurers was not settled within the prescribed period. The co-insurers share was outstanding for a period ranging from 4 months to 33 months (July 2010). In DO II & DO XX Delhi RO I an amount of ₹ 18.96 lakh (number of cases not made available) was outstanding from co-insurers for a period ranging from 4 months to 16 months (July 2010). Whereas, there was nothing outstanding against claims payable on outgoing co-insurance basis in case of the DOs selected for audit except in DO-VI for ₹ 0.51 lakh. It was observed that the details of settled claims were not intimated to the co-insurers in 68 cases (July 2010) amounting to ₹ 73.19 lakh which remained unrecovered (September 2010).

There was no system of reconciliation of the amounts due to / from other persons or bodies carrying on insurance business in the Company. The amount of huge cash outflow on account of settlement of claims on behalf of other insurers without reconciliation/ early settlement was detrimental to the interest of the Company.

The Management stated (September 2010) that recommendations of audit were noted and suitable instructions were issued to operating offices to intensify efforts for recovery of co-insurers' share of premium and claims settled.

Recommendation

The Company may introduce a system of periodic reconciliation for collection of the

amount paid on behalf of other co-insurers and ensure the compliance thereof.

9.5.2 Compliance deficiencies

Terms and conditions of the policy are the guiding principles for settlement of the claims and are binding. During test audit of seven selected Divisional Offices of the Company, instances were noticed from among the selected sample of 2702 claims settled (20 percent of total claims settled) in different operational offices wherein, the Company settled the claims ignoring the stipulated policy conditions which resulted in *avoidable expenditure of ₹18.14 crore* as discussed below:

Claims settled on compromise basis

9.5.2.1 In DRO-I a loss of theft/robbery of goods occurred on 01 June 08 under special contingency (Exhibition of Jewellery in USA) policy issued in favour of M/s GM Products Pvt. Ltd. for the period 22 May 2008 to 22 July 2008. As per the policy the plain/studded gold jewellery (goods) was to be kept in one tin box and the Company was not liable if the goods were left unattended. The surveyor in the report stated that the goods were kept in two bags and the insured lost attention due to distraction which resulted in the loss. Though the loss took place due to chain of events yet there was negligence on the part of the insured in taking proper care of goods as opined by BO/DO also. However, the claim was settled on compromise basis for ₹ 1.02 crore which was not payable as per terms and conditions of the policy, as the goods remained unattended to at the time of robbery.

The Management stated (September 2010) that attending to the insured goods was a matter of interpretation as per the circumstances at the time of loss. In the instant case, the insured had placed the bags on the floor closed to their body and were very much attended to by them. The reply was not acceptable as the form of carriage was changed to two packages instead of one tin box which was in violation of policy conditions. The claim should not have been settled based on interpretation of circumstances which was subjective. In absence of the Company's norms to settle claims on non-standard basis in such special contingency (Exhibition of Jewellary) policies, the claim should have been repudiated.

9.5.2.2 DRO-I settled a claim in August 2009 for ₹ 73.81 lakh on compromise basis under all risk policy (Jewellers' policy) issued in favour of M/s K.K. Jewels Impex. The Company was not liable in case of a theft occurred from a car other than the one which was not fully enclosed type having at the time all doors and windows and other openings securely locked and properly fastened. Audit observed that car doors were open leaving the keys inside and the goods were in suitcases instead of stored in tinned boxes hence the claim was not payable as per exclusion clause of the policy.

The Management stated (September 2010) that the case met all the requirements provided in the policy and the stand that car was left unattended to and that there was failure to take reasonable steps to safeguard the jewellery or lack of efforts to retrieve the same from the robbers would be untenable. The reply was not acceptable as the theft took place from a car which was unlocked and not properly secured establishing the facts that reasonable care was not taken. Hence, the claim was not payable as per exclusion of the policy and also general principles of insurance.

Claims on Machinery

9.5.2.3 DRO-II settled a claim in August 2007 against a Mega Risk Policy issued (July 2005) in favour of NTPC Limited for ₹ 4.98 crore. In contravention of policy condition that the actual value of machinery damaged shall be payable after deducting depreciation at five *per cent* per year on reducing method subject to maximum of 50 *per cent,* the Company settled the claim without deducting ₹ 1.51 crore towards depreciation.

The Management stated (September 2010) that this clause was amended from the policy period 1 July 2006 onwards and endorsement in this regard was issued in June 2007. The reply is not acceptable as the clause revised from the policy period 1 July 2006 onward was not applicable in the instant case as the subject claim settled by the Company was based on the policy for the period 1 July 2005 to 30 June 06 i.e, before issue of the endorsement.

9.5.2.4 In another case, under the policy issued (July 2007) in favour of NTPC Limited the Company settled a claim in April 2009 for ₹ 6.78 crore in respect of damage of a 23 year old Generating Transformer without applying the exception clause as per the policy terms which stipulates that the insurer shall not be liable for damage due to continued operation. The high power enquiry committee and the surveyor report also specifically stated that the loss was due to gradual deterioration for being used for more than 23 years. Ignoring these reports, the Company settled the claim for ₹ 6.78 crore.

The Management stated (September 2010) that these transformers were operating for the past 35 years at various places and such transformer can also be used for a period of 40 years. Reply is not acceptable as the loss took place due to gradual deterioration of insulation because of accelerated aging of transformer which was also confirmed by the surveyor and high power committee appointed in this case.

Claims not reported within the prescribed time

9.5.2.5 In case of an all risk policy (Jewellers) the insured (M/s Crystal gold Pvt. Ltd.) was required to give immediate notice and furnish a statement of loss within 14 days of the date on which the event occurred. A claim reported on 14 July 2008 for the loss occurred on 19 June 2008 was settled on non-standard basis for ₹ 37.37 lakh instead of repudiating it as recommended in survey report.

The Management stated (September 2010) that reporting of the claim after gap in no way adversely affected the quantum of loss. Reply is not acceptable. The Company had lost the opportunity of first hand investigation of the incident and there was no justification for delay in reporting the claim in view of the fact that the insured Company had its office at Delhi and also got confirmation from the police that the goods were not recoverable and traceable.

9.5.2.6 As per the transit insurance policy issued to Food Corporation of India by DO-VI, the insured was to submit insurance claims with supporting documents for any transit loss of grains to the Company through authorised broker on fortnightly basis. Scrutiny of data revealed that the DO settled 757 claims during the period 2008-09 to 2009-10 for an amount of ₹ 6.48 crore where the delay in lodging the claims ranged from 17 to 1200 days beyond the stipulated period.

The Management while accepting the observations of the audit stated (September 2010) that it is issuing instructions to offices suitably and the delays were inevitable considering the size and span of operations. The reply is not acceptable in view of the fact as the volume, size and span of operations of FCI was known to the Company before entering into the agreement.

9.5.2.7 Terms and conditions of the special contingency policy (default in payment by insured's distributors) issued to M/s. Metro Ortem Ltd in DO- XX required:

- a periodical declaration by insured about unpaid invoices of more than 120 days;
- quarterly declaration of the list of debtors who delayed their payment beyond 30 days; and
- that the insured should not agree to any rescheduling of payment of an insured debt without prior written approval of the Company.

Even though the insured did not adhere to any of these conditions, the Company settled a claim for ₹ 3.85 lakh on non-standard basis.

The Management stated (September 2010) that on the basis of the legal opinion and keeping in view the commercial relations with this client it was decided by the competent authority to settle the claim on compromise basis. The reply is not acceptable as lower claim ratio of the insured was not a valid ground to settle an inadmissible claim.

9.5.2.8 As per the Marine policy (M/s. Maharashtra Seamless Ltd.), the insured was required to lodge claim for loss on the port authorities, sea/road carriers within a stipulated period of seven days and one year respectively from the date of discharge at port failing which the claim should be settled on non-standard basis being recovery rights not protected. In this case no claim was lodged on port authorities and road carriers rejected the claim. However, the Company (DO-XIII) settled the claim fully for ₹ 95.72 lakh instead of settling on non-standard basis by deducting ₹ 23.59 lakh.

The Management stated (September 2010) that claim on sea carriers was lodged within one year and rights of recovery was protected. Further, a recovery suit was initiated. However, the fact remained that no claim was lodged on the port authorities and the road carriers while refusing the claim stated that the damage could have occurred at handling point at port. Further, as per the records made available to audit no recovery suit was initiated on the sea carriers.

Inadmissible payment of duties

9.5.2.9 In terms of CENVAT Credit rules* a manufacturer or producer of final products or a provider of taxable service shall be allowed to take credit for duties paid such as Excise duty, Counter Vailing Duty (CVD), education cess on CVD and additional duty on inputs. Scrutiny of the claim files in selected offices revealed that though the offices concerned were deducting the amount incurred by the insured towards the duties for which the insured is entitled for availing CENVAT credit, there were instances in which the Company made payments to the extent of ₹ 52.74 lakh on this account. This was mainly due to absence of clear instructions from the Company in this regard and based on recommendations of the surveyors' concerned.

* ***CENVAT Credit Rules, 2004 issued by Government of India***

The Management issued (October 2010) a detailed circular to make the issue more clear and understandable for all the dealing officials.

> ***Recommendation***
>
> ***The Company may introduce effective internal control system in operating offices and ensure compliance thereof.***

Miscellaneous Issues

9.5.2.10 DO VI allowed claim expenses towards architects, surveyors & consulting engineers charges in excess of three *per cent* i.e. ₹ 43.41 lakh permissible as per the terms of the policy in respect of a fire claim relating to M/s. Jindal Steel & Power Ltd in July 2009 . The Management stated (September 2010) that these expenses were part of repair charges directly related to the repair costs and hence part of assessment made by the surveyors. The reply is not acceptable as charges paid were part of the payments made to consultant engineers/ service engineers for stay, travel etc, towards inspection.

9.5.2.11 Insuring the vehicle at higher Insured Declared Value (IDV) in two cases (one each in DO-XIII and DO-XXII under DRO-II) resulted in excess settlement of claims (₹ 27491 + ₹ 40900) by ₹ 0.68 lakh.

The Management stated that to educate and clarify the interpretation of GR 8 of Motor Tariff a circular from HO was being issued to all Regional Offices.

Conclusion

There was significant achievement in reducing the turnaround time of settlement of claims to 30 days and 29 days during 2008-09 and 2009-10 in respect of Motor OD through attachment of a few operating offices with service centers. However, adherence to time schedule in appointment of surveyors, receipt of survey reports, utilization of services of in-house surveyors, settlement of claims and recovery from co-insurers required further improvement as discussed in preceding paragraphs.

There were deficiencies in compliance with the terms and conditions of policies leading to payment of inadmissible claims amounting to ₹ 18.14 crore. Compliance deficiencies related to settlement of claims, on compromise basis, without deducting depreciation or damage, belated reporting of claims and settlement on other than on non-standard basis etc. Thus, the Company needs to improve its internal controls, system of processing and disposal of claims and enforce strict observance of the terms and conditions of the policies.

The Management while noting the issues stated that by the end of 2010-11 they expected to fully centralise the claim processing at the service centers; issue strict instructions duly providing for controls in all offices for appointment of surveyors and getting reports within prescribed time limits. Further, strict action would be taken against defaulters and instructions on statutory matters were being given from time to time by way of circulars, letters, workshops and training sessions.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

United India Insurance Company Limited

9.6 Internal controls on Underwriting

Introduction

Insurance Regulatory and Development Authority (IRDA) was constituted (April, 2000) to regulate, promote and ensure orderly growth of the insurance and re-insurance business in India. As a result of opening up of insurance sector and de-tariffing 'Marine Cargo' and 'Fire and Engineering insurance', insurance companies were permitted to fix the tariff for underwriting after independent risk analysis, subject to limit on maximum discount on tariff rates earlier fixed by Tariff Advisory Committee (TAC). In the de-tariff scenario, United India Insurance Company Limited (UIIC), instead of doing fresh risk assessment and fixing premium rates on their own, reduced the basic rates fixed by TAC by a fixed percentage and adopted this as their guideline rates. Further, discounts were also permitted on the guideline rates to market insurance products. UIIC delegated powers to its operating offices (Regional, Divisional and Branch Offices) for underwriting business and allowing discounts. The underwriting procedure for Fire and Engineering and Marine procedures were manualised and additional instructions as necessary were being issued as circulars.

Scope of Audit

Audit undertook (August 2010) a study on compliance with guidelines on underwriting by operating offices in respect of selected Fire, Engineering and Marine Cargo portfolios. These constituted 24 *per cent* of the total premium for all portfolios of ₹ 9,517 crore during 2008-09 and 2009-10 by selecting 688 policies for underwriting limits and 215 policies for discount from 10 Divisional offices (DOs) under two Regional offices (ROs).

Audit Objectives and criteria

Audit was conducted with the objectives to review the adherence to:

- manuals, procedures and instructions on underwriting as part of internal control mechanism; and
- IRDA guidelines on discounts.

Audit examined these with reference to the following criteria:

- IRDA's regulations regarding discount
- Manuals, guidelines and circulars issued for policy underwriting
- Delegation of powers by the UIIC

Audit Findings

9.6.1 Manual of procedures for underwriting and claims settlement

The manuals for Fire and Engineering and Marine were updated in 1987 and 2001 respectively. However, in the de-tariffed regime, where the companies had been permitted to fix their own tariff based on proper risk assessment, these manuals have become outdated and irrelevant.

Recommendation

UIIC may expedite preparation of Manuals for the de-tariff scenario.

9.6.2 Issue and receipt of circulars/Instructions issued by Head office

- The circulars issued by the Head Office of the UIIC were neither subject-wise nor serially numbered to enable the receiver to ensure receipt of all circulars. The circulars / instructions were also put on the intranet of UIIC. However, no archive of all circulars was available. In spite of the dual system existing, the operating offices could not keep themselves updated of the latest circulars.
- No system existed at the Head Office to obtain acknowledgement for the receipt of circulars from the field offices.
- None of the sampled offices had all the circulars as per the HO list.

Audit selected five circulars at random issued (not through intranet) during the years 2007-09 by the Fire Tech Division of Head Office and test checked its receipt by the operating offices. It was observed that in six of the 10 DO test checked, one or more of the five circulars could not be produced on request.

9.6.3 Non-Compliance to circulars/instructions

Audit checked compliance to two important requirements, viz, risk acceptance limits and allowance of discounts by DOs and observed the following:

(a) Non-adherence to prescribed risk acceptance limits

All the policies under Fire, Engineering and Marine Cargo falling beyond the underwriting limits (688 policies) of the 10 selected DOs which required approval of the competent authority did not have the approvals of the RO/HO and there was 100 *per cent* deviation.

The offices agreed that no prior approvals in writing had been taken. For oral approvals stated to have been obtained, there was no corroborative evidence available. Certain other offices claimed that policies written in excess of their powers had been duly reported in their Management Information System (MIS) reports. One of the offices (Chennai RO), which was the designated authority for 240 policies out of total 688 policies, stated (October 2010) that all the policies were underwritten in a highly competitive scenario and within a short span of time and hence oral approvals were given in all the cases without ratification in writing. However, they were not able to provide any evidence like file noting or record of discussion in support of consideration of individual proposals.

The reply of the Management was an after-thought as no system of seeking or providing approvals was in place.

Recommendation

UIIC may ensure compliance to underwriting limits and in case oral approvals were inevitable in the business scenario, necessary procedures may be evolved for authenticating such approvals.

(b) Allowance of discounts by DOs on policies falling beyond the underwriting limits of DOs

UIIC prescribed that in respect of policies falling beyond the underwriting limits of the DOs, they were not empowered to grant any discount. Audit test checked 31 *per cent* (out of 688) of such policies, and it was observed that discounts were allowed on 88 *per cent* of these policies under the three portfolios. Also discounts had been granted by the DOs without bringing on record the justification such as favourable claim experience, details of competition faced, etc.

The IRDA had directed (March 2007) all the general insurers that the net rates of premium for individual rated risks, after considering all the discounts and loadings, should not be below 48.75 *per cent* of the basic/tariff rates. UIIC had fixed 70 *per cent* of the basic/tariff rates as their guideline rate. As such, UIIC was not empowered to grant discounts beyond 30.36 *per cent* of their guideline rates. However, it was observed by Audit that in 92 *per cent* of the cases where discounts were allowed, the discount was in excess of the IRDA permitted limits.

(c) Non-revision of guideline rates to realistic levels

In the competitive business scenario, it is imperative to do proper risk assessment of portfolios periodically based on past data, to revise/adjust the basic rates of premium to realistic levels sustainable in the market and to delegate powers for granting discounts to the operating/regional offices to such an extent necessary to retain the existing business and to attract new business. However, UIIC did not initiate measures in this regard. Test checks as above revealed that discounts in excess of 50 *per cent* were granted in 80 *per cent* of the policies and in 54 *per cent* of the policies the discount allowed was more than 75 *per cent.* The operating offices stated that the business scenario warranted such discounts. Thus, the base rates fixed by UIIC needed revision.

Recommendation

UIIC may undertake portfolio wise risk assessment, revise the basic premium rates to the levels sustainable in the market and revisit the delegation of powers for granting discounts and lay down procedure for grant of discounts.

Conclusion

The guidelines and relevant data for effective underwriting in line with present business scenario need to be updated. Operating offices had been underwriting business and allowing discounts beyond delegated powers and also beyond the limits prescribed by IRDA without recording justification.

The matter was reported to Ministry in December 2010; reply was awaited (February 2011).

CHAPTER X: DEPARTMENT OF HEAVY INDUSTRIES

Bharat Heavy Electricals Limited

10.1 Technology Upgradation in Electronics Division-BHEL, Bangalore

Introduction

Bharat Heavy Electricals Limited (Company) established the Control Equipment Division (CED) in Bangalore in July 1976 to take over Radio and Electricals Manufacturing Company (REMCO), a State Government Undertaking. REMCO was merged with CED during May 1980 and renamed as Electronics Division (Division) in May 1987. This Division was formed with the objective of centralizing, coordinating and expanding the manufacture of control equipment required for industries in the fields of Power, Transport, Steel, Aluminum and Copper, etc., which were being manufactured earlier by various units of the Company on a small scale. The product range was enlarged over the years with technology obtained either from collaborators or developed in-house.

Product Profile

The Division manufactures Control Equipment, Semiconductors, Photo Voltaic cells and modules and Defence simulator equipment *etc.* The Control Equipment[♣] are the major products with 98.82 *per cent* share in the total turnover of the Division. The Automation and Control Systems/equipment (also known as Distributed Control Systems or Control and Instrumentation Systems) comprise, mainly, micro processor based electronic modules, assembled and wired in racks and housed in panels which along with requisite system and application software perform the automation and control functions.

Scope of Audit

The present study covers implementation of Technical Collaboration Agreement established with the Technology collaborator for providing state of the art Control and Instrumentation automation platform and for manufacture of high end Digital Processing Units (DPU);

Audit Objectives

Audit was conducted with a view to assess implementation of the Division's plan for expansion of production facilities.

Audit Criteria

The following criteria were used:

- Collaboration agreements with the technical collaborator and execution reports, feedback paper, time schedule for compliance etc.;

[♣] ***Control for Boilers, Steam Turbines, Hydro and Gas Turbines, Station Control and Instrumentation, Machine Man Interface and Supervisory Control, and Data Acquisition System (SCADA), Alternate Current and Direct Current drive controls, Static Excitation Systems/Automatic Voltage Regulator, Alternate Current Loco/Electro Motive Units Controls.***

- Feasibility reports, project reports, progress reports of capital investment etc.;
- Agenda and minutes of the meetings of the Board of Directors of the Company; and
- Production records, cost records, order book records etc.

Financial Performance

Working results of the Division for the last three years ended 31 March 2010 are indicated in the (***Annexure-V***). The turnover and profit of the Division has shown an increasing trend, which was due to good order book position and execution of order.

Production Performance

The installed capacity of the Division is measured in terms of 'cubicles', 'number of power devices' and 'Kilowatts' (KWs) in respect of the different products *viz.*, control equipment, power devices and photo-voltaic, respectively. The Division's actual production vis-à-vis installed capacity for the last three years was as follows:

Products	2007-08		2008-09		2009-10	
	Installed capacity	Actual production	Installed capacity	Actual production	Installed capacity	Actual production
Control Equipment (in Cubicles)	2,500	3,058	4,300	4,222	4,300	5,897
Power Devices (in Nos.)	12,000	14,994	12,000	18,214	20,000	19,420
Photo Voltaic (in KWs)	3,000	1,155	3,000	1,203	8,000	1,155

Audit Findings

Audit findings and recommendations are discussed in the following paragraphs:

10.1.1 Technical Collaboration Agreement - Phase I

In order to meet the changing demands of customers, the Division entered (December, 2000) into a Technical Collaboration Agreement (TCA) with M/s Max Control Systems Inc., USA, presently known as Metso Automation Inc. (MAF) for obtaining technical know-how for manufacture of Distributed Control Systems (DCS) with Max DNA technology.

The terms of TCA, *inter-alia,* included the following:

- Licensor (MAF) shall furnish to Licensee (Company) all relevant information including technical reports resulting from special studies and experiments carried out by the Licensor in the areas related to DCS and the Licensee shall have the right to use all such information received from the Licensor without any additional payment.
- The Licensor to allow the Licensee's personal access to the research and development laboratories of the Licensor with prior approval to hold discussions with the specialists of the Licensor for developmental activities relating to DCS.
- The Licensor shall automatically furnish at no additional cost any and all improvements and modifications whether patented or not, to the know-how and/or

DCS as soon as the same has been introduced by the Licensor in its current programme for commercial production.

The Division paid a lump sum fee of US$ 2.5 million (₹ 12.14 crore) for the technology. Further, consequent upon transfer of technology, depending on the requirement, the Company placed order on MAF for supply of finished Digital Processing Units (DPU) modules which are printed (fitted) into the Printed Circuit Board of the DCS. In terms of the TCA, the Company was liable to pay royalty (1.5 *per cent* to 3.25 *per cent*) on net sales price from time to time to MAF on the actual sales of the DCS after deduction of cost of DPU modules imported and accordingly, ₹ 20 crore were paid to MAF during the last three years ended 2009-10.

Phase-I investment was completed in 2002-03 by creating a Surface Mount Technology (SMT) line and related facilities for manufacture and testing of Printed Circuit Boards (PCBs) with an investment of ₹ 11.23 crore. Post investment, the Division produced more than 17,000 max control modules and more than 3,000 racks in 2003-04, which was more than the expected load of 10,500 per year production as envisaged in Feasibility Report (FR) and was also successful in absorption of technology offered by MAF. About 500 Digital Processing Units (DPU) (Module DPU 4E with ceramic version) was produced during 2003-04 itself.

The Agreement was renewed (September 2009) for a further period of 10 years.

10.1.2 Technical Collaboration Agreement - Phase II

To meet the increased demand for Metso Automation hardware modules, over and above the facilities created in Phase I investment, the Division proposed (May 2004) augmentation of the manufacturing facilities. The additional investment was necessitated to meet the increased load and to enable manufacture of new version of the processor module (DPU4F). The Division invested a sum of ₹ 7.90 crore during the years 2004-05 and 2005-06 and augmented the facilities as envisaged in the Phase II investment proposal. Audit scrutiny of the implementation of the TCA Phase II revealed the following:

10.1.2.1 Failure to obtain DPU4F technology from Collaborator

During Phase-I, DPU4E (with ceramic geode processor) version of DPU was being produced by the Division. The new version of the processor *viz.,* DPU4F was developed by Metso Automation after implementation of Phase I of the TCA (2002-03), but the Division submitted a proposal for Phase II augmentation only in May 2004. In reply to Audit, the Division admitted (July 2010) that they were not aware of the exact date of commercialisation of the DPU4F module by the collaborator. On review of records relating to TCA and creation of the production facilities, it was observed that:

- The Division did not pursue to obtain the documents from the collaborator for establishing facilities for manufacture of modules with DPU4F (ceramic version) immediately after commercialisation of the product by the collaborator, as per the terms of TCA, but instead obtained a price quote for purchasing DPU4F modules in May 2004 and started importing DPU4F module from the collaborator instead of accelerating creation of facilities for manufacture of the module.

- Corporate office approval (May 2004) to the proposal for augmentation programme was received only on 1 November 2004, *i.e.,* after a gap of five months.
- The Division commenced establishing assembly and inspection facility line in May 2005, completed testing facilities in August 2005, and after trial runs *etc.*, started commercial production of DPU4F module only in January 2006.
- In the meanwhile, to meet production requirement for 2005-06 and first half of 2006-07, the Division imported 1,701 (Nos.) DPU4F modules during March 2005 to January 2006 at a cost of ₹ 29.69 crore as per the price offer of the collaborator. This led to avoidable expenditure of ₹ 21.84 crore when compared to in-house manufacturing cost of ₹ 7.85 crore.

The Management stated (September 2010) that collaborator was responsible for transfer of technology as per the terms of TCA agreement. The collaborator started furnishing the documents from February 2004 and further design changes were made in December 2004, May and December 2005. Accordingly, the Division planned change over from DPU4E to DPU4F in 2005-06 and completed in August 2005 as planned. This being a complex technology, only reasonable time was taken to complete the indigenisation process by January 2006 and modules were imported to meet the production requirement during the interim period. However, the Management assured that in response to audit observation, concerted efforts would be made to further shorten the time required for updation of know-how and manufacturing facilities in future.

Reply of the Management was not acceptable as:

- Efforts were not made by the Division to keep itself abreast of the technological developments made by the collaborator despite a provision in the TCA that allows the Licensee access to the Research and Development facilities of the Licensor.
- Pro-active action was not taken by the Division to obtain the required documentation from the Collaborator (as per Article 5 and 6 of TCA) immediately after introduction of new version modules/components in the market by the collaborator.
- Extra expenditure of ₹ 21.84 crore had to be incurred by the Company in importing the newer version of the module from the same collaborator because of failure of the latter in not supplying the know-how for the new version of the module to the Company as per the provision of the TCA, though the collaborator could manufacture and sell the new version to the Company. This deprived the Company of the saving it could have effected in manufacturing the new version of the module indigenously. However, no action was initiated by the Company against the collaborator for the consequences of breach of contract on the part of the latter.

Had the complete sets of documents been obtained immediately after commercial production by the collaborator, the Division could have completed the indigenisation and production of the DPU4F modules in 2004-05 itself and avoided import of DPU4F module at an extra cost.

10.1.2.2 Delay in establishment of facilities for change in technology

Under Phase I and Phase II expansion, the Division manufactured DPU4E/4F modules using ceramic geode processor chips supplied by M/s AMD Singapore. M/s AMD, Singapore had declared ceramic geode processor as obsolete in October 2005 itself, replacing it with the plastic geode processor♠ version and intimated (October 2005) the Division accordingly.

It was observed that though the plastic geode processor had replaced the ceramic geode processor in October 2005, the Division placed purchase orders for procurement of re-flow oven (from M/s Vitronics Soltec PTE Limited Singapore in April 2008) and ICT test fixture (from M/s Metso Automation Max Controls, USA in July 2008) required for handling plastic geode processors only in April 2008, after a lapse of 29 months. The equipment costing ₹ 0.58 crore were installed in July 2008 and trial operations started only in August 2008. Meanwhile, as the Division did not have facilities for production of DPU modules with plastic geode processor, it imported (March 2008 and December 2008) 600 (Nos.) DPU4F modules (with plastic geode processor) from the collaborator at a cost of ₹ 19.24 crore. The additional cost of import when compared to in-house manufacture cost was ₹ 9.94 crore.

In reply the Management stated (September 2010) that:

- Complete technical details of DPU4F module version were received in June 2007 and indigenised in August 2008 using plastic geode;
- To meet the production requirements of second quarter of 2008-09, the Division had to import the bare minimum quantity of modules; and
- Concerted efforts would be made to further shorten the time required for updation of know-how and manufacturing facilities in future.

Reply of the Management is not acceptable as the ceramic version of the geode processor was declared obsolete by the supplier in October 2005 itself. The Division failed to immediately obtain documentation from the collaborator. The equipment required for production of modules with plastic geode was installed only in July 2008 leading to avoidable expenditure of ₹ 9.94 crore on import of DPU modules with plastic geode processor which could have been produced in house.

Conclusion

Inability on the part of the Management to enforce the terms and conditions of the Technical Collaboration Agreement and to take pro-active action to obtain technical know-how in time from the Collaborator for improvement /modification of products and failure to keep abreast of the latest developments in the market coupled with delay in creation of facilities resulted in avoidable expenditure of ₹ 31.14 crore (₹ 21.84 crore plus ₹ 9.30 crore).

The matter was reported to Ministry in September 2010, reply was awaited (February 2011).

♠ ***Geode processors (ceramic or plastic) are bought out items used in the manufacture of DPU modules.***

Recommendation

The Company should take pro-active action for (i) obtaining the technical know-how from the collaborator on improvements /modification to the technology and (ii) timely re-designing of manufacturing line to use the alternatives.

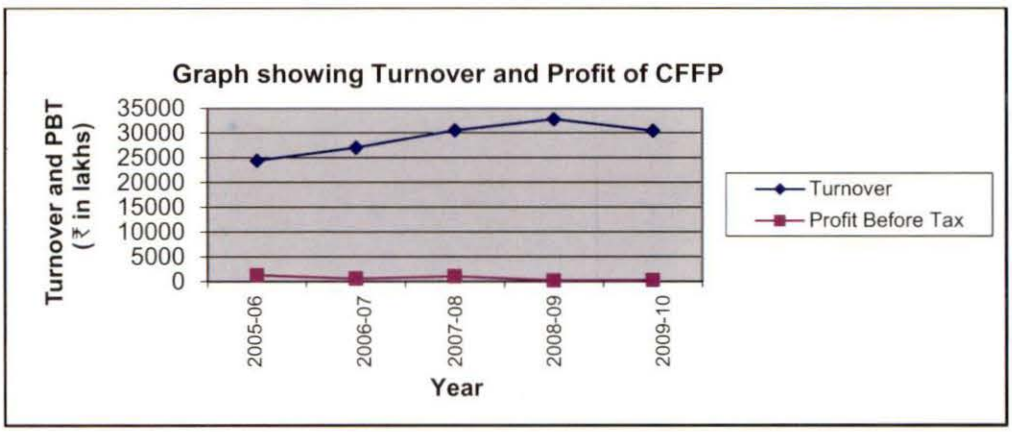
10.2 Forging Capacity Utilisation at CFFP, Haridwar

Introduction

The Bharat Heavy Electricals Limited (Company) is one of the largest engineering and manufacturing enterprise in India in the energy-related/ infrastructure sector set up in November 1964. Amongst 14 of its manufacturing plants spread all over India, the Central Foundry Forge Plant (CFFP) was set up in 1976 at Haridwar in technical collaboration[1] with M/s. Creusot Loire, France to manufacture steel castings[2] and forgings[3] for meeting in-house requirements of other units of the Company. The Technical Collaboration Agreement (TCA) with M/s. Creusot Loire expired on 31 March 1988.

Performance of CFFP

The Turnover as well as Profit Before Tax (PBT) of CFFP during last 5 years (i.e. 2005-06 to 2009-10) is presented in the graph below:



The above graph indicated that although the turnover of CFFP increased progressively over the period from 2005-06 to 2008-09, the profit (PBT) had not increased proportionately. Further, the percentage of PBT to the turnover ranged from 0.63 *per cent* to 5.21 *per cent* only.

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[1] ***The technical collaboration with M/s. Creusot Loire included preparation of detailed project report (DPR), setting up of facilities at CFFP and transfer of technology.***

[2] ***Castings are hollow objects made by giving shape to molten metal by pouring it into sand/clay moulds.***

[3] ***Forgings are solid objects manufactured by pouring molten metal in cast iron moulds, heating in furnace and shaping by press (hammer). Forgings are comparatively better in quality and strength (dense) than castings.***

Manufacturing process of Rotor forgings[1]

The audit examined in detail the manufacturing process of rotor forgings which is having three production shops viz. Steel Melting Shop (SMS), Forge Shop divided in Medium Forge Shop (MFS) & Heavy Forge Shop (HFS) and a Machine Shop.

Making rotor forgings

To manufacture a forging, required quantity of steel scrap is melted in Electric Arc Furnaces (EAFs) and processed in secondary refining facilities[2]. Molten steel is poured & processed under vacuum in cast iron moulds in the vacuum tank. Simultaneously, vacuum is created inside the tank till desired vacuum level is achieved and maintained for some time to diffuse out the gases from the molten metal. Finally, the vacuum cover is removed and ingot is left to solidify and cooled before stripping it for forging. It is mandatory for the forging ingot to have low gas content. The presence of gases beyond certain limit causes hair line cracks, inclusions etc. leading to rejection. Thus, adequate vacuum is essential for making ingots so that gases diffuse out.

What is forging

Forging is a mechanical process through which ingot is forged with the help of Forge Press at pre-determined temperature to shape it in a desired dimension and to avoid irregular microstructure. Quality heat treatment of rotor forging is an essential requirement to avoid the irregular microstructure which becomes a cause of rejection of forging.

Scope of Audit and Audit Methodology

The thematic study covered utilization of capacity of CFFP to manufacture rotor forgings during the period 2005-06 to 2009-10. The production process included quality control and rejection for which a sample of 25 nos. (187 MT) out of 75 nos. (611 MT) rotor forgings rejected during April, 2005 to March, 2010 was selected by using 'Random Sampling Method'. Besides, records relating to five rotor forgings cleared in quality test were also examined.

Audit Objectives

The objectives were to assess whether:

- the capacity of CFFP was utilized optimally taking into account the demand for rotor forgings received;
- the Management took timely action for technological up-gradation;
- norms for rejection of rotor forgings were prescribed to measure the deviation against the standards;
- the reasons of rejections were avoidable or not; and
- effective steps were taken to keep the rejection levels within the norms.

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[1] ***Rotor forging is a type of forging manufactured in CFFP which is used inside steam turbines for producing electricity and can rotate at the rate of 3000 rpm at 1650° C.***

[2] ***Refining facilities constituted Vacuum Arc Degassing (VAD)/ Vacuum Oxygen Decarburization (VOD) furnaces located in SMS.***

Audit Criteria

The performance of the Unit was assessed against the following items:

- Production data sheets;
- Rejection Notes and Ultrasonic Test reports;
- Metallurgical and Root Cause Analysis Reports; and
- Recommendations of various technical consultants and their implementation.

Constraints

Audit encountered following constraints while conducting this study:

Non-availability of Detailed Project Report

The Detailed Project Report (DPR) prepared at the time of setting up of CFFP (1976) was not available with the Management. In the absence of DPR, the operating norms adopted by the CFFP could not be verified in Audit. The actual time taken in different operations was compared with the norms adopted by the Management.

Discrepancy in production/rejection data of rotor forgings

As per initial information furnished by the Management (August 2008, February 2010 and May 2010), rotors equivalent to 3214 MT were produced during 2005-10 out of which 1171 MT were stated to have been rejected. Subsequently, (July2010), while furnishing year wise rejection details, rotors equivalent to 610.569 MT (75 nos.) were stated to have been rejected. This mismatch in the basic production /rejection data was brought to the notice of Management in August 2010. The Management failed to reconcile this mismatch despite several reminders. Further, as per information furnished in January 2011, 364 nos. rotors (3000 MT) were produced out of which 117 nos. (1058 MT) were stated to have been rejected. Since the Management continued to change the data, initial information furnished by the Management was considered in Audit.

Audit findings

10.2.1 Installed capacity and utilization

The installed capacity of the unit (based on annual accounts) for steel forgings (medium and heavy) was 3000 MT and 2410 MT, respectively. Review of actual production vis-à-vis installed capacity during last 5 years revealed that the actual production of medium forgings during the period under review ranged between 53 *per cent* (in 2009-10) and 77 *per cent* (in 2008-09) and heavy forgings between 27 *per cent* (in 2007-08) and 34 *percent* (2009-10). Thus, the capacity utilization of medium forgings was not satisfactory while the capacity utilization of heavy forgings was low.

10.2.2 Reasons for low capacity utilization in respect of the rotor forgings

10.2.2.1 Old and inadequate facilities

Most of the production facilities (EAFs, Transformers and Forge Press), installed in 1976, were not upgraded/ modernized.

Analysis of utilization of two transformers revealed that one transformer (attached with 30 Ton EAF) remained under break down for 18 months while the other transformer (attached with 70 Ton EAF) remained under break down for 25 months during 2005-10.

In the absence of stand by transformers, CFFP continued the production with lower capacity transformers leading to production loss of ₹ 81.98 crore (12919.35 MT liquid metal). This indicated that Management approach was lacking in risk-assessment of unforeseen events as well as alternate measures for un-interrupted production.

It was further observed that HFS was set up (1995) at CFFP with imported second hand 7500/9000 Ton Forge Press. However, all the balancing facilities[1] were not installed resulting in non-production of large size rotors.

Management, while confirming (September 2010) the facts, stated that revamping of 30 Ton EAF could not be carried out due to breakdown of another 70 Ton EAF as the same was forcefully operated on low capacity transformer. Reply was not convincing as no standby arrangement of the production facilities was created for uninterrupted production process.

10.2.2.2 Change in product-mix

The Company attributed (July 2008) reduction in yield of medium forgings from 43.50 *per cent* to 34 *per cent* to change in product mix (from Russian design to German[2] design also known as KWU design) which tapered down over a period during early 1990 and to customers' insistence for supply of forgings close to their finish machined dimensions. Audit observed that no steps were taken to upgrade/modernize the forging technology for better yield.

10.2.2.3 Rejection in rotor forgings

Standard maintained with regard to rejection of rotor forgings by forging units operating internationally was five *percent.* Audit, however, observed that inspite of 34 years' operations, no norms for rejections were fixed at CFFP. Analysis of production data revealed that the rejection level at Forge Shop (producing medium and heavy forgings) ranged from 7.60 *per cent* to 19.21 *percent* which was significantly higher than the international standard. Analysis further revealed that the rejection level of rotor forgings ranged from 28.36 *per cent* to 48.99 *per cent* while rejection level of forgings other than rotor forgings ranged from 1.51 *percent* to 10.10 *percent.* Further, percentage of rotor forging rejections out of total forgings rejected ranged from 43.03 *percent* to 83.92 *percent.*

Thus, major part of the rejections was contributed mainly by rotor forging.

Management stated (September 2010) that rejection norms for rotor forgings could not be fixed until the process was fully established. Management's reply was not acceptable as even after lapse of 34 years time the Management was unable to fix rejection norms which were necessary to have better managerial control over efficient operations.

10.2.2.4 Reasons for rejection

The reasons for rejections during last 5 years, ended in March, 2010, as analyzed by Audit on the basis of the Root Cause Analysis (RCA)/ Metallurgical/Technical Test Reports, made available by the Management, were as detailed below.

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[1] ***Balancing facilities mean use of manipulator.***

[2] ***The rotors required for German design thermal sets require low content of Sulphur and Phosphorous than the Russian design. Thus, the German design was more sophisticated than the other.***

(a) Inadequate vacuum suction capacity and inclusions

Review of records revealed that the vacuum degassing units available with the units did not have sufficient suction capacity (less than 1 milibar) to evacuate gases generated during processing and pouring of steel of very low Aluminum, low Silicon grade required for rotors. An analysis of rejection of rotor forgings in 2006-07 by the Management (July 2007) revealed that of the total rejections of 34 rotors, 33 rotors rejected were due to inclusions in the forgings.

Although the issue of inadequate vacuum suction capacity was flagged by the Management in 1995 and by the metallurgical consultant in 2002 engaged by the Management to pin point the shortcomings in steel melting process and two proposals were sent to the Corporate Office for rectification of the defects noticed, but only in December 2008, a new Vacuum Ejection System (VES) (valuing ₹ 8.78 crore) of required suction capacity was installed.

Audit further observed that out of 25 cases of rejections audited, the basic cause of rejection in 14 cases was inclusions which would have been formed during steel melting process. Test check of production sheets of 30 heats at Steel Melting Shop (SMS), revealed that the average time for melting the scrap by the EAFs was three to seven hours against the technological requirement of three hours.

Management stated (August 2010) that there could be host of factors effecting formation of inclusions but a good vacuum helps in reducing inclusion formation and attributed reasons for higher scrap melting time to low input power to the EAF, setting up electrode movement, intermittent breakdowns, lunch break in between process, delay in readiness of the moulds for pouring etc. However, the fact remained that new VES was installed with a significant delay of 13 years which was avoidable.

(b) Lack of proper heat treatment of the rotor

It was observed from RCA/Metallurgical/Chemical Test Reports that irregular microstructure of the metal in three forges♣ out of 25 cases examined was due to lack of proper heat treatment of the rotor. As a result, the heating effect at the centre of the rotor got reduced resulting in irregular microstructure and consequential rejection. Further, improper quenching was also observed as one of the reasons for rejections.

Management stated (September 2010) that the rejected rotors did not reach the stage of final heat treatment, as they showed ultrasonic test indications before being subjected to quality tests. Since final heat treatment of rotors was not done, an irregular microstructure was always expected.

Reply was not acceptable because as per root cause analysis above during August 2009 to February 2010 by Corporate R&D, Hyderabad in respect of three forges, irregular microstructure was due to improper heat treatment of the rotor.

10.2.3 Non-availability of technical know-how

Audit observed that despite of the fact that the technological know-how provided by M/s. Creusot Loire was for smaller rotors of Russian design and the TCA had expired in 1988, CFFP switched over to manufacture of bigger rotors of Siemens design by extrapolating

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♣ *No.4531, 4380,4491*

the know-how provided by M/s. Creusot Loire instead of entering into fresh TCA and/or establishing any specialized R&D facility for rotors. Thus, the manufacturing of rotors was done on trial and error basis.

It was further observed that the Company entered (February, 2010) into an agreement with M/s. Sheffield Forgemasters International Limited (SFIL), UK for acquiring technology for higher weight rotors (up to 1000 MW) after a lapse of 22 years. The Company expected reduction in rejection rate less than 10 *percent* and five *percent,* in case of rotor forgings and other forgings, respectively.

Management stated (September 2010) that all possible options available at the time were used. None of the established forging manufacturers was willing to share its know-how. With great efforts finally SFIL agreed for a tie up in year 2010. The fact, however, remained that acquisition of the appropriate technology was inordinately delayed.

10.2.4 Non availability of Active Oxygen Measuring Instrument

To produce quality steel, checking of oxygen level is an essential activity. Audit observed that since inception, the Unit did not have any Active Oxygen Measuring Instrument, which could provide instant results of oxygen content. Availability of Active Oxygen Measuring Instrument could have reduced the defects in the production. Management confirmed (August 2010) that the process being adopted by CFFP, to ascertain Oxygen level took 2-3 days time, and instant corrective action could not be taken by the Management in the absence of above instrument.

10.2.5 Impact of under utilization of capacity

10.2.5.1 Expenditure on imports

It was observed that due to inability of CFFP to supply rotors timely against requirement of sister units, the Company had to procure 409 rotors worth of ₹ 654.45 crore through imports.

Management stated (September 2010) that CFFP was never designed to make all 100 *per cent* forgings (including increased requirement) needed by BHEL in house. It was only intended to reduce dependence on foreign suppliers and to have control over price of imports. Reply was not acceptable as CFFP was set up to cater to in-house requirement for other sister units but it failed to achieve its intended objective.

10.2.5.2 Delayed delivery of rotors

Impact of delayed delivery as observed in Audit was as below:

- As on 31 March 2010, supply of 69 rotors valuing ₹ 26.05 crore were pending execution where the delivery was overdue. The delay was ranging from two months to 58 months (Wanakbori TPS). It was further observed that at one side the production capacity was not fully utilized and on the other side supply of 69 rotors was behind schedule.
- 60 orders placed by sister units for supply of 117 rotors (₹ 56.58 crore) were cancelled due to inability expressed by CFFP for timely supply. Further, on subsequent procurement of 55 rotors from outside sources with a delayed delivery ranging from 0 to 42 months, Company incurred loss of ₹ 2.68 crore.

- Audit further observed that supply of 6 rotors (Mejia Unit 5 & 6, Chandrapura Unit 7 & 8 and Jindal Raigarh Unit 3 & 4) ordered by its sister units were delayed by three to seven months which contributed to delayed commissioning of these projects.

Conclusion

Due to outdated and inadequate facilities, the CFFP could not achieve optimal utilization of its forging capacity. After expiry of technical collaboration agreement with M/s Cleusot Loirs, France in March 1988 the Company could not find a technology partner for 22 years. In the meantime the Company tried to improve its performance on the basis of experience acquired by it over the period but the percentage of rejections was very high ranging from 28 to 49 percent as compared to standard of five percent maintained by forging units internationally. Thus, CFFP was unable to meet the demand of its sister units for rotors. Eventually, the sister units were forced to cancel their orders placed on CFFP and to procure rotors from the open market. Thus intended purpose of setting up CFFP could not be achieved to a large extent.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

Recommendation

Efforts should be made for optimum utilization of the installed capacity by taking necessary corrective measures such as fixing of rejection norms and timely up-gradation/renovation of existing facilities and establishing Research & Development facilities to acquire latest technology.

10.3 Avoidable expenditure on purchase of Gas Turbine

Avoidable expenditure up to ₹ 15.56 crore due to delay in seeking quotation for purchase of Gas Turbines by BHEL

GSPC Pipavav Power Company Limited, Amreli (Pipavav) and Gujarat State Energy Generation Limited, Hazira (Hazira) invited tenders on 26 October 2006 and 15 November 2006 respectively for Engineering, Procurement and Commissioning of power projects which inter-alia included supply of three Gas Turbine Generators (GTG) with a capacity of 350 MW each. Accordingly, Heavy Power Equipment Plant (HPEP), Hyderabad, a unit of Bharat Heavy Electricals Limited (Company) placed Request For Quotation (RFQ) on General Electric Company (GE), USA (22/ 23 January 2007) for one number Flange to Flange Frame 9FA Gas Turbine Generator (F–F GTG)[1] and two number Phase - III rotor kits (Kit)[2] for submitting quotations to Pipavav and Hazira .

In response to RFQ for Pipavav, GE submitted (5 May 2007) proposal for supply of F–F GTG and Kit for US $ 25,725,700 and US $ 19,107,800 respectively which was valid up to 30 November 2007. In the meantime, the delivery schedule in respect of Hazira was curtailed (18 April 2007), forcing HPEP to import F – F GTG. Instead of placing RFQ on GE for F – F GTG immediately, RFQ was placed only on 4 October 2007 with a delay of 6 months for which the price offered (5 October 2007) was US $ 28,807,700 with validity

[1] ***Fully finished Gas Turbine Generator directly imported from General Electric Company***

[2] ***Sub-assemblies imported from GE for in-house manufacture of GTGs***

up to 31 October 2007. Consequently, HPEP placed orders on GE (27 October 2007) for supply of two F–F GTGs and one Kit as per the price quoted by GE on 5 May 2007 and 5 October 2007.

Meanwhile price offer to the tender was submitted (29 June 2007) by the Company to Hazira in line with Pipavav.

The delay in seeking quotation from GE led to increase in price for F–F GTG from US $ 25,725,700 (5 May 2007) to US $ 28,807,700 (5 October 2007) and the reasons for such delay were not on record. The avoidable delay led to an additional expenditure up to ₹ 15.56 crore.

The Management in its reply (September 2010) mainly contended that in view of the excessive load for machining and very long deliveries quoted for casing castings, a critical input for converting Kit to F–F GTG, the Company decided to import a F–F GTG for Hazira.

The contention of the Management is not convincing in view of the following:

- it could have obtained proposal for two F–F GTG machines[♥] for a price of US $ 25,725,700 each instead of one F–F GTG before receipt of proposal from GE (5 May 2007) as the amendment for delivery schedule in respect of Hazira was received on 18 April 2007 and
- the Company's decision to procure one F–F GTG for Hazira was mainly based on tight delivery schedule and not on the perceived constraints in machining capacity.

Thus, the avoidable delay in seeking quotation for F–F GTG led to an additional expenditure up to ₹ 15.56 crore.

The matter was reported to Ministry in October 2010, reply was awaited (February 2011).

[♥] ***One for Pipavav and one for Hazira***

CHAPTER XI: MINISTRY OF HOUSING & URBAN POVERTY ALLEVIATION

Housing and Urban Development Corporation Limited

11.1 Lending Operations in Urban Infrastructure Schemes

Introduction

Housing and Urban Development Corporation Ltd. (HUDCO) was incorporated on 25 April 1970 with the main objective of providing long term finance for Housing and Urban Development programmes in the country. For fulfillment of these objectives HUDCO finances a variety of schemes formulated by the Government/Non-Government Agencies through its 20 Regional offices across the country.

Scope of Audit

Out of total loans of ₹ 67141 crore sanctioned during the period from 2005-06 to 2009-10, an amount of ₹ 56214 crore (84 *per cent)* was sanctioned for Urban Infrastructure (UI) schemes. Lending operations in UI schemes of HUDCO, during the above period of five years ended on 31 March 2010 were examined during the thematic study.

Audit Objectives

The audit assessed whether:

- adequate control mechanism relating to appraisal, sanction, release and recovery of loans existed.
- the funds disbursed were utilized effectively/efficiently for the intended purpose.
- the objectives set by the Company for UI lending were achieved.
- speedy legal action was taken in the cases of default
- the control mechanism was effective enough to safeguard the financial interest of HUDCO and to cover the risk of lending.

Audit Criteria

The performance of HUDCO was assessed against the following criteria:

- Govt. of India directives and HUDCO targets set for UI lending
- Guidelines of National Housing Bank (NHB)
- Codal provisions and guidelines of HUDCO for lending.

Audit Methodology

Out of total 560 schemes, 60 schemes were selected on random basis for examination. Random sampling was based on quantum of financing, sanctions to private agencies, achievement of objectives, defaults in repayment and level of Non-Performing Assets (NPAs). In addition, nine One Time Settlement (OTS) cases were also audited. The records relating to the above selected schemes/cases were audited at Corporate Office and nine Regional Offices* of HUDCO during May to July 2010.

11.1.1 Targets and Achievements

Audit analysed the target of financing UI schemes and achievements of the Company there against. The target and achievements for sanction and release of loans under UI schemes during the last five years up to 2009-10 were as under: -

(₹ in crore)

Year	No. of Schemes sanctioned	Targets		Achievement		Percentage of actual release to sanction
		Sanction	Release	Sanction	Release	
2005-06	101	8820	4410	8553	2691	31.46
2006-07	135	9900	4950	9284	2622	28.24
2007-08	150	8553	3500	11349	2864	25.24
2008-09	104	9408	4340	13121	3131	23.86
2009-10	70	10349	4774	13907	2296	16.51
Total	**560**	**47030**	**21974**	**56214**	**13604**	

The above table indicated consistent decline in release of funds against the amount sanctioned. Targets and achievements for sanction and release for last five years up to 2009-10 (as indicated in the above table) showed that the Company could not meet the targets. Reasons for decline in performance were as under:

(i) Out of 560 schemes, 162 closed without release of funds where either the agencies failed to fulfill the sanction conditions or did not turn up for loan due to higher rate of interest of HUDCO, resulting in loss of business of ₹ 22418.34 crore to HUDCO as under:-

Year	2005-06	2006-07	2007-08	2008-09	2009-10	Total
No. of Schemes closed	37	39	48	32	6	162
Amount (₹ in crore)	5463.59	3659.24	5208.85	6918.64	1168.02	22418.34

(ii) Similarly, there were 120 schemes sanctioned for a loan of ₹ 5134.44 crore during the three years up to 2007-08 against which the loan release was ₹ 2991.66 crore up to March 2010. The balance loan could not be released as agencies availed of funds from other sources and some projects were behind schedule.

(iii) Funds could not be fully released against sanctioned loans as both Central and States Governments were releasing funds for different projects relating to UI schemes at much more attractive rates of interest.

(iv) As institutional support to HUDCO was not available, it borrowed from market resulting in higher cost of funds.

* *Delhi (NCR), Chandigarh, Kolkata, Guwahati, Mumbai, Hyderabad, Chennai, Bengaluru and Thiruvananthapuram*

11.1.2 Performance in Financing UI schemes

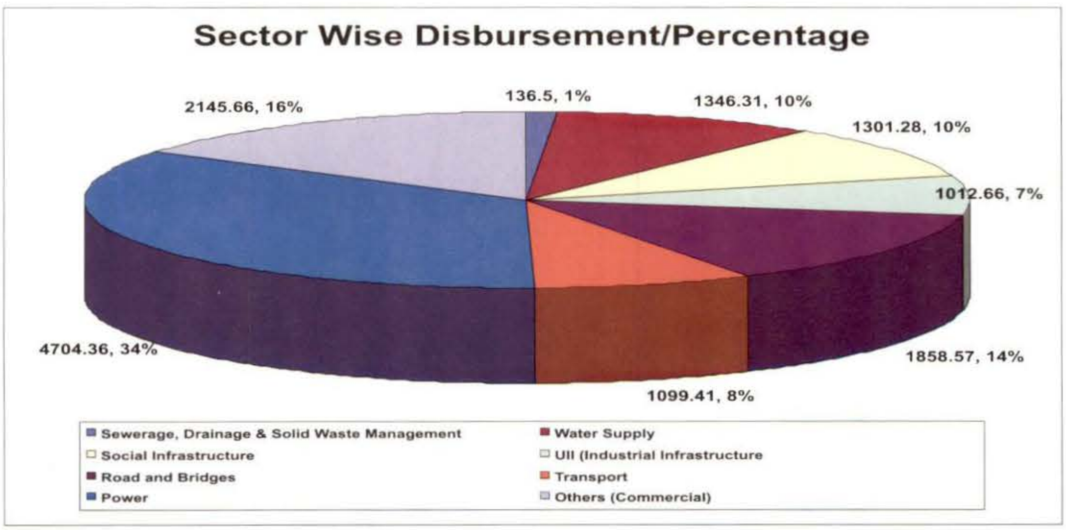
11.1.2.1 Operational Performance

As may be seen from the operational performance of the Company in financing UI Schemes during the last five years (***Annexure-VI***), the loans outstanding against Government agencies decreased from ₹ 12064.04 crore during 2005-06 to ₹ 9725.46 crore during 2009-10, but the defaults increased from ₹ 635.77 crore to ₹ 801.72 crore during these years. In case of Non-Government agencies there was increasing trend in outstanding loans as well as defaults in repayments and the same ranged between 19.62 *per cent* and 28.29 *per cent* during the five years up to 2009-10. Thus defaults by Non-Govt. agencies were alarmingly high which increased from ₹ 517.94 crore (in 2005-06) to ₹ 1047.10 crore (in 2009-10).

The Management stated (September 2010) that releases were dependent on various factors and in the event of delay in payment by Government agencies, HUDCO was not having any access / recourse to the funds available for State Governments.

11.1.2.2 Sector wise performance

The position of sector wise release of loans during the last five years up to 2009-10 is shown in the tabular form in ***Annexure-VII*** and Pie-chart as under:



From the above chart it would be seen that out of eight segments of Urban Infrastructure major financing (34.57 *per* cent) was made for power sector. Financing to power plants was mainly made on consortium basis where the schemes were appraised and approved by lead lender and the Company released its share as a consortium member.

As against parameters set out in MOU by the Administrative Ministry the Company achieved satisfactory level in sanction of loans, however, in case of release of funds for UI schemes and percentage of releases for priority* infrastructure the performance of HUDCO was rated as "poor" by the Ministry during all the five years up to 2009-10. The Management stated (September 2010) that 34.13 *per cent* of total UI funding was made towards priority sector in the last five years. However due to entry of banks, cut-throat

* ***Drainage, Sewerage, Solid Waste Management, Water supply, Roads and Social Infrastructure***

competition and absence of Government support for low cost funds and other benefits to HUDCO, it had to widen its area of funding to power and commercial infrastructure.

11.1.3 Audit Findings

HUDCO had laid down guidelines for appraising the loan applications, sanction and release of loans. The shortcomings in the control system on these issues along with the reasons for default in the recovery system noticed in audit are discussed in succeeding paragraphs:

11.1.3.1 Non-adherence to guidelines

Para 28(1) of the Housing Finance Companies (NHB) directions 2001 provided that no housing finance Company shall lend to any single borrower exceeding 15 percent of its Net Owned Funds (NOF) and any single group of borrowers exceeding 25 percent of its NOF. However, HUDCO framed (May 2005) its own credit concentration norms which provided for lending to various State Governments with no limit and Government agencies up to 50 percent of NOF in contravention of NHB norms. This had resulted in over exposure leading to greater risk in lending for which no additional security to cover the same was obtained by HUDCO.

The Management stated (September 2010) that NHB exposure norms were fully complied with respect to private sector borrowers and in case of State Government/State Government agencies, HUDCO has been requesting the Ministry / NHB for relaxation of NHB norms. Audit, however, noticed that Ministry / NHB has not accepted the proposal of HUDCO so far (September 2010).

11.1.3.2 Appraisal of loan proposals

(a) HUDCO sanctioned loan of ₹ 33.05 crore to 14[♥] Cold Storage projects between February 2006 and January 2008 in Bihar classifying these as commercial projects, though the same did not fall under Urban Infrastructure. An amount of ₹ 23.97 crore was released to 11 agencies up to March 2010 and no release was made to three agencies (March 2010). 10 agencies were in default of ₹ 8.56 crore (March 2010) due to delay in completion of projects and uneconomical operation of cold storages. Project reports prepared by two consultants were based on storage of agrarian products without taking into account the inherent risk of wide fluctuation in output thereof. The parameters of cash flow and major cost elements were also kept constant over the period of 10 years. Thus due diligence was not exercised in appraisal of loan proposals as required under HUDCO guidelines. The Management stated (September 2010) that the schemes were sanctioned as a part of UI services after sensitivity analysis and that it had no involvement in preparation of DPRs. The reply was not tenable as the viability of the

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[♥] ***(i) Maruti Construction Pvt. Ltd., Hazipur (Scheme No. 18839, 18902),(ii) Ramandi Cold Store, Kusa, Khobi (18912),(iii) Shree Chand Cold Storage P. Ltd., Korha (18951),(iv) Tri Raj Cold Storage P. Ltd., Gaya (19004), (v)Sona Developer and Cold Storage P. Ltd., Madhepura (19026),(vi) Pansalwa Cold Storage P. Ltd., Pansalwa (19074),(vii) Kamath Cold Storage P. Ltd., Charrapati (19255), (viii) Nirbhay Cold Storage P. Ltd., Dumraon (19257),(ix) Champanagar Cold Storage P. Ltd., Champanagar (19258),(x) Aman MP Cold Store, Chaimpur (19303), (xi) Shri Ram Praikshan Cold Storage P. Ltd.Chandsarai(19311), (xii) Bilas Cold Storage P.Ltd., Gwalpada (19341), (xiii)Thakur Nikunj Cold Storage p. Ltd., Madhurapur (19358) and (xiv)Shashi Bhushan Cold Storage P.Ltd, Bhitti (19395)*** projects sanctioned on unrealistic parameters was doubtful due to which the agencies remained in default.

(b) The Company sanctioned (May 2005) a loan of ₹ 54.00 crore to M/s Global Education Net (the agency) (Scheme 18675) out of which an amount of ₹ 35.44 crore was released upto August 2008 to the agency to set up a Medical College and Hospital at Agartala in Tripura. Audit analysis revealed that the Management did not verify credit rating of agency and enforceability of corporate guarantee/ mortgaged security, as prescribed in HUDCO guidelines, before sanction and release of the loan to the above agency. The State Government of Tripura terminated (May 2009) its agreement with the agency as the agency failed to create infrastructure as per requirements of Medical Council of India resulting in blockage of funds of HUDCO. The Management stated (September 2010) that State Government of Tripura had formed a committee for assessment of assets and liabilities of the scheme /agency for further running the hospital and that it was expected that the matter would be resolved within the financial year. The reply was not acceptable as the Company had not ensured credit rating of the agency and enforceability of corporate guarantee/mortgaged security before sanction /release of loan of ₹ 35.44 crore which remained blocked (March 2010).

(c) The Company sanctioned loan of ₹ 85.00 crore (Scheme-17333) to M/s Konaseema EPS Ockwell Power Ltd. against which ₹ 80.45 crore were released up to May 2006 and balance ₹ 4.55 crore was released in January 2008. The power plant could not be made operational due to non availability of natural gas and the State Government also did not allow operation of the power plant with alternative fuel. The Management stated (September 2010) that the project was completed in time (August 2006) but the operation was delayed due to delay in commercial exploitation of gas. The reply was not acceptable because while participating in consortium lending, the Company, as a prudent financier, should have ensured that the Project was viable and fuel supply would be available to it.

11.1.3.3 Sanction and Release of loans

(a) HUDCO sanctioned (March 2005 to May 2008) loan of ₹ 49.63 crore for three commercial complex projects with following deficiencies: -

(i) HUDCO sanctioned a loan of ₹ 25.00 crore to M/s. Today Hotels (Andhra) Pvt. Ltd. (Scheme-19058) and released (March 2008) an amount of ₹ 20.75 crore to Hyderabad Urban Development Authority (HUDA) on behalf of the agency. It was observed that the title of the land was not registered in the name of the agency. As such in absence of prime security the above amount of loan was unsecured. The Management stated (September 2010) that the agency and the Hyderabad Urban Development Authority had undertaken in a tripartite agreement to create equitable mortgage in favour of HUDCO and that agency had also offered equitable mortgage of the land owned by its group company at New Delhi. The reply was not acceptable as the mortgage of the land in favour of HUDCO was awaited (April 2010).

(ii) Loan of ₹ 12.95 crore was sanctioned (May 2008) to M/s Durga Developer Pvt. Ltd. (Scheme 19513) for construction of a multi storeyed commercial complex at Ranchi, out of which an amount of ₹ 6.16 crore was released. Audit observed that the loan was released without ensuring clear title of the project land which was disputed and under litigation due to which the project could not be completed and funds were blocked. The Management stated (September 2010) that further release of loan to the borrower was stopped in view of dispute. The reply was not acceptable as the Management had released loan to the extent of ₹ 6.16 crore without ensuring clear title of land.

(iii) Loan of ₹ 11.68 crore was sanctioned (March 2005) to M/s Harsha Associates Private Limited (Scheme 18601) for construction of commercial complex. Audit observed that HUDCO released ₹ 9.57 crore to the agency though it had not brought required contribution and capital in the project and diverted funds of the project for other purposes. The advances received from customers were also not routed through escrow account. The Management stated (September 2010) that legal action had been initiated against the agency. The reply was not tenable as the loan was released without ensuring compliance to pre-disbursement conditions.

(b) HUDCO sanctioned loan of ₹ 76.81 crore for two hotel projects with following deficiencies:

(i) Loan of ₹ 71.07 crore was sanctioned (March 2007) to M/s. Shristi Urban Infrastructure Development Corporation Ltd. (Scheme 19125), a Joint Venture Company (JVC) of HUDCO, for construction of a Hotel-Mall Multiplex project. The loan was sanctioned by relaxing security norms in violation of HUDCO guidelines. Promoter's contribution was reduced to 10 *per cent* against the required level of 25 *per cent*, corporate guarantee and personal guarantee of promoters were not obtained and sub-lease hold land was considered as prime security. Audit observed that the project was not covered under objective clause of JVC and subsequently, the loan was transferred (July 2007) to a special purpose vehicle (SPV) of JVC, M/s. Shristi Udaipur Hotels and Resorts Pvt. Ltd. First two instalments of ₹ 3.75 crore each only could be released up to projected completion period (March 2010) of three years for want of compliance to pre-disbursement conditions. The Management stated (September 2010) that relaxation in norms was made as the borrower was a JVC of HUDCO. The reply was not acceptable as relaxation in norms was not admissible to SPV which was a separate entity and financing of a project to be set up on a sublease land was also not as per guidelines of HUDCO.

(ii) Loan of ₹ 5.74 crore was sanctioned (March 2006) to M/s Birsa Hotel Pvt. Ltd. (Scheme 18863) with a release of ₹ 5.58 crore. Audit observed that loan was sanctioned without taking into account the take out finance and the debt servicing record of the agency resulting in default (May 2009) against HUDCO dues. The Management stated (September 2010) that the agency had promised to clear the dues of State Government agencies and that the loan was sanctioned by HUDCO on merits. The reply was not acceptable as the loan was sanctioned to a party who had been a defaulter in repayment of dues of other lenders.

11.1.3.4 Recovery of dues and Non Performing Assets (NPAs)

Timely recovery of the dues from the borrowers is of utmost importance for regular recycling of funds and to avoid loans turning into NPAs. HUDCO does not have any system to analyse the actual amount recovered against the amount due for recovery and analysis of old and current dues. In the absence of requisite data on this aspect the Management was not in a position to assess its recovery performance at a particular point of time.

The age wise details of defaults under UI scheme at the end of each year from 2005-06 to 2009-10 are given below.

(₹ in crore)

Age wise	2005-06	2006-07	2007-08	2008-09	2009-10
0-3 months	50.07	78.29	112.34	59.15	76.59
3-6 months	9.53	9.71	19.42	15.11	2.58
6-30 months	160.91	112.23	62.28	81.70	143.45
Above 30 months	933.20	1096.46	1274.89	1559.91	1626.20
Total	**1153.71**	**1296.69**	**1468.93**	**1715.87**	**1848.82**

From the above table it is evident that defaults in repayment had an upwards trend which increased from ₹ 1153.71 crore (Govt. - ₹ 635.77 crore and Non Govt. - ₹ 517.94 crore) during 2005-06 to ₹ 1848.82 crore (Govt.- ₹ 801.72 crore and Non Govt. – ₹ 1047.10 crore) at the end of March 2010. The defaults which were more than 30 months old ranged between ₹ 933.20 crore and ₹ 1626.20 crore and were 80.88 *per cent* to 87.95 *per cent* of the total defaults during these years indicating that there was higher risk of non recovery of this amount. An amount of ₹ 419.99 crore related to the cases which were five to ten years old and ₹ 1097.98 crore related to cases in default for a period exceeding 10 years.

A few default cases worth highlighting were as under:

(i) HUDCO sanctioned (April 2007) a loan of ₹ 12.00 crore to M/s Evergreen Properties Pvt. Ltd. for construction of commercial complex(Scheme 19201). Audit observed that HUDCO released ₹ 10.20 crore for the project from time to time without ensuring the proportionate contribution to be made by the agency. The project remained incomplete and the premises could not be leased out or sold leading to non generation of revenue and default (March 2010) of ₹ 4.96 crore. The Management stated that legal action by HUDCO was under process. However, the tangible legal action to recover the dues was awaited.

(ii) Against the loan of ₹ 75.07 crore released (September 1998) to Maharaji Education Trust (Scheme 12941) for setting up Institute of Allied Health Science, no repayment was received after January 2001. OTS for ₹ 172.22 crore offered (December 2004) by HUDCO was not honoured by the agency. The recovery suit filed (August 2002) by HUDCO in DRT Delhi was decided (June 2008) for recovery of ₹ 148.08 crore plus interest. HUDCO neither could attach the mortgaged properties nor was able to recover the dues which accumulated (March 2010) to ₹ 692.33 crore. The Management stated (December 2010) that the dues of agency had been re-cast in terms of Debt Recovery Appellate Tribunal order dated 6 October, 2010 and first monthly installment of ₹ 50.00 crore was due in November 2010. However the fact remained that the recovery mechanism of HUDCO was not effective in this chronic default case and even after recast of dues no repayment was received.

(iii) HUDCO had released loan of ₹ 141.35 crore to Jalgaon Municipal Corporations (JMC) under various schemes. Audit observed that the agency remained a chronic defaulter even after rescheduling (March 2004) the loan and waiver of ₹ 3.41 crore. JMC's overdues accumulated (March 2010) to ₹ 22.68 crore (UI Schemes). The Management while intimating the amount outstanding against Jalgaon Municipal Corporation as ₹ 50.62 crore, stated (September 2010) that the matter had been taken up by the CMD, HUDCO with the Chief Secretary, Government of Maharashtra. The reply was not convincing as lack of effective action by the Management to recover dues resulted in accumulation of outstanding amount.

(iv) Loan of ₹ 11.70 crore was sanctioned (April 99) to M/s Enbee Infrastructure Ltd. (Scheme 16219) for a waste to energy project. Audit observed that the agency neither provided revolving bank guarantee nor created lien on escrow account and diverted the funds to other purposes. The project was abandoned by the agency after first release (October 2000) of ₹ 3.88 crore. The recovery suit filed (November 2002) by HUDCO in Debt Recovery Tribunal (DRT) Mumbai remained pending for want of jurisdiction clause until High Court remanded (August 2006) the case. The Management stated that recovery proceedings were pending in DRT Mumbai and DRT Delhi. However, the fact remained that release of loan was not justified in view of irregularities. Further, absence of jurisdiction clause in the agreement with the agency delayed the legal proceedings resulting in accumulation of overdues to ₹ 23.15 crore (march 2010).

11.1.3.5 One Time Settlement (OTS) of overdues

The guidelines of HUDCO provided for One Time Settlement to resolve the chronic default cases including NPAs through default resolution package for final settlement of dues. During the period covered in audit, HUDCO settled 27 cases of OTS where the loans were sanctioned prior to the period covered in audit. The OTS packages were approved for ₹ 661.04 crore against the dues of ₹ 944.74 crore thereby forgoing ₹ 283.70 crore during the five years up to 2009-10. Audit observed that failure of managerial control at various stages of sanction, release and recovery of loans led to ultimate loss in OTS cases. Some of the OTS cases are discussed below:

(i) HUDCO released a loan of ₹ 10.62 crore up to September 1996 to M/s Punjab Wool Combers Ltd. (Scheme 12798) for construction of commercial complex. Audit observed that the agency remained in default from December 1996 and also filed (August 1997) a case before the BIFR for declaring it as a sick Company within one year of release and the case was decided in May 2005. As per HUDCO guidelines the OTS of the case was worked out to ₹ 25.12 crore. However, only principal amount of ₹ 10.62 crore was recovered (May 2007) in OTS against the outstanding dues of ₹ 111.31 crore. Management replied that agency was not a sick Company at the time of release of loan by HUDCO. The reply was not acceptable because moving the case by the agency before the BIFR for declaring it as a sick Company within one year of release of loan indicated serious lapse in the system adopted by the HUDCO for assessment of borrower, which failed to assess that the agency was on the verge of being sick.

(ii) HUDCO released a loan of ₹ 58.01 crore up to August 2004 to M/s Mysore Sugar Company Ltd. (Scheme 16757 & 16989) for setting up co-generation power plant which remained un-operational. Audit observed that the agency was in default since September 2004 and reported to BIFR for declaring it as a sick Company and was declared to be so in September 2005. HUDCO neither invoked State Govt. Guarantee nor exercised its mortgage rights of properties to recover the dues. The agency was allowed (February 2010) OTS of ₹ 92.41 crore against dues of ₹ 109.42 crore thereby forgoing ₹ 17.01 crore. The OTS amount was allowed to be paid in seven years instead of two years as per HUDCO guidelines. The Management stated (September 2010) that concessions were extended to agency on the request of State Government of Karnataka and in view of business interest. However the fact remained that the loan was released to a sick Company and relaxation in recovery were allowed against HUDCO guidelines.

(iii) HUDCO sanctioned a loan of ₹ 14.53 crore to M/s Wise Infrastructure Ltd. (Scheme 13183) for construction of commercial complex against which ₹ 6.75 crore was released up to May 1997. Audit observed that the Project land was under dispute/litigation which resulted in non-completion of project and non-payment of HUDCO dues. Ultimately HUDCO recovered (Sept. 2006) ₹ 15.67 crore in OTS against the dues of ₹ 49.46 crore thereby forgoing ₹ 33.79 crore. The Management stated that default had become NPA for which OTS was approved. The reply being irrelevant was not acceptable as financing of a project on a disputed land had led to non recovery of dues resulting in NPA.

Conclusion

The Company did not apply due diligence while appraising loan proposals. Consequently, financing of unviable projects ended up in blockage of Company's funds. The Company also released loans to borrowers without ensuring that the loan amount was adequately secured. In a few of the cases noticed in audit the Company released loan by relaxing pre-disbursement conditions which proved detrimental to the financial interests of the Company as subsequently these lenders defaulted. The mechanism for recovery of dues was also not effective as was evident from the fact that the amount in default was rising as it increased from ₹ 1154 crore in 2005-06 to ₹ 1849 crore in 2009-10. This included ₹ 1097.98 crore relating to cases in default for more than ten years due to deficiencies at various stages and inadequate pursuance of recoveries. Failure of Management control at various stages of sanction, release and recovery of loans led to ultimate loss in settling the overdue cases through OTS. The Company had to forgo an amount of ₹ 284 crore to settle dues of ₹ 945 crore through OTS packages approved by it over the period of five years reviewed.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

Recommendations

- ***Managerial control mechanism at all stages of operations required to be strengthened.***
- ***HUDCO Management should take suitable steps to increase financing in priority sector for urban development.***

CHAPTER XII: MINISTRY OF PETROLEUM AND NATURAL GAS

Bharat Petroleum Corporation Limited, Hindustan Petroleum Corporation Limited, Indian Oil Corporation Limited

12.1 Revenue Foregone

Inability to utilise pipeline as planned resulted in loss of opportunity to earn revenue of ₹ 5.17 crore besides avoidable expenditure of ₹ 15.99 crore.

Aviation Fuel Station (AFS) of all three Oil marketing companies viz. Indian Oil Corporation Limited (IOCL), Bharat Petroleum Corporation Limited (BPCL) and Hindustan Petroleum Corporation Limited (HPCL) at Chennai receive Aviation Turbine Fuel (ATF) from Chennai Petroleum Corporation Limited (Refinery), a subsidiary of IOCL. Indian Oil Corporation Limited (Company) commissioned (21 December 2008) dedicated ATF pipeline between the Refinery and AFS Chennai at a cost of ₹ 47.52 crore with a capacity of 0.18 million metric tonne per annum on single shift operation basis to avoid transport by tank trucks (TT).

The project was approved (November 2005) by the Chairman and Managing Director, after taking into consideration, *inter alia,* the proposal by the Executive Director (Finance), that the projected Internal Rate of Return (IRR) of *6.77 per cent,* which was below the benchmark IRR 11 of *per cent,* would be improved by sharing the pipeline and collecting charges from other Oil Marketing Companies (OMC) on commissioning. Further, OMCs had executed in March 2002 an agreement for sharing of logistics.

HPCL used the pipeline on two occasions (May-August 2009 and February 2010) for transporting 5,527 MT of ATF. The arrangement came to an end as the Company's demand of ₹ 612 per MT was not agreed to by HPCL because it was incurring ₹ 183 per MT for transportation through TTs.

Audit observed the following:

- During the period between December 2008 and September 2010, the other two OMCs had transported a total of 282,466 MT of ATF from the Refinery to AFS, Chennai through TT by incurring ₹ 25.16 crore (transportation cost of ₹ 5.17 crore and quality checking, handling and other expenses for transporting through TTs of ₹ 19.99 crore).
- IOCL did not make any efforts to market its pipeline to other OMCs.
- The matter of non- finalisation of transportation charges was not escalated to the higher levels even after having a master facility sharing agreement between the three OMCs.

This resulted in estimated extra expenditure of ₹ 15.99 crore by HPCL and BPCL towards quality checking, handling and other expenses, which could be avoided by transportation through pipelines besides transportation charges ₹ 5.17 crore through truck transfers.

The Management of HPCL and BPCL did not reply while the Management of IOCL contended (September 2010) that they never envisaged that this facility would be extended to other OMCs as it was intended to create a strategic advantage. Further, assistance to OMCs would be subject to certainty of protecting their business interest, surplus capacity being available and mutually acceptable commercial terms.

The Company's present statement contradicted the justification provided in the IRR, where it was clearly stated that the pipeline IRR would be improved by carrying the fuel of other OMCs. Besides, sharing infrastructure, which was envisaged in the Product Sharing Agreement dated 31 March 2002 would be beneficial to the Government, the major stakeholder of all the OMCs.

As regards the strategic advantage claimed by IOCL, it did not sound logical or justifiable as IOCL only supplies ATF to HPCL and BPCL in any case from the Refinery at Chennai and denying more efficient transportation alone would not serve the stated purpose. Moreover, the benefits that would accrue to the society from reduced hazardous traffic in highly crowded city roads and the reduction in carbon footprints by not using motor transport were also to be considered.

Thus, expenditure of ₹ 15.99 crore incurred by the other two OMCs on quality control and transportation charges of ₹ 5.17 crore besides underutilisation of pipeline could have been avoided by use of pipeline for transportation of ATF from Refinery to AFS, Chennai. Further, IOCL lost revenue on pipeline usage which would have been between ₹ 5.17 crore and ₹ 17.29 crore[♣] based on the rates to be decided by OMCs.

The matter was reported to Ministry in December 2010; reply was awaited (February 2011).

GAIL (India) Limited

12.2 Undue benefit extended to power producers

GAIL (India) Limited supplied natural gas at APM rates, in violation of the Ministry's directive, to ineligible consumers generating and supplying electricity to their customers at commercial rates through the grid of Tamil Nadu Electricity Board. This led to under recovery of ₹ 227.37 crore, undue benefit to such producers to that extent and extra burden of subsidy on the Government.

GAIL (India) Limited (Company) was supplying Natural Gas to its consumers under administered price mechanism (APM) at prices determined by the Government of India (GOI). To dismantle APM in a phased manner over the next three to five years, the Ministry of Petroleum and Natural Gas (Ministry) restricted use of APM gas only for fertiliser and for power generating companies supplying electricity to the grid for distribution to consumers through public utilities/licensed distribution companies (June 2005). Consequently, in June 2006, the Ministry revised the rates for APM gas supplied

[♣] ***Estimated at ₹ 5.17 crore as per cost of truck transfers of 282465 MT by HPCL and BPCL at the rate of ₹ 183 per MT incurred by HPCL and ₹ 17.29 at the rate of ₹ 612 per MT demanded by IOCL.***

to certain category of consumers other than power and fertilizer sector consumers from ₹ 3200/MSCM[1] to ₹ 3840/MSCM and from ₹ 1920/MSCM to ₹ 2304/MSCM for North-east consumers.

The Company while implementing the GOI directives segregated its gas consumers in Cauvery Basin under four categories viz.

- Category A- State Electricity Boards and Government Companies generating power for supply to Grid for distribution to consumers;
- Category B- Private Companies generating power and selling to State Boards as Independent Power Producers (IPP);
- Category C- Consumers generating electricity for captive consumption without supplying to GRID; and
- Category D- Consumers generating electricity and supplying to various consumers using wheeling arrangement[2] with State Electricity Boards.

The Company charged its customers under Category A and B at the rate of ₹ 3200/- per MSCM and also Category D consumers at the rate of ₹ 3200/- per MSCM on provisional basis. The Company sought (July 2006) clarification from the Ministry whether Category D consumers were entitled for APM price. The Ministry's clarification was stated to be still awaited (August 2010).

Audit observed (July 2009) that even though there was no ambiguity in the Ministry's directives regarding applicability of APM gas price to consumers generating power for supply to the grid for distribution through public utilities/licensed distribution companies only (and not to the Category D consumers supplying power at commercially agreed rates), the Company, in violation of the Ministry's directives, extended the benefit of APM gas price rate to such Category D consumers. This resulted in under-realisation of ₹ 227.37 crore from seven consumers during the period from April 2006 to March 2010 in the Gas Pool Account. The undue benefit of ₹ 227.37 crore passed on to these consumers was bound to increase further till receipt of clarification from the Ministry.

The Management in its reply (May 2010/November 2010) stated that Natural Gas consumers under Category D were supplying power to stake holders/industrial consumers through the transmission network/grid of Tamil Nadu Electricity Board (TNEB) by giving about *15 per cent* of the electricity as wheeling charges to TNEB and that as the Ministry's directive did not mention about different rate to be charged to those consumers who were selling power to private parties through wheeling arrangement, GAIL had been charging APM gas price.

The reply of the Management is not tenable as the consumers falling under Category D were utilising the TNEB services for wheeling and the electricity generated from the gas utilised by consumers under Category D was being supplied to end users at commercial rates. Hence, being custodian of Gas Pool Account, it was the responsibility of Company to charge the correct rate instead of extending benefit to private parties on assumption basis under the shelter of referring the case to the Ministry for clarification and leaving

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[1] ***Metric Standard Cubic Meter***

[2] ***The act of providing the service of transporting power over transmission lines***

the matter unresolved for an indefinite period. Further, such supplies at APM rates to non-eligible consumers enhanced the subsidy burden on the GOI.

Thus, supply of gas under the APM rates to non-eligible consumers in violation of the Ministry's order resulted in loss of revenue to the tune of ₹ 227.37 crore in the Gas Pool Account during April 2006 to March 2010.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

Indian Oil Corporation Limited

12.3 Duty Drawback claims

Introduction

Section 75 of the Customs Act,1962 (Act) allows refund, known as drawback, of element of excise duty paid on indigenous inputs or customs duty paid on imported inputs included in the export of output. The Customs and Central Excise Duties Drawback Rules, 1995, (Rules) framed (May 1995) under the Act, define "export" to, inter alia, include "loading of provisions or store or equipment for use on board a vessel or aircraft proceeding to a foreign port". It prescribes certain procedures for claiming duty drawback on the exports. Rule 6 of the Rules, ibid, provides for fixation of brand rates (rate at which drawback is to be claimed), where 'all industry rates' (drawback rates notified for standard products) are not available for any category of goods exported. The exporter has to make an application, together with all supporting documents[1] for fixation of brand rate, to the relevant Customs and Central Excise Authorities, having jurisdiction over the manufacturer from where the goods are taken for export. Further, he has to register with the Customs authorities (Customs) at the Ports from where exports take place to enable claiming of drawback.

The Oil Marketing Companies (OMC) import crude to meet the domestic demand. While exporting the surplus products depending upon market conditions, OMCs also supply Aviation Turbine Fuel (ATF) to foreign bound aircrafts on regular basis out of bonded stock[2] which is deemed to be exports as per the Rules. Thus, OMCs are eligible to claim drawback for the customs duty suffered on the imported crude element included in the ATF/petroleum products exported, as well as such deemed exports.

Until the year ended 31 March 2002, the marketing and pricing of petroleum products were governed by Administered Pricing Mechanism (APM), under which, Government of India (GOI) controlled the prices of the products marketed by OMCs with assured marketing margins. During the APM Regime, the Indian Oil Corporation Limited (Company) acted as the canalising[3] agent to import crude/export petroleum products on behalf of all OMCs up to March 2001.

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[1] ***Disclaimer certificate, production statement, process flowchart, worksheet for proposed brand rate, value addition statement, statement of imports and duty suffered thereon, proof of export etc.***

[2] ***Stock moved from refinery/terminal to Aviation Fuelling Stations without payment of excise duty.***

[3] ***A terminology used to indicate authorized service provider for execution and documentation of imports/exports.***

It did not, however, evolve systems and procedures to claim eligible drawback for the products including ATF exported during APM Regime. Consequently, the Company could not claim the drawback for its eligible exports. When the APM regime was dismantled the authority for the import/export vested with respective OMCs from April 2001 onwards.

Ministry stated (February 2011) that availing of duty drawback on ATF exported to foreign going vessels was never contemplated because of complexity of operations for distribution and impossibility of complying with legal requirements. Efforts were made by IOCL in consultation with PPAC[1] to simplify the procedures for claiming drawback.

The Customs and Central Excise Duties Drawback Rules which provide for claiming drawback on supplies to foreign going vessels came into effect as early as May 1995 and the time taken (more than eight years) to initiate procedures to claim the benefits under the Rules could have been reduced.

For the first time, the Company appointed (October 2003) M/s. Shangrila Pvt. Ltd., Mumbai (consultant) to assist it in getting the brand rate fixed and claiming the drawback for the ATF exported out of supplies taken from the refineries at Chennai and Haldia. The scope of the consultant was limited, on trial basis, to the claiming of drawback for the exports made from its Aviation Fuel Stations (AFS) located at Chennai and Bengaluru in Southern Region (SR) and Kolkata in Eastern Region (ER). The contract, valid for a period of one year, was extended from time to time to include exports made in SR up to March 2008 and provided for payment of service charges at 6.50 *per cent* of the amount actually received.

Consequently, the Company lodged its first claim in May 2005 in AFS, Chennai covering exports made from January 2004 and received drawback in January 2006. After gaining claim experience, scope of the consultant was extended (May 2007) for the ATF exported by AFS, Begumpet, Hyderabad which was taking supplies from refinery at Chennai. Similar efforts were not, however, made for other four out of five[2] AFS in SR which also exported ATF by taking supplies from refinery at Chennai.

The table below indicates the details of drawback amount claimed and received by the Company in the four Regions up to March 2008

(₹ in crore)

Region	Claim Lodged/ (Received)	Claims for exports covered during	Remarks
Southern Region	74.70/(70.94)	Jan 2004-Mar 2008	Claim of ₹ 7.24 crore for further exports in April-May 2008 is still in process.
Eastern Region	3.36/(0.02)	Jan 2004-Jan 2007	Switched over to the Advance Authorization Scheme (AAS) after January 2007.
Northern Region	0.69/(0.02)	Nov 2005- Nov 2006	Stopped claims on the basis of a legal opinion due to product comingling[3] issues.
Western Region	Not claimed for reasons not on record.		

[1] ***Petroleum Planning and Analysis cell***

[2] ***Trichy, Coimbatore, Calicut, Nedumbassery and Thiruvananthapuram.***

[3] ***Combining imported and indigenous crude in such a way deterring identification of imported component included in the exported output.***

Scope of Audit

In view of its success in claiming drawback for the ATF exported in SR, this thematic study aims at reviewing the systems and procedures evolved for ensuring drawback claims on all eligible ATF exports made out of bonded stock by all AFS locations irrespective of the source of supply. The scope for assessing consultant's performance is limited to the amount of claims made against the actual exports in the locations assigned, as no correspondence was made available between the Company and the consultant for assessing the qualitative aspects.

Audit objectives

The main audit objective is to examine whether

- There existed proper system for claiming duty drawback for all eligible ATF exports and
- Company had a system to prefer the drawback claims for other locations by virtue of the experience gained.

Audit criteria

The theme audit was based mainly on the following criteria:

- Provisions contained and prescribed in the Duty Drawback Rules, 1995;
- Terms and conditions of the work order issued to the consultant; and
- The claims data as furnished by the consultant and system extracted data on exports.

Audit Methodology

Audit followed the following methodologies -

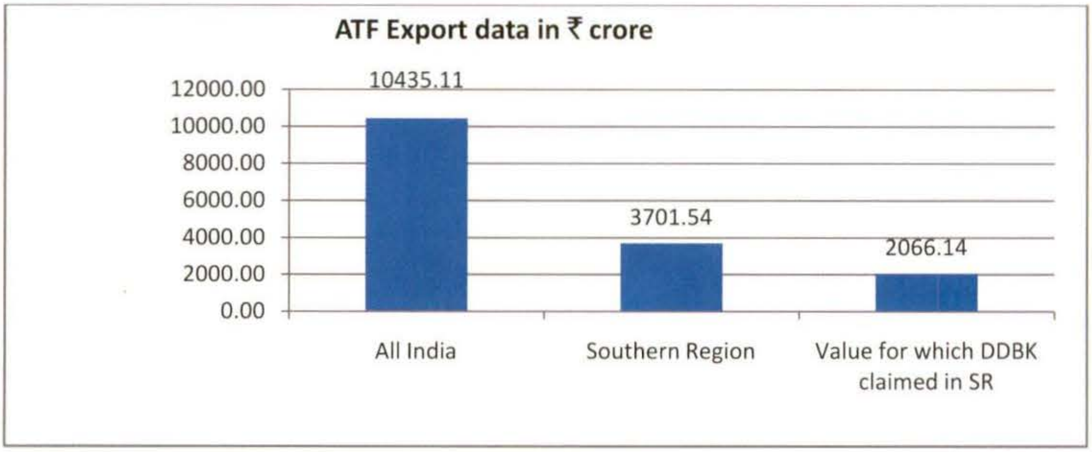
- Review of compliance of the provisions under the Duty Drawback Rules; 1995
- Comparison of the Consultant's performance with the scope of work;
- Review of reports on shipping bill-wise claims submitted by the Consultant; and
- Review of export data, circular instructions, Board Minutes and Agenda Notes.

Audit Findings

The audit observations are discussed in detail in the succeeding paragraphs:

12.3.1 Failure to claim eligible refunds

The chart given below summarises the value of ATF exported by the Company in the country and in SR between January 2004 and March 2008 and the value of ATF exports for which drawback was claimed in SR:



Source: Quantitative data - SAP reports; Value - Petroleum Planning and Analysis Cell, MOPNG, GOI.

It may be seen that though the Company exported ATF to the extent of ₹ 10435.11 crore in the country, it claimed drawback only for a partial value of ₹ 2066.14 crore against ₹ 3701.54 crore of ATF exported in SR. Out of ₹ 6733.57 crore exported in other regions, only ₹ 4.05 crore was claimed in ER and NR.

Ministry attributed (February 2011) it to the general constraints faced by oil industry all over India and such constraints including comingling and operational complexities, as the reasons for non/short-claiming of duty drawback. The reply further stated that, 72 *per cent* of the total exports were inadmissible due to legal complexities and only seven *per cent* could not be claimed.

As a coordinating and regulating agency, the Ministry could have taken the initiative and resolved the general constraints and addressed the legal complexities to facilitate timely claim of eligible drawback. Further, even after the appointment of consultant the drawback unclaimed worked out to 24.5 *per cent*[1] of the admissible claim.

The audit observations made on analysis of the SR data are discussed below in detail:

12.3.1.1 Incomplete claims

The export data on the ATF exported in SR between 2004-05 and 2007-08 revealed a total export of 1461 TMT[2] (value ₹ 3701.54 crore). Whereas the Duty Drawback of only ₹ 74.70 crore was claimed for a quantity of 759 TMT (value ₹ 2066.14 crore), leaving a balance of 702 TMT (value ₹ 1635.40 crore[3]) unclaimed. In two AFS locations, where the drawback claims were made, the drawback amount not so claimed worked out to ₹ 16.13[4] crore for a quantity of 165 TMT (Chennai 122 TMT and Bengaluru 43 TMT).

Ministry stated (February 2011) that formulating the claim procedure took time because of the operational complexities and procedural requirements. The reply further stated that

[1] 382707/1562122 = 24.50 percent

[2] Thousand Metric Tonnes.

[3] The value is lower than that claimed due to period difference.

[4] Chennai AFS ₹11.91 crore and Bangalore AFS ₹4.22 crore reckoned at their respective brand rates.

certain clarifications sought from CBEC[1] and RBI were awaited for taking necessary action as per legal provisions irrespective of the commercial benefits.

The fact remained that the Rules came in to existence from May 1995 but systems and procedures were not formulated up to 2003-04. Further, the drawback amount not so claimed included ₹ 1.37crore (Chennai ₹ 0.15 crore and Bengaluru ₹ 1.22 core) on 13.70 TMT (Chennai 1.57 TMT and Bengaluru 12.13 TMT) of ATF exported later during January 2006 to March 2008. As a facilitating agency, Ministry should have taken prompt action to obtain clarification from the authorities concerned and with the efflux of time the possibility of getting drawback is remote.

12.3.1.2 ATF exported from other locations

The AFS situated at Calicut, Trivandrum, Trichy and Coimbatore also received bonded stock of ATF from the refinery at Chennai and exported 7.20 TMT during the four year period ended 31 March 2008. Though eligible, the Company did not claim drawback for the reasons not on record. Since the scope of the consultant's work was specific to cover collection of documents from the exporting locations that were sourcing ATF from the refinery at Chennai, the Company should have taken preliminary steps to extend his scope in getting the brand rates approved, preparing the export documents etc. The failure had resulted in foregoing drawback claim of ₹ 65.55 lakh in the said locations.

Ministry stated (February 2011) that normally ATF for Calicut, Trichy and Coimbatore was sourced from the refineries situated at Kochi and Mangalore owned by other OMCs and that due to supply constraints, these AFS received product from refinery at Chennai, which could not be envisaged at the time of placing work order to the Consultant.

However, AFS at Trichy and Coimbatore started receiving the bonded stock of ATF continuously from the refinery at Chennai from November 2007 and March 2008 respectively and no arrangements were made for claiming drawback on exports.

12.3.1.3 ATF sourced from other refineries

As per the Rules, the exporter alone is eligible to claim drawback. With the opening up of economy, all the refineries in Public Sector are owned by the OMCs either individually or jointly. The Product Sharing Agreement, executed (March 2002) among OMCs for sourcing different petroleum products from refineries for marketing across the country, did not provide for sharing relevant documents and information to facilitate drawback claim in the event of export of products sourced from the refinery of another OMC.

Owing to non-availability of disclaimer certificate (a document required to get brand rate fixed) from the manufacturer, the Company could not claim drawback on a quantity of 343 TMT of ATF sourced from the refinery at Kochi owned by Bharat Petroleum Corporation Limited and exported between January 2004 and March 2008 from its AFS at Calicut (115 TMT), Nedumbassery (130 TMT) and Trivandrum (98 TMT). The drawback not so claimed worked out to ₹ 33.60 crore[2] (Calicut ₹ 11.32 crore, Nedumbassery ₹ 12.68 crore and Trivandrum ₹ 9.60 crore) adopting the brand rates of refinery at Chennai for the relevant period.

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[1] ***Central Board of Excise and Custom***

[2] ***Reckoned at the relevant brand rates of Chennai Refinery in the absence of brand rate of Kochi Refinery***

Ministry stated (February 2011) that there was reluctance on the part of other OMC refineries to go for duty drawback rates and hence the drawback for supplies taken from them could not be claimed. The reply added that as the industry sub committee viewed (April 2000) that PSU oil companies would not be eligible for duty drawback on supply of ATF to foreign going aircrafts, the same ATF price had been fixed for domestic/foreign going aircrafts.

It is pertinent to note that the same committee recommended that the matter of duty drawback on ATF supplies to international airlines should be taken up by the MOPNG with the Ministry of Finance to enable claiming of duty drawback, which had not been implemented (February 2011). Irrespective of the price of ATF, the Rules provide for claiming of drawback by OMCs on supplies to international airlines which would have only increased their margin. Further, there was also no evidence of this matter having been taken up with other OMCs or proactive action by the Ministry for resolving the issue of claiming drawback on supplies sourced from refineries of other OMCs.

12.3.1.4 Revenue loss due to delays in decision making

AFS at Begumpet, Hyderabad started (February 2006) taking bonded supply from refinery at Chennai for its exports. The preliminary steps involved in drawback claim for the exports were, however, taken only in May 2006. In the previous three month period, a quantity of 5.166 TMT of ATF involving unclaimed drawback amount of ₹ 44.93 lakh[1] was exported by the said AFS. In view of their restricted working hours at Begumpet, Customs demanded (18 August 2006) payment of mandatory overtime charges (MOT) of ₹ 23895 per week for extended period of working hours required in execution of documents.

A decision for making such payment was taken belatedly in March 2007. On receipt (April 2007) of approval, AFS Begumpet released the first weekly payment on 5 May 2007 and commenced the export of ATF under the drawback shipping bill from the next day. During the intervening period between 18 August 2006 and 5 May 2007, the Begumpet AFS exported 15.814 TMT of ATF, of which, the quantity eligible for drawback worked out to 15.339 TMT after giving allowance for ineligible unscheduled flights[2]. Considering monthly average drawback of ₹ 15 lakh not claimed in the previous quarter, if a cost benefit analysis was done to decide on MOT within two weeks, the Company could have recovered a net drawback amount of ₹ 1.34[3] crore.

While accepting the delay in commencement of drawback claims in Begumpet, Ministry stated (February 2011) that the initial problems were resolved and claims commenced. The fact remained that there was a delay of nine months leading to loss of revenue.

12.3.2 Deficient Systems and procedures.

While appointing (October 2003) the consultant, the Company neither specified any time limit in their scope of work nor put in place any control mechanism to monitor the timely processing of claims. Moreover, the responsibility for preparation of primary documents (like drawback shipping bills, Aviation Delivery Receipt etc.,) required to organize the drawback claim was retained by the Company and the officials managing the AFS

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[1] ***Reckoned at the relevant brand rate of Chennai refinery***

[2] ***Special Chartered flights***

[3] ***On 15339.25 MT reckoned at the then brand rates of Chennai Refinery after reducing the MOT charges.***

locations did not have expertise in taxation matters. The detailed instructions explaining documentation procedure to be followed for making drawback claims were issued only in August 2007. Audit observed that these led to a situation where:

- delays ranging between 14 and 20 months from the date of first export occurred in claiming the refunds in three[♣] locations sourcing their ATF from the refinery at Chennai;
- claims amounting to ₹ 2.66 crore (involving 29.461 TMT in 1418 cases) were disallowed by Customs in Chennai for reasons like inadequacy/discrepancy in the documentation;
- there was an under recovery of ₹ 1.15 crore (Chennai ₹ 60.64 lakh and Bangalore ₹ 54.24 lakh) due to filing the claims either for an aggregate quantity lower than that was allowed in brand rate orders or by adopting incorrect brand rates; and
- In the said three AFS locations, there were delays in getting the refunds beyond the prescribed period of one month varying up to 1210 days.
- No MIS was available on the claim process i.e. date of deemed export, date of claim, date of receipt in respect of each export location in the Company. Only the status report as reported by the consultant on the position of submission/receipt in respect of documents collected by him was available.

Ministry stated (February 2011) that there were discrepancies in the claims preferred as the activity was handled for the first time and that the claims were cleared after furnishing of documents.

The reply is not acceptable as the issues could have been avoided through proper training of personnel at the locations. Further, the rejected claims of ₹ 2.66 crore pertained supplies for non-scheduled flights or quantity in excess of that approved by Customs, the possibility of refund is remote.

Conclusion

- The Company did not claim the drawback for the exports made between May 1995 and March 2002 as there was no system of incentive during APM Regime;
- Audit appreciate the efforts taken by the Company to claim drawback when the other OMCs were not claiming the same; and
- The attempt made by the Company to claim drawback was partial in terms of exporting locations/sources of products.

12.4 Early payment of Running Account bills before due date - Loss of interest

Indian Oil Corporation Limited, by releasing 'On Account' payments earlier than the due date to the contractors of lumpsum turnkey contracts, incurred loss of ₹ 5.37 crore.

[♣] *AFS at Chennai, Bangalore and Hyderabad*

Indian Oil Corporation Limited (Company) is executing a Residue Upgradation Project (RUP) for production of Euro III/IV compliant Motor Sprit (MS) and High Speed Diesel (HSD) at Gujarat Refinery. The Board of Directors of the Company approved (January 2007) the project at an estimated cost of ₹ 5,693 crore with scheduled date of commissioning in January 2010. A number of Lumpsum Turnkey (LSTK) contracts were awarded under this project. The General Conditions of Contract (GCC) for the LSTK contracts included a provision for '*On Account*' payment against Running Account bills. The GCC also included a provision for interest payable by the Company on delayed payment of Running Account bills and notional interest on early payment of Running Account bills to be adjusted against interest on delayed payment not exceeding the delayed payment interest. Under Clause 6.4.8.3* of the GCC, the due date of payment for the purpose of interest on delayed payments and notional interest on early payments was reckoned as 56 days from the receipt of Running Account bills by the Engineer-in-Charge.

A test check of 217 of the 274 payments made to major vendors related to the period from January 2008 to March 2010 revealed that the Company had been making '*On Account*' payments before the due date as prescribed in Clause 6.4.8.3 of the GCC *i.e.* before expiry of 56 days from the receipt of Running Account bills by the Engineer-in-Charge without availing of the full period available with the Company for making '*On Account*' payments as per the conditions of the contract. Of the 217 cases test checked by Audit, early payment of Running Account bills for a total amount of ₹ 789.80 crore in 182 cases with loss of interest amounting to ₹ 5.93 crore and delayed payment for a total amount of ₹ 104.03 crore in 31 cases involving an interest cost of ₹ 0.56 crore were noticed. This resulted in a net interest loss of ₹ 5.37 crore to the Company on account of making payments earlier than the due date.

The Management stated (August 2010) that Clause No. 6.4.8.3 of GCC was not the clause for releasing the payment within stipulated time and the provision of clause 6.4.8.3 could not be construed to mean that any credit facility had been allowed to the Company. The Management added that payments against the Running Account bills were released as and when supplies were made and services were rendered and that these were not early payments but only timely payments to arrest any slippage in the project completion schedule.

The Ministry, while endorsing the views of Management, admitted (December 2010) that there was no time schedule in the present GCC for payment of running bills, whereas the time schedule of 56 days indicated in the clause 6.4.8.3 was for the purpose of calculating late payment interest and notional interest.

The justification given by the Company as well as Ministry for the early release of payment was not commercially prudent in view of the following:

The due date by which '*On Account*' payments had to be released had not been defined or spelt out in the contract except in clause 6.4.8.3 of GCC. By including the clause

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* ***Clause 6.4.8.3: For the purpose of calculating late payment interest and notional interest the relevant due date shall be the date terminating with the expiry of 56 (fifty six) days after the date the contractor delivers his Running Account Bill to the Engineer-in-Charge for certification in accordance with the contractual provisions***

6.4.8.3 in the GCC forming part of tender documents, the Company had led the prospective bidders to believe that the payment would be rightfully due only after 56 days and, therefore, they ought to have priced their rates by building up the interest on the working capital for 56 days. Considering the fact that the Company had been resorting to heavy borrowings from the market by not availing this clause in full, the Company had not only lost the opportunity afforded by the GCC, but had also given an unintended benefit to the contractors. As the Company was making e-payments through RTGS[♣] system, it should have released payments on the working day preceding the due date, to avoid loss of interest.

Recommendation

The Company should review the clauses in the General Conditions of Contracts to lumpsum turnkey contracts relating to interest on delayed/early payment and modify them suitably so that the due date of payment of running bills is unambiguous and no unintended benefit flows to the contractor.

Numaligarh Refinery Limited

12.5 IT Audit on Enterprise Resource Planning – SAP

Numaligarh Refinery Limited implemented SAP R/3 in 2005. Delays in up-gradation to SAP ECC version 6 resulted in non utilization of hardware purchased at a cost of ₹ 1.49 crore for the purpose. Review of the system revealed lack of referential integrity regarding excise duty, lack of input controls resulting in excess provision for entry tax, incomplete master data, non charging of depreciation as per policy of the Company etc. Further, Goods receipt based invoice verification feature was not used compulsorily for payment of goods received. Thus, the SAP ERP needs further customization to enable generation of reliable data.

Introduction

Numaligarh Refinery Limited (Company) was incorporated in April 1993 as a Government Company under the Ministry of Petroleum and Natural Gas. The Company has its Corporate Office at Guwahati, Assam and Refinery at Golaghat, Assam. The Company commenced commercial production from October 2000. The products of the Company are mainly evacuated through Bharat Petroleum Corporation Limited. The Company has also engaged in retail marketing through 108 retail outlets.

IT Systems

Initially, the Company implemented Ramco Marshal Enterprise Resource Planning (ERP) system. Due to technical limitations of the RAMCO system and also to ease synergy of operations with group companies, the Company decided (August 2004) to switch over from RAMCO ERP to SAP R/3 (Enterprise edition 4.7). This ERP system was customized and implemented by SAP India Pvt. Ltd, Bangalore using Oracle 9i as

[♣] ***RTGS - Real Time Gross Settlement System is funds transfer system where transfer of money takes place from one bank to another on a 'real time' and on 'gross basis'. Settlement in real time means payment transaction is not subjected to any waiting period. 'Gross settlement' means the transaction is settled on one to one basis without bunching or netting with other transaction, once processed payments are final and irrevocable.***

Database Management System (DBMS) at a total cost of ₹ 8.33 crore. The system went live on 1 August 2005. It has been running on six servers viz., Production, Application, Development, Backup, Quality and Test in addition to other servers for Networking Services at the Refinery site, Golaghat, Assam. The Company also maintains one server at Kolkata office for off-site back up. The Company initially procured 230 operational users and 10 information user licenses from SAP. The Company has implemented Finance and Controlling (FICO), Material Management (MM), HR and Payroll, Sales & Distribution (SD), Project System (PS) and Plant Maintenance (PM) modules of SAP R/3 ERP and is in the process to upgrade to SAP ERP 6.0.

Scope of Audit

Audit reviewed the implementation of the ERP system and the areas covered in MM module and general ledger, accounts payables, accounts receivables and assets accounting in Finance & Controlling (FICO) module. Further, various Information System (IS) controls inbuilt in the system ensuring integrity of the data and security were also examined. For this purpose, data for the period 2005-06 to 2009-10 were evaluated during March 2010 to July 2010.

Audit Objectives

The objective of audit was to seek assurance whether the implementation of MM and FICO modules in the Company had been carried out in the most effective manner. To achieve the main objective audit focused on the following:

- Whether effective input controls and validation checks existed in the system to ensure reliability and integrity of the data;
- Whether customization of the system suited the requirements of the Company and its users;
- Whether the mapping of the business and managerial requirements of the Company were adequate and complete and
- Whether security controls adopted by the Management were adequate.

Audit Criteria

The following criteria were adopted:

- Accounting policy of the Company and orders/circulars/notification issued by Government of India and the concerned State Governments etc., from time to time.
- Business rules and procedures.
- Various control and security parameters as prescribed by the Company in its IS Policy.

Audit Methodology

The following methodology was used during audit:

- Study and scrutiny of relevant records/ documents relating to system development.

- Interaction/ discussion with the ERP Team as well as end-users through issue of audit requisitions/ queries.
- Analysis of data, extracted from SAP tables as well as from standard and in-house developed SAP reports, using Computer Assisted Audit Technique (CAAT).
- Before the commencement of audit, an entry conference was held at Golahat, Assam in April 2010, detailing the broad objectives of IT Audit. The findings of the audit during the review were discussed in the exit conference (October 2010) with the Management.

Audit Findings

12.5.1 Upgradation of ERP

The Company, to remain up to date, decided (October 2008) to upgrade the existing SAP ERP R/3 Enterprise Edition 4.7 to SAP E.C.C[1] version 6. Accordingly, apart from the existing 240 SAP user licenses, additional 114 SAP user licenses and 516 licences for ESS[2] were obtained (December 2008) at a cost of ₹ 99.54 lakh for upgradation. It was noticed that the department could utilise only 308 SAP licenses till October 2010 and thus additional 46 SAP user licenses and 516 ESS licences procured remained un-utilised. Further, hardware procured at a cost of ₹ 1.49 crore also remained idle as the upgradation process which was to be completed in October 2009 was yet to be completed (September 2010).

The Management accepted the facts and stated (October 2010) that the unused licences were kept for future requirement. Management further stated that the hardware purchased were being gradually utilised with the upgradation of SAP.

The Company should speed up the process of upgradation so as to utilize the user licenses and hardware procured.

12.5.2 Segregation of duties

Analysis of authorization/ responsibilities allotted to various users revealed that in one department of the Company, nine users were given rights to create as well as release Purchase Orders. This indicated deficiencies in segregation of duties and deficiency in control mechanism.

While accepting the observation, the Management stated (October 2010) that necessary corrective action would be taken.

12.5.3 Referential Integrity:

In a relational database system, data integrity is ensured by referential integrity due to which any changes in data will have a cascading effect on all the related records. It was observed that Excise duty has to be paid as per the terms and conditions defined in the Purchase Order. Thus the amount of excise duty as per Purchase Order (PO) should automatically flow to the payment bill. Scrutiny of data relating to excise duty as captured in the PO vis-à-vis that captured in the tax invoice revealed that out of 8487 POs for which excise duty was paid during the period covered under audit, in respect of 1347

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[1] Enterprise Central Component
[2] Employee Support Services

POs the amount of excise duty as per PO condition was not matching with excise invoices. It was further noticed that excise payment exceeded by ₹ 4.75 crore in case of 897 POs while in case of 450 POs, the payment shown was lesser by ₹ 2.94 crore. This indicated that the system did not have sufficient validity checks to ensure correctness of payment of excise duty as per conditions laid down in the PO.

The Management stated (October 2010) that the problems in standard SAP programme in this regard were being corrected. Management further stated that subsequent revision, if any, of excise duty was captured in a separate table and not got updated in the relevant purchase order.

The Management's contention itself was an indication that there was lack of data integrity between the two records. Further, non-revision of the PO condition would lead to under/over provision of non-deductible taxes, like entry tax, etc. in the system.

12.5.4 Input Control and validation checks

The following deficiencies were noticed in this regard:

12.5.4.1 Vendor Master

Analysis of the Vendor Master revealed the following:

- In Vendor Master, 32 vendors had been allotted two vendor code each indicating lack of validation controls. It was also observed that purchase orders were issued to those vendors under different vendor IDs which may result in generation of incorrect creditors' balance.

  While accepting the existence of duplicate vendors in the system, the Management stated (October 2010) that except three duplicate vendors, others are required as per business requirement of different categories of payment. However, it was noticed that 17 duplicate vendors of the same category still existed indicating absence of input controls in this regard.

- The vendor master must be maintained with complete information including address of the vendors. However, due to absence of input controls, complete information about the vendors like street, postal code, contact numbers were not captured. Further, the system was not customized to capture email ids of vendors.

While accepting the observations, the Management stated (October 2010) that corrective action would be taken.

12.5.4.2 Material Master

The Material Master contained 73,517 material codes as on 31 March 2010. It was noticed that 4391 materials were allotted 12,923 material codes indicating allotment of multiple codes for the same material description. It was also observed that different quantity of stock was lying in stores for these materials under different codes. Existence of same stock under different IDs may not help proper inventory control.

The Management stated (October 2010) that difference in such materials could be traced from the long text of the material. However test check revealed that the long text was also the same in respect of 11 such duplicate material codes. The Management also stated that a new codification system which would eliminate duplicate codes would be implemented soon.

12.5.4.3 Customer Master

Customer Master should have complete and accurate information for all the customers. Review of customer master revealed that:

- Crucial information like postal codes (in 20 customers), telephone numbers, and e-mail IDs were not captured.
- Postal codes for 97 customers contained incorrect codes.

The Management stated (October 2010) that PIN code of 'Numaligarh' was captured considering the billing location of those customers. This could not be accepted since the Customer Master should have the correct details of the customers for future references.

12.5.4.4 Credit to Customers

As per the business requirement, the Company extended credit to its various customers after taking prior approval and such credit limits are fed in the system for individual customers. However, data analysis showed that though the credit limit to four customers was set as 'zero', credit between ₹ 2.57 lakh and ₹ 72.37 lakh was allowed to those customers. This indicated absence of validation controls to ensure control over credit management.

The Management stated (October 2010) that credit was allowed to these direct customers as per the terms of the supplies. It is however reiterated that such credits approved should be duly entered and monitored through the system.

12.5.4.5 Creation of Purchase Requisition

Review of purchase requisitions revealed following inadequacies:

- Out of 6257 purchase requisitions, 128 purchase requisitions valuing ₹ 22.67 crore were created after placement of purchase orders.

The Management stated (October 2010) that no purchase requisitions would be entertained subsequent to release of the final PO. However further analysis of data showed that Management's contention is not acceptable as system accepted release of purchase requisitions even after the release of 47 POs.

- It was noticed in audit that 5122 purchase requisitions valuing ₹ 184.64 crore were kept pending without placement of purchase orders for more than 3 months (June 2010). Out of these, in respect of 4516 purchase requisitions, the required delivery date had expired. Further, in 613 cases, POs were placed based on fresh requisitions when the earlier requisitions for the same item were still pending. This may lead to unwarranted procurement.

The Management stated (October 2010) that open and unwanted purchase requisitions would be deleted from the system.

12.5.4.6 Purchase Order Conditions

During the period from 2005 to 2010, the Company placed 25014 purchase orders. Analysis of data relating to PO condition revealed the following discrepancies which indicated absence of input controls:

- Excise duty in respect of 1342 items involving 51 purchase orders was captured twice in the PO condition. Consequently, entry tax liability is being generated in the system incorrectly.
- In case of 36 Purchase Orders, the entry tax element was shown twice in the PO condition. As a result, there was excess provision of entry tax amounting to ₹ 10.38 lakh.
- In case of 122 Purchase Orders, insurance element was shown twice in the PO condition resulting in excess provision of insurance.

The Management accepted the facts and stated (October 2010) that action would be taken to contain these deficiencies.

12.5.4.7 General Ledger Account

Scrutiny of Chart of Accounts data revealed the following discrepancies:

- "Cost of Project Surplus Materials" being a single ledger account was assigned two different General Ledger Account codes which indicated lack of control in assigning General Ledger codes.
- Narration, indicating summary is an integral part of recording of accounting transactions. It would be difficult to understand the transactions in absence of narrations. However it was noticed that in most of the transactions, narration was not fed against.

The Management accepted the facts and stated (October 2010) that due care would be taken in future to avoid such recurrence. Further, it was assured that input of 'narration' would be made mandatory.

12.5.4.8 Capital work-in-progress

On account of payment of capital advances without reference to their WBS[♣] elements and consequent failure in clearing of capital advances due to partial capitalization of projects resulted in difference in the value of asset under construction between SAP standard report and GL account of capital work-in-progress to the tune of ₹ 75 crore. The difference was further reduced to ₹ 1.11 crore manually by the Management after being pointed out. This indicated lack of adequate input control over payment and adjustment of capital advance.

While accepting the fact, the Management assured (October 2010) necessary corrective action.

12.5.5 System Customization

Following deficiencies were observed during scrutiny of customisation of SAP ERP system in line with the business rules of the Company:

12.5.5.1 Unit of measurement

Out of 73517 material codes defined in the master, for 63282 materials, the Unit of measurement (UoM) was defined as "Numbers (NOS)" which meant the quantity of the

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[♣] ***WBS = Work Breakdown Structure. For any project defined there should be at least one WBS element to identify the particular project.***

materials could be represented only in whole numbers. It was, however, observed that in seven cases, the stock of the material was indicated in fractional quantities. This indicated deficient customization in this regard.

While accepting the observation, the Management stated (October 2010) that corrective action would be taken.

12.5.5.2 Entry Tax

As per Assam Entry Tax Act 2008, Entry Tax is payable on original invoice value including Insurance, Excise Duty, Freight and all other charges incidentally levied on the purchase of goods. It was observed that entry tax had been calculated in the system without considering higher education cess on excise duty, freight, etc. which was in contravention of the Assam Entry Tax rules and regulations.

While accepting the observations, the Management stated that required correction had been made in the system.

However, since the revised excise duty is not captured in the PO condition as pointed out in para 2.3 supra, incorrect provisioning of Entry Tax still persist in the system.

12.5.5.3 Materials in Transit

Material in Transit (MIT) indicates those materials which have been dispatched by the vendor but yet to be received by the Company. Test check of data generated through customized Report on MIT revealed that it included materials valuing ₹ 16.02 lakh against 62 closed purchase orders which were placed during the period 2005 to 2008. Thus, the possibility of goods remaining in transit against closed order and that too, over a period of two to three years was remote. Thus due to improper customization, purchase orders were allowed to be closed in the system without taking into account of the MIT.

The Management stated (October 2010) that corrective action would be taken after necessary review.

12.5.5.4 Valuation of Stock

Scrutiny of records of stock items in the system revealed the following discrepancies:

- Countervailing Duty (CVD) is required to be paid as a part of Customs Duty in connection with import of materials. In most of the cases, this CVD can be claimed as modvat credit. As per Accounting Standard, this should not form part of the purchase cost of materials. It was, however, observed in the system that in case of import of Methyl Tertiary Butyl Ether_(MTBE), CVD had been included within the purchase cost of materials and was accordingly considered for valuing closing stock. Thus, the system configuration was not in conformity with the Accounting Standard, which necessitated passing of manual entries, thereby, leaving scope for errors and omissions.

While accepting the facts, the Management stated (October 2010) that it occurred due to use of wrong transaction code which had since been corrected.

- As per Company's Accounting Policy, stores and spares are to be valued at weighted average cost. However, scrutiny of stores as on 31March 2010 revealed that 84 materials, returned to stores on being found excess on physical verification in refinery, were valued at nil despite having quantities available in the stock.

This indicated that the system has not ensured complete customisation of data which is indicative of deficiency in mapping of business processes and rules.

The Management stated (October 2010) that corrective action would be taken.

- Scrutiny of stock as on 31March 2010 revealed that same materials (52 numbers) with different valuation with different quantity were lying in stock. The valuation of these materials at different rates is against prudent accounting principles. This may lead to improper inventory control.

The Management stated (October 2010) that same materials had been valued under different rates depending upon the purpose of procurement such as normal store, project or consumption. The Management contention could not be accepted as the same is not a good practice for inventory control in the system.

12.5.5.5 Depreciation

As per accounting policy of the Company, depreciation is to be charged on addition/deletion of assets on pro-rata monthly basis including the month of addition/deletion. As such, the depreciation on assets should be charged from the month in which it was capitalized. The Company, however, maintained three dates, "Capitalization Date", "Ordinary Depreciation Start Date" and "First Acquisition Date" in its asset related data. Test check of assets' records vis-à-vis its depreciation charged revealed the following inconsistencies:

- Though the capitalization date matched with First acquisition date in case of 2203 assets, it was not matching with Ordinary depreciation Start date.
- There was no consistency in the system regarding the starting date of depreciation. A Test check of assets (valuing more than ₹ 5000) capitalized after April 2007 showed that 454 assets valuing ₹ 8.44 crore, the depreciation was not charged from the month of capitalization, being the policy of the Company. Out of these cases, in respect of four assets valuing ₹ 8.36 lakh, the depreciation was charged with reference to Ordinary Start date and in respect of 79 assets valuing ₹ 6.35 crore, it was charged with reference to 'First Acquisition Date'. In another four assets valuing ₹ 27.01 lakh, the depreciation followed the 'Ordinary Start date' and 'First acquisition date'(both were same), while for 367 assets valuing ₹ 1.73 crore neither of the three dates had been followed for charging the depreciation Above inconsistency indicated that method of charging depreciation as per accounting policy was not customized properly.

While accepting the observation, Management stated (October 2010) that required action would be taken to rectify the above-mentioned errors.

12.5.5.6 Materials not accounted in Stock

Scrutiny of records revealed that purchase orders valuing ₹ 36.05 crore were placed for directly charged items, i.e., items to be directly booked to the cost centre and no stock account was maintained for this type of items. As such, actual consumption, availability of stock or otherwise of these items was not controlled through the system. In the absence of which, control over huge quantity of inventory along with consumption of direct materials could not be enforced through the system.

The Management stated (October 2010) that control of consumption of the directly charged materials is maintained manually. The Management's contention indicated that it could not take benefit of the computerized system for proper inventory control in respect of directly charged materials.

12.5.5.7 Budgeting Activities

It was observed that activities like – placement of budget proposal from various user departments to finance department, allocation of budgetary funds to various user department, approval of budgets so allocated – all were performed manually using MS-EXCEL. After approval by the higher authority, the same was fed into the system. This indicated that the generation of budget was not configured in the system.

The Management stated (October 2010) that considering the business requirement budgeting process was kept outside the SAP. The reply indicated that the resources of the system were not fully utilised.

12.5.6 Business Process Mapping

Review of mapping of business rules into the system revealed the following deficiencies:

12.5.6.1 Payment to vendors without Good Receipt

As per business process requirement, payments to the vendor for purchase of goods will be either an advance payment against delivery of documents through bank or after receipt and inspection of materials. The system has the provision for "Goods Receipt-based Invoice Verification" which, if activated, verifies the quantity and value mentioned in the invoices with the figures of good receipt (GR) for processing payments.

During review of GR and invoice verification, it was noticed that for 150 line items relating to 69 Purchase Orders, payment of ₹ 4.27 crore was released against goods receipt value of ₹ 3.32 crore and payment of ₹ 0.91 crore relating to 61 POs was released though no GR existed in the system. This indicated absence of proper customization for compulsory use of the Invoice Verification feature. The system was therefore exposed to various risks like excess payments to vendors and payments without any supply.

The Management stated (October 2010) that action would be taken after analyzing the imbalances. They further stated that over a period of time all POs would be created based on the GR based invoices.

12.5.6.2 Liquidated Damages

The calculation of liquidated damages was not mapped into SAP system, though liquidated damages of ₹ 12.28 crore were deducted from vendors manually since implementation of SAP.

The Management agreed (October 2010) to explore the option in the upgraded version of SAP.

12.5.7 Goods Receipt/Invoice Receipt (GR/IR) Account

GR/IR is an intermediary account used for payments against goods received. It was observed that as on 31 March 2010, ₹ 53.83 crore unadjusted balances in GR/IR account was pending for clearance. Out of ₹ 53.83 crore, ₹ 36.29 crore was lying unadjusted for more than one year. This indicated lack of proper monitoring by the Company.

While accepting the observation, the Management stated (October 2010) that action is being taken to rectify the imbalance.

Conclusion

The delay in the upgradation process would result in delayed utilization of the new aspects of the version including Employee Support Services. The system did not have adequate input controls and validation checks which resulted in improper maintenance of master data and generation of incorrect provisions in the accounts requiring the manual intervention on several occasions. The SAP R/3 system was also not customized properly and the business rules were mapped inadequately which resulted in incorrect valuation of stores, errors in charging depreciation, risk of excess payment to vendors, etc.

Recommendations

The Company should:

- ***Ensure early completion of upgradation process and utilize the ESS licences procured for the intended purpose***
- ***Strengthen monitoring and authorization controls of transaction and access to the system.***
- ***Ensure that input controls and validation checks are inbuilt in the system so as to ensure completeness and correctness of the data.***
- ***Review the 'Master Data' periodically for ensuring veracity of the data and authorization thereof.***
- ***Utilise the system for better material management.***
- ***Customize all the available functionalities of the ERP system to the meet the business requirements.***

Oil and Natural Gas Corporation Limited

12.6 Unproductive investment besides expenditure on interim facilities due to improper planning

Improper planning in setting up of plant for extraction of ethane, propane and butane from liquefied natural gas resulted in unproductive investment of ₹ 573 crore since December 2008 besides expenditure of ₹ 100.47 crore on interim facilities.

In February 2003, the Ministry of Petroleum and Natural Gas (MOPNG) assigned Oil and Natural Gas Corporation Limited (Company) the right to extract C_2 (ethane), C_3 (propane) and C_4 (butane) from the Liquified Natural Gas (LNG) imported by Petronet LNG Limited[♣] (PLL) at Dahej. Based on the Detailed Feasibility Report (DFR) prepared by Engineers India Limited (EIL), the Board of Directors of the Company (Board)

[♣] ***Petronet LNG Limited (PLL) was set up as a JV by the Government of India. The JV was promoted by GAIL, IOCL, BPCL and ONGC. The marketing rights were given to GAIL, BPCL and IOCL.***

approved (May 2004) a proposal[1] for setting up a plant (C_2C_3 plant[2]) of 10 million metric ton per annum (MMTPA) capacity at an estimated cost of ₹ 1,493.49 crore for extraction of ethane, propane and butane. The completion schedule was 30 months from the date of Board's approval. The Company invited (August 2005) bids for five MMTPA[3] capacity plant and awarded (November 2005) the contract to M/s Toyo Engineering at a cost of ₹ 573.29 crore with scheduled completion by May 2008. Though plant was mechanically completed by December 2008, it could not be commissioned till December 2010 as there was no arrangement to off-take the products.

The Audit observed that:

- DFR for setting up C_2C_3 plant had envisaged supply of the products (C_2, C_3 and C_4) to a petrochemical plant of IPCL[4] /Reliance Industries Limited (RIL) located at Dahej at a distance of two kilometers (kms.) from the proposed plant through a pipeline till the Company (ONGC) could set up its own petrochemical plant at Dahej. However, the Company had not taken up the matter with RIL till May 2007. Laying of a pipeline of two kms. required eight months' time and, hence, could have been completed within 30 months time allowed for setting up C_2C_3 plant. The Company, however, awarded a contract for laying of the pipeline only in July 2009. Though, the pipeline had been completed (July 2010) at a cost of ₹ 8.45 crore, no agreement could be reached with RIL till date (December 2010).
- As RIL had expressed interest in offtaking only C_2 (ethane) for interim period, the Company awarded (December 2009) a contract to M/s Toyo Engineering for creating truck loading facility costing ₹ 95.62 crore for supplying C_3 and C_4 to oil marketing companies (OMCs), but no agreement had been entered into with OMCs till date (December 2010). An expenditure of ₹ 71.83 crore had been incurred on this work till December 2010. The truck loading facility had not been completed. As a result, C_2C_3 plant could not be commissioned till date (December 2010).
- The products of the C_2C_3 plant were envisaged to be finally used as feed stock in a new petrochemical complex to be set up by the Company at Dahej. However, notification of award (NOA) for setting up a Petrochemical Complex at Dahej (DPC) at an estimated cost of ₹ 13,690 crore was issued in December 2008 with scheduled completion by December 2012.
- Due to the time gap between commissioning of C_2C_3 plant and the DPC, the Company was compelled to request (December 2009) M/s Toyo Engineering to extend the process performance guarantee beyond the original contractual period at a cost of ₹ 28.85 crore. Till December 2010, an expenditure of ₹ 20.19 crore has been incurred on this account. Consequently, the C_2C_3 plant completed in December 2008 at a cost of ₹ 573.29 crore proved to be unproductive besides

[1] ***In December 2003, the Board had originally approved the proposal for setting up of 1X5 MMTPA capacity plant at projected cost of ₹ 609.12 crore.***

[2] ***While C_2 and C_3 comprise major products, production of C_4 is marginal.***

[3] ***Due to restricted allocation of only 5 MMTPA of LNG to the Company by the Ministry.***

[4] ***IPCL was disinvested in 2001 and 21 per cent shares was taken over by Reliance Industries Limited (RIL).***

incurring expenditure of ₹ 100.47 crore[1] in creating interim facilities for offtake of the products and extended performance guarantee.

The Management in reply (September 2010) stated that:

- The response from RIL was at significant variation from the scenario considered in the DFR due to change in the Management and rapid deterioration in global business environment. Since RIL was ready to take only 50 *per cent* quantity of C_2 for short term, for C_3 and C_4 the Company approached the OMCs who agreed to uplift the entire quantity of C_4 and matching quantity of C_3 for supply as LPG after blending[2].
- Keeping in view the changing business environment and to mitigate the negative impact of idling of the plant, truck loading facility was proposed to evacuate the products. It was decided to go ahead with the truck loading facilities even before firm commitment from OMCs as the Company was confident of concluding marketing tie up for C_3 and C_4 products as there was a huge supply demand gap for the products in India.

The Ministry endorsed (January 2011) the views of the Management.

Reply of the Management/Ministry was not acceptable in view of the following:

- As per the DFR of December 2003 and February 2004, IPCL, Dahej was identified as a user for the C_2C_3 products till the setting up of a petrochemical complex. The Company, however, did not discuss the matter with IPCL/RIL till May 2007. Hence, the statement that the response from RIL was at significant variation from the scenario considered in the DFR was not tenable. Moreover, the negotiations with the OMCs had not been firmed up (December 2010).
- The contract for creation of facilities for evacuation of C_2, C_3, C_4 products *viz.* the pipeline and truck loading facilities were awarded only during July 2009 and December 2009 respectively. However, the Company had not signed an agreement with RIL for lifting of the product[3] till December 2010. Further, the truck loading facilities which were not envisaged in the original scope of work awarded in December 2005 would be rendered redundant on commissioning of the DPC.

Thus, improper planning resulted in unproductive investment of ₹ 573 crore since December 2008 besides expenditure of ₹ 100.47 crore till December 2010 on interim facilities.

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[1] ***Pipeline completed in July 2008: ₹8.45 crore plus actual expenditure till December 2010 towards truck loading facility: ₹71.83 crore against contract of ₹95.62 crore and performance guarantee: ₹20.19 crore against commitment of ₹28.85 crore.***

[2] ***In which case the Company would be required to put up blending facilities involving additional expenditure and time lag of eight months.***

[3] ***For C_3 and C_4 negotiations are on with the OMCs. Moreover, the OMC have agreed to lift only C_4 and limited portion of C_3 to the extent that could be blended with C_4 as OMCs did not have the marketing rights for C_3.***

Recommendation

The Company should fine tune its planning process to ensure synchronization between related projects in order to optimize operational synergies and obviate avoidable expenditure and should also institute a system of value assurance review at different stages of large projects so that the changes in assumptions are adequately addressed.

12.7 Injudicious payment of golden jubilee incentive

The Company made an outright payment of ₹ 50,000 to each of its employees amounting to ₹ 173.70 crore as part of its golden jubilee celebrations. This payment was, however, not consistent with the Department of Public Enterprises' guidelines on ex-gratia, honorarium, reward *etc.* and performance related payments.

As part of its Golden Jubilee celebrations, the Board of Directors of Oil and Natural Gas Corporation Limited (Company) approved (July/August 2006) the grant of a gold medallion of 15 grams and a golden jubilee incentive built in the pay throughout the service period of the employee to yield a net present value of ₹ 50,000 per employee to all employees on rolls of the Company on 14 August 2005. However, subsequently, the Company revised (September 2006) its earlier decision and decided to pay the Golden Jubilee incentive of ₹ 50,000 as lump-sum (besides the gold medallion of 15 grams) to regular employees, including full time Directors, on the rolls of the Company as on 14 August 2005 and paid a total amount of ₹ 173.70 crore.

In reply to the audit observation that the payment of golden jubilee incentive, not being a payment under an approved incentive scheme, was in contravention of the Department of Public Enterprises (DPE)'s guidelines of 20 November 1997, the Management stated (June 2008) that the one time payment of ₹ 50,000 was a special dispensation given to all employees on the occasion of golden jubilee celebration to boost their morale and to ensure their commitment to the organization and also as a retention tool. The Management justified this payment on the ground that (i) DPE guidelines (25 June 1999) provided for Profit Sharing incentive up to 5 *per cent* of distributable profit based on the performance of work force in case the compensation to the employees was not appropriate; (ii) the payment (and the gold medallion) was approved by the Board and (iii) it did not squarely fall within the definition of incentives so as to bring it under the umbrella of DPE guidelines.

Audit observed that the one time payment was not performance related and not covered by the June 1999 guidelines above. Also the payment was not admissible under the November 1997 guidelines as the same clarified on incentives in the form of ex-gratia, honorarium, reward etc.

It was further observed that:

- During the period from September 2006 to September 2010, 653 employees had resigned or were removed from service after receiving the golden jubilee incentive. Of these, 339 employees had resigned/removed within one year of receiving the incentive.

- The Company made a payment of ₹ 11.50 lakh to 23 employees who had resigned or had been removed from service before the due date for drawal of salary for September 2006.
- In a clarification addressed to audit, the DPE confirmed (February 2011) that ₹ 50,000 paid as Golden Jubilee incentive and/or gold medallion of 15 grams was not part of approved performance related payment and not covered by its guidelines of June 1999 or the guidelines issued by it under 2007 pay revision of the public sector undertakings.

The Ministry stated (November 2010) that in future such an incentive would be linked to the condition that an employee serves for a minimum specified period after receipt of the incentive.

Recommendation

The Ministry of Petroleum and Natural Gas in conjunction with the Department of Public Enterprises should issue appropriate guidelines on payment of reward, in cash or in kind, to the employees of PSUs on commemorative events.

12.8 Unfruitful expenditure in exploration block beyond re-grant period

Failure of the Company in establishing any lead in the nomination block KK-DW-12 and 17 despite retaining the block for 11 years and acquisition of fresh seismic data in the block without ensuring extension of the petroleum exploration license beyond five years of re-grant period followed by surrender of the block resulted in unfruitful expenditure of ₹ 12.13 crore.

Oil and Natural Gas Corporation Limited (Company) acquired (April 1997) petroleum exploration license (PEL) for deepwater nomination block KK-DW-12 and 17 in Kerala Konkan Offshore. The Company obtained re-grant of PEL for four years cycle effective from 01 April 2003 to 31 March 2007 and extension for fifth year uptil 31 March 2008.

During the re-grant period of five years, though the Company completed the work commitments, it could neither fulfill its commitment of drilling a well in the fifth year nor establish any lead/discovery in the block since its acquisition. The Company requested (March 2008) the Ministry of Petroleum and Natural Gas (MOPNG) for extension of PEL for the block for sixth and seventh year on the ground that the regional prospectivity analysis carried out by its consultant in November 2007 indicated possibility of gas generation in Konkan basin. As no lead/discovery had been established by the Company in this block, the MOPNG did not agree to the request of the Company and directed (March 2008) it to surrender the block immediately.

The Company, however, again requested (May 2008) the MOPNG for seeking retention of the block for sixth and seventh year alongwith dispensation for drilling moratorium to fulfill drilling commitments, on the ground that available data and studies indicated improved prospectivity in the block and that drilling of the well in the fifth year could not be carried out due to non-availability of deep water rigs. It also indicated its plan to acquire 1,400 line kilometers (LKM) of long offset 2D seismic data for understanding the leads and for assessing the block. During November 2008 and January 2009, the

Company incurred an expenditure of ₹ 12.13 crore on acquisitions, processing and interpretation (API) of 1,200 LKM of 2D long offset seismic data.

In January 2009, the MOPNG replied to the Company that the latter was holding the block for more than 11 years and as such it did not find any justification for the Company seeking special dispensation. The Ministry reaffirmed (January 2009) its decision of March 2008 and directed the Company to surrender the block immediately. In February 2009, the Directorate General of Hydrocarbons (DGH) intimated that the block stood surrendered.

Audit observed that:

- As per policy of the Government of India (GOI) for nomination blocks, a nomination block has to be surrendered by the licencee in case no lead/discovery is established in it by the licencee by the end of fifth year of the re-grant period. The decision communicated by the Ministry in March 2008 was in consonance with the said policy of GOI. As the Company failed to establish any lead/discovery in the block despite retaining it for 11 years, it was not reasonable to expect re-grant of extension for sixth and seventh year.
- Though the Company's consultant had carried out the study in November 2007 indicating possibility of gas generation in the block, the Company did not approach the GOI well in advance for further extension of PEL and requested the GOI for the extension at the end of March 2008 when the validity of the PEL for the fifth year was expiring and the GOI had already decided to ask the Company for surrendering the block. In case, the Company had a strong case for further extension of PEL in deviation of the GOI's policy, the case should have been pursued with the GOI well in advance.
- Pending decision of the MOPNG, the Company incurred an expenditure of ₹ 12.13 crore on 1,200 LKM of 2D long offset seismic data during November, 2008 and January 2009 was not in order. Thus, failure to ensure the extension of the PEL before acquisition of fresh 2D long offset data rendered the expenditure unfruitful.

The Management stated (September 2010) that:

- MOPNG had sought for (June 2008) clarification from the Company regarding commitment of a well in the block for considering the proposal for extension which indicated that the block was not being asked to be surrendered. In the hope of getting positive response, the Company carried out seismic survey. However, after a gap of eight months of its request for retaining the block, MOPNG informed (January, 2009) about its decision to surrender the block.
- In previous instances, DGH had granted sixth and seventh year's extension on the basis of G&G evaluation in nomination blocks *viz.* Gamij Extension III and Ahmedabad East Extension 1 in Cambay basin, KK offshore block in Kerala Konkan basin and WO-9 block in Western Offshore).
- All the data acquired formed the data repository of the Company to be used in subsequent rounds and, hence, the expenditure could not be construed as unfruitful. The Ministry endorsed the views of the Management in January 2011.

Reply of the Management/Ministry was not acceptable in view of the following:

- As response of the Ministry for reconsidering the decision was awaited, the Company should not have acquired 2D long offset seismic data. Further, the Company also did not apprise the Ministry of the fact that pending approval it was going ahead with the acquisition of the 2D long offset data.
- In case of the block WO-9, application for sixth and seventh year's extension was made on 21 November 2007 and approval was received on 28 February 2008. Fresh 3D survey was carried out only after receipt of approval *i.e.* in February 2009. As regards the blocks KK offshore, Gamij Extension III and Ahmedabad East Extension-1, Audit observed that no fresh/additional data was acquired during the sixth and seventh year of re-grant period. Hence, these blocks could not be compared with KK-DWN-12 and 17. Moreover, since the MOPNG in the first instance had already asked the Company to relinquish the blocks KK-DWN-12 &17 and also in view of the fact that there was no lead in these blocks, chances of acceptance of the request of the Company for extension were remote.
- If the Company had awaited the final decision of MOPNG before acquiring the fresh data, unfruitful expenditure of ₹ 12.13 crore could have been avoided.
- As per direction (February 2009) of DGH, the Company was required to surrender all the Geological and Geophysical (G&G) data collected in the block to the DGH for offering the relinquished block in the next NELP round of bidding. The seismic data acquired for the surrendered block did not serve the intended objective.

Recommendations

- ***The Company should ensure extension of PEL by DGH/MOPNG before acquiring additional/fresh data in any block especially when there had been no leads by the end of fifth year of re-grant period in which case Company was liable to surrender the block as per policy of the Government of India.***
- ***The Ministry should also expedite processing of requests for extension of PEL so as to allow the operator to firm up the work programme/action plan.***

Petronet India Limited

12.9 Unfruitful expenditure due to delay in taking decision

The change in policy of the Government and failure to take prompt action resulted in unfruitful expenditure of ₹ 16.05 crore.

In order to cater to the growing demand for petroleum products across the country and for developing an efficient pipeline network, the Government of India (GOI) felt the need to expedite the implementation of the pipeline projects. The GOI approved (April 1996) formation of a holding Company with equity participation from public sector oil companies (50 *per cent*) and from private companies, financial institutions and public by pooling the technical, financial and human resources available in the oil industry and minimising the limitations of individual oil companies. It was envisaged that the holding

Company would be in the nature of a financial Company and would form subsidiary companies for implementation of identified and prioritised pipeline projects. Accordingly, Petronet India Limited (PIL) was incorporated (May 1997) as a Joint Venture Holding Company by public sector Oil Marketing Companies (OMCs)[1] and financial institutions for development of petroleum product pipelines in the country on a 'Common Carrier Principle' for use of OMCs.

During the period from May 1998 to December 2000, PIL co-promoted five[2] Joint Venture (JV) companies for implementation of five pipeline projects. The oil companies in public and private sector as well as financial institutions participated in the promotion of these projects in different proportions depending upon their interest in the pipeline routes.

In November 2002, the Ministry of Petroleum and Natural Gas (MOPNG) issued revised policy guidelines which gave a free hand to individual oil companies to put up their own pipelines, which was a reversal of its earlier policy for setting up pipeline projects on 'common carrier principle'. This threatened the survival of PIL as even during the implementation of pipeline projects of PIL, oil companies backed out of the JV projects and started constructing their own pipelines independently.

One of the JV companies *viz.* PCTML was taken over by IOCL. The operations of another JV Company *viz.* PVKL commissioned in May 2000 had been suspended since May 2006 as the IOCL's product pipeline, to which this JV Company's pipeline was the feeder, was converted into crude service. Another two JV companies *viz.* PCCKL and PMHBL commissioned their projects in September 2002 and August 2003 respectively and the oil companies which transported their products in these two pipelines and had majority share in the respective JV companies showed interest in taking over the pipelines by themselves.

The project undertaken by the fifth JV Company *viz.* PCIL was dropped after spending an amount of ₹ 10.78 crore on survey and other preliminary expenses during the period from 2001-02 to 2004-05, of which ₹ 5.13 crore was spent between 2003-04 and 2004-05 after the GOI changed (November 2002) its policy for setting up pipeline projects. Majority of the shareholders expressed (January 2003) disinterest in continuing the project. The pipeline was to be implemented through 'Build, Operate and Transfer' process in which firm commitment of 'take or pay' was required to be given by the users of the pipelines. Since none of the OMCs agreed for the 'take or pay' clause, the project activities were discontinued, thus, rendering the expenditure of ₹ 10.78 crore unfruitful.

Since operations as well as the purpose for which PIL was formed came to a complete standstill consequent to the revised guidelines issued by the MOPNG, the shareholders of PIL unanimously opined (March 2004) that continuation of PIL was not viable and winding up process should be initiated. Accordingly, PIL intimated (August 2004) the MOPNG of its decision to wind up. However, no concrete decision had been taken by the

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[1] ***Indian Oil Corporation Limited (IOCL), Hindustan Petroleum Corporation Limited (HPCL) and Bharat Petroleum Corporation Limited (BPCL)***

[2] ***Petronet VK Limited (PVKL – for Vadinar Kandla Pipeline), Petronet CK Limited (PCCKL - for Cochin-Coimbatore-Karur Pipeline), Petronet MHB Limited (PMHBL - for Mangalore-Hassan-Bangalore Pipeline), Petronet CTM Limited (PCTML – for Chennai-Trichy-Madurai Pipeline) and Petronet CI Limited (PCIL – for Central India Pipeline).***

Government till date (December 2010) on future of PIL. PIL continues without any useful activity and incurring avoidable overheads in the form of salaries to staff and other administrative expenses like rent *etc.*[♣] After allowing a reasonable period of two years for taking a decision either to strengthen or to close the PIL from the time of PIL's representation (August 2004) to the GOI, an expenditure of ₹ 5.27 crore incurred by PIL from August 2006 to March 2010 on salaries and other administrative overheads was avoidable and unfruitful.

Thus, while the change in the pipeline policy of the GOI resulted in unfruitful expenditure of ₹ 10.78 crore on a project which had to be abandoned as a fallout of the policy change, failure to take timely action regarding the future of PIL resulted in an unfruitful establishment expenditure of ₹ 5.27 crore from August 2006 to March 2010.

The Management stated (August 2010) that due to new guidelines for laying petroleum product pipelines issued by MOPNG the promoters of PIL themselves began implementing their respective pipeline plans without routing it through PIL. The promoters had shown unwillingness in the PCIL project and on account of conflict of interest among promoters the project was abandoned.

As regards audit comment on the expenditure of ₹ 5.13 crore spent in financial years 2003-04 and 2004-05 after the GOI changed its policy in November 2002, the Management stated that since the work was on an ongoing basis, contracts had been awarded and liabilities committed right from financial year 2000-01 onwards. They further stated that closure or winding up of PIL was not possible without the MOPNG's (Administrative Ministry) approval.

The Ministry, while endorsing the views of Management, stated (December 2010) that PIL being a holding Company could be wound up only after the Subsidiary/JV companies co-promoted by PIL are wound up and added that the continued incurring of administrative expenses was unavoidable as PIL has to comply with the various statutory requirements till such time it was wound up which was a time taking process and could be done only with the approval of the GOI.

Reply of the Management/Ministry was not acceptable as Board of PIL had unanimously decided in March 2004 to wind up PIL and the same was intimated to the MOPNG in August 2004. However even after a lapse of six years no action has been taken in this regard.

Recommendation

The Ministry should take conclusive action regarding the future of PIL without further delay.

[♣] ***In the range of about ₹1.25 crore to ₹1.50 crore per annum.***

CHAPTER XIII: MINISTRY OF POWER

NHDC Limited

13.1 Extra expenditure on interest

Due to not availing the opportunity of drawing loan at a lower rate of interest, the Company would be incurring extra expenditure of ₹ 30.31 crore.

NHDC Limited had (Company) drawn (June 2005) a loan of ₹ 1350 crore from a consortium of 11 bankers, with Union Bank of India as the lead banker at an interest rate of seven *per cent* per annum (payable monthly) for financing its Omkareshwar Project. This loan was to be repaid in 10 equal annual instalments commencing from 31 March 2009. The loan agreement with the consortium of bankers had a provision for put/call option at the end of three years from the date of first drawl (28 June 2005) with a prior notice of 60 days.

All member banks of the consortium exercised (April 2008) the call option and asked Company to repay the entire loan amount. The Board of Directors deliberated (May 2008) the issue of refinancing the above loan and desired that Company should make conscious study of the market and ensure raising of funds for refinancing the loan at competitive rate of interest and formed a committee of four members for the purpose.

The committee after examining the various offers recommended (June 2008) that ₹ 750 crore may be raised through issue of Bonds at the rate of 10.35 *per cent* and term loan of ₹ 600 crore from HUDCO at the rate of 10.25 *per cent* per annum. The shortfall in loan from either of these two options was recommended to be drawn from PFC, HDFC, Bank or UCO Bank. The Board of Directors did not accept (June 2008) the recommendations and directed to raise funds from PFC (₹ 750 crore) and HUDCO (₹ 600 crore). The shortfall, if any, from HUDCO was to be availed from PFC as it had quoted for the full loan amount of ₹ 1350 crore or less.

Sanction of loan of ₹ 1350 crore or less was received from PFC on 12 June 2008. HUDCO did not sanction any loan to the Company. The Company drew the full amount of ₹ 1350 crore from PFC on 28 June 2008 and the loan from the consortium of banks was repaid on the same day. The rate of interest of loan from PFC was fixed at 11.89 *per cent* with provision to reset the interest at the end of every third year beginning with date of first disbursement.

Audit observed that even though the Company had an option to raise funds of ₹ 750 crore through bonds at a lower rate of interest (10.35 *per cent*) it decided to draw entire requirement of ₹ 1350 crore from PFC at a much higher rate of interest (11.89 *per cent*), which was not justified. This resulted in avoidable extra interest payment of ₹ 23.33 crore up to September 2010. Till the date of first reset of interest (28 June 2011), the Company would be further paying extra interest of ₹ 6.98 crore. Thus, due to not availing the opportunity of drawing loan at a lower rate of interest, the Company would be incurring extra expenditure of ₹ 30.31 crore which in turn will adversely affect the beneficiaries by way of higher tariff.

Management stated (September 2010) that the option of floating rate of interest was taken in view of the then prevailing very high cost of debt so that overall cost could be reduced by taking advantage of reduced rates in future which was highly probable. Management also stated that it was premature at this stage to conclude that any extra interest has been paid as there was an option to prepay the loan at the end of 6th and 9th year.

The Ministry in its reply (January 2011) endorsed the views of the Management and stated that the decision of the Board was judicious in the prevailing circumstances. The reply further added that in 2nd and 3rd reset of interest rate, which would take place in June 2014 and June 2017, respectively, Company had the option of premature payment (without penalty) in case the rate of interest at that point of time was found on the higher side.

The replies of the Management and the Ministry were not acceptable because interest rate of PFC loan was subject to reset only once in every three years. Thus, due to not availing the option of issue of bonds at a lower rate of interest, which was available to Management till the first resetting of interest by PFC, the Management would be incurring extra expenditure of ₹ 30.31 crore on payment of interest.

Power Finance Corporation Limited

13.2 Fund Management

Introduction

Power Finance Corporation (PFC) was set up in July 1986 as a Financial Institution dedicated to power sector financing and committed to the integrated development of the power and associated sectors. It was notified as a Public Financial Institution under Companies Act, 1956 in 1990 and was registered as a Non-Banking Financial Company (NBFC)♣ (Non-Deposit taking) by RBI in 1997. PFC was listed (23 February 2007) in the stock exchange after its Initial Public Offering (IPO). PFC is a Government Company within the meaning of Section 617 of the Companies Act as the President of India holds 89.78 *per cent* of the total equity. In June 2007 PFC was conferred 'Nav-Ratna' status. In July 2010, RBI granted the status of 'Infrastructure Finance Company' (a new category under NBFCs) to PFC. The share of PFC in power sector financing during the current Five Year Plan (2007-2012) was 11.50 *per cent*. Till 31 March 2010, PFC had sanctioned cumulative loans amounting to ₹ 2,70,480 crore against which disbursements amounting to ₹ 1,37,282 crore were made.

Scope of Audit

The audit covered various activities pertaining to fund management during the five year period from 2004-05 to 2008-09. Audit covered all cases of borrowings having monetary value above ₹ 500 crore and 20 *per cent* of the remaining cases having value less than ₹ 500 crore. Accordingly, out of total 355 cases of borrowings (for ₹ 74131 crore) 106 cases (30 *per cent*) for ₹ 38008 crore (51*per cent*) were covered.

♣ ***A company registered under the Companies Act, 1956, engaged in the business of loans and advances etc. Functions of NBFCs are akin to that of banks. However unlike banks, NBFC cannot accept demand deposits, issue cheques drawn on itself etc.***

Audit objectives

The objective of this audit were to assess whether:

- Funds were raised after proper planning and were commensurate with the business requirements.
- Due diligence and economies were exercised while borrowing.
- Sound treasury management system existed

Audit criteria

The following criteria were used to assess performance of PFC for the period under scope:

- Operational Policy Statement of PFC
- PFC's internal guidelines relating to mobilization of funds
- Annual Resource Mobilisation Plans of PFC.
- PFC's Risk Management Policy.
- Best practices followed by the Industry.

Audit Findings

PFC mobilised total funds of ₹ 74131 crore during the five year period from 2004-05 to 2008-09 through various instruments like bonds, term loans from banks, commercial paper etc. The major sources were bank loans (47.52 *per cent*) and bonds (44.09 *per cent*). The funds mobilised during the period under review constituted 98.72 *per cent* through domestic loans and remaining 1.28 *per cent* through foreign currency loans. In addition, PFC also mobilised funds of ₹ 997 crore through its Initial Public Offering (IPO) in January-February 2007.

The examination of two main activities viz. assessment of requirement and raising of funds revealed as under:

13.2.1 Assessment of requirement

PFC assessed requirement of funds on the basis of targets given in the Memorandum of Understanding (MOU) entered into with Government of India every year, disbursement demands, debt repayment obligations, expected recoveries of existing loans and growth rate. PFC introduced (November 1990) an Operational Policy Statement (OPS) outlining its operational philosophy. As stipulated in OPS, PFC was required to maintain a primary liquidity reserve adequate to meet anticipated disbursements in next fortnight and a secondary liquidity reserve adequate to meet three months' disbursements. The liquidity reserves were mainly in the form of fixed deposits invested for periods ranging from four to 244 days♣.

♣ ***Period of FDs and percentage of amount invested-4-7 days (11-23 per cent), 8-14 days (12-29 per cent), 15-30 days (35-55 per cent), 31-60 days (7-32 per cent), 61-182 days (0.1-6 per cent).***

Audit analysed the liquidity reserves considering total disbursements made during the years 2006-07 to 2008-09[♥]. Status of liquidity reserves worked out vis-à-vis actual fixed deposits held by PFC during the three years 2006-07 to 2008-09 was as under:

(₹ in crore)

Year	Annual Disbursements	Primary Liquidity Reserve (15 days)			Secondary Liquidity Reserve (3 months)		
		Amount required to be maintained as reserve	Lowest balance of FDs on any day during the year	No. of days when FD balance was less than the reserve required	Amount required to be maintained as reserve	Highest balance of FDs on any day during the year	No. of days on which FD balance was in excess of the reserve
2006-07	14055	600	0	213	3600	1694	0
2007-08	16211	700	171	53	4200	4675	18
2008-09	21054	900	0	127	5400	3804	0

As may be seen from the table above the Management could not maintain primary and secondary liquidity reserves up to the desired levels as stipulated in OPS.

Further, PFC required funds for its lending operations as well as debt repayment obligations and other expenses. While debt repayment obligations and administrative expenses were known in advance, lending operations entailed forecast of disbursement requirements of borrowers. Audit analysed the assessment made by PFC at the time of floating bond issues with a view to check the efficacy of the assessment mechanism. The 60 bond series in 32 issues during the five year period from 2004-05 to 2008-09 mobilised funds of ₹ 32683 crore, out of which Audit selected 24 bond series (20 issues) in which funds of ₹ 24120 crore were mobilised (74 *per cent*).

Audit observed that:

- In three out of 20 issues, requirement of funds was in the range of ₹ 600 to ₹ 1000 crore (Bond issues 27 A, B etc.), ₹ 1000 to ₹ 1200 crore (Bond series 31A) and ₹ 1500 crore to ₹ 2000 crore (Bond series 52 A&C), even for short term of 15-24 days. The variation between assessed disbursement and actual disbursement was between 11 and 50 *per cent* in nine issues and 51 and 102 *per cent* in three issues. Out of these 12 issues, six were of over assessment and six were of under assessment.
- Out of six issues of over assessment, PFC actually mobilised extra funds in two cases and incurred avoidable interest cost of ₹ 3.71 crore, due to deployment of the amount in Fixed Deposits which carried lesser interest than the interest paid on borrowings. Out of six issues of under assessment, PFC had to borrow funds, in three issues, at higher interest rates to meet the fund requirement. The higher interest cost works out to ₹ 39.64 crore.

Ministry replied (January 2011) that infrastructure projects including power projects were subject to uncertainty and delays and hence the borrowers were unable to predict their fund requirement accurately.

[♥] ***Reserves could not be analysed for 2004-05 and 2005-06 due to non furnishing of cash flow statements by PFC for 2004-05 on account of crashing of their computer hard disk and the cash flow statements furnished by PFC for the year 2005-06 did not show day end balances of fixed deposits***

The reply was not acceptable in view of the fact that PFC had adopted the mechanism of having drawal schedule besides provision of levying commitment charges to avoid uncertainties and delays at borrowers end from effecting its assessment and as such appropriate assessment was possible. Audit however, observed that while making disbursement forecast, PFC did not consider drawal schedules committed by the borrowers. Audit further observed that Management of PFC did not insist on obtaining drawal schedule from small borrowers. Such cases where there were no drawal schedules ranged from 17 *per cent* to 42 *per cent* during the period 2004-05 to 2008-09. Thus mismatches in assessment were due to deficiencies in the disbursement forecast mechanism.

13.2.2 Borrowing Decisions

As per the Resource Mobilisation Manual of PFC, borrowing decisions required joint authorization by Chairman and Managing Director and Director (Finance & Financial Operations). Audit observed that during the period from August 2008 to July 2009 the post of CMD and Director (F&FO) was held by the same incumbent, as such all the borrowing decisions of this period were taken by a single authority which cannot be considered as good corporate governance practice.

Ministry stated (January 2011) that the Board of Directors had delegated powers jointly in favour of CMD and D(F) to take all the borrowing decisions and CMD was holding additional charge of D(F) during this period as per directives of Ministry of Power, Government of India.

The reply was not acceptable since borrowing decisions by a single authority were against the principle of joint authorisation laid down in the Resource Mobilisation Manual.

13.2.3 Issue of Bonds

Based on GOI guidelines, PFC laid down (June 1998) internal guidelines for issue of bonds on private placement basis. Out of total borrowings of ₹ 74131 crore made by PFC during 2004-2009, ₹32683 crore (44 *per cent* of total borrowings) were mobilized through 60 series of bonds on private placement[1] basis. Examination of audit sample of 24 bond series revealed as under:

13.2.3.1 Higher Coupon rates

PFC being an AAA[2] rated company fixed the coupon rates for bonds on the basis of prevailing AAA bond rates as shown in the Reuters screen[3] and also consulted arrangers regarding pricing and structure of the bond issues. A comparative study of coupon rates of bonds issued by PFC during 2004-09 with the prevailing AAA bond rates revealed that PFC's rates were fixed higher in 13 out of 24 bond series. Due to the higher coupon rates, PFC was incurring additional expenditure to the extent of ₹ 14.54 crore annually. Accordingly, the Company would have to incur an amount of ₹ 120 crore over the tenure of bonds.

[1] ***Private placement means an issue offered to a select group of persons (not to the public)***

[2] ***AAA rating:-Rating symbol for highest credit safety given by CRISIL, one of the credit rating agencies approved by SEBI.***

[3] ***Reuters screen – Reuters is a trading platform, which gave AAA rates, derived from the contributed rates of 20 market players including banks, brokers and Mutual Funds.***

Management replied (December 2010) that Reuter's AAA rates might or might not be true indicator of the market levels of the particular day and quantum of the amount and market conditions play a vital role in fixation of the interest rate.

Ministry endorsed (January 2011) the reply of the Management.

The reply was not convincing since PFC considered Reuter's AAA rates as the reference rates while fixing the coupon rates for bonds. Further, Audit also compared the coupon rates of PFC bonds with those of PSUs in the power and finance sector viz. Indian Railway Finance Corporation Limited (IRFC), Rural Electrification Corporation Limited (REC), NTPC Limited (NTPC), Power Grid Corporation of India Limited (PGCIL), which were launched around the same time. Out of 19 common series in five years under review, PFC's rates were higher for similar or shorter tenor in 15 series and in one series the other Company was able to raise funds for longer tenure at equal rates. Besides, Audit also compared the rates with AAA spreads[1] as per FIMMDA[2] and found that PFC's coupon rates were higher than FIMMDA rates in 10 bond series (out of the 24 bond series). The higher interest cost in these 10 series worked out to ₹ 132.30 crore for the entire tenor of bonds.

Ministry stated (January 2011) that the bond rates with companies like NTPC, REC and IRFC were not comparable as their security structure was not the same. Regarding FIMMDA rates, it stated that these were used by banks to make investment and were generally published only at the end of the month. Further, it stated that keeping in view the frequency of PFC bond issues and volatility in the market, FIMMDA rates cannot be applied as benchmark.

The reply was not acceptable since all the companies considered by Audit had the same credit rating (i.e. AAA) and were CPSUs in the same sector viz. Power/Finance. The comparative trend analysis over a time frame of five years from 2004-05 to 2008-09 showed that coupon rates of PFC bonds were higher than that of similarly rated Government Companies and different reference (FIMMDA) rates. As regards FIMMDA, the timing of the publication of rates cannot nullify the trend analysis, which showed that PFC's rates were higher.

Apart from the above, Audit observed that economy of borrowings was being assessed by the Administrative Ministry through a parameter called 'borrowing cost-domestic' linked to Government Security rates in the MOUs, during 2005-06 and 2006-07. The parameter was deleted from the year 2007-08 and since then there were no targets for assessing economy of borrowings. The main reasons for higher bond rates identified by Audit are discussed below:-

(a) Frequent bond issues and limited investors

Comparative study of frequency of PFC bond issues with that of other PSUs revealed that PFC floated 32 bond issues in five years as against 13 on an average, by four other PSUs in Power / Finance Sector. Further as per the Companies Act, there was no upper ceiling on the number of subscribers to whom bonds could be issued on private placement by a

[1] AAA spreads – It is an indicator of risk premium for a AAA rated paper over Government securities (G sec)

[2] FIMMDA - Fixed Income Money Market and Derivatives Association of India

Public Finance Institution (PFI) as against the limit of 50 investors for other issuers. Audit observed that PFC did not avail this benefit adequately as the number of investors subscribing to PFC's bonds was less than 50 in 15 out of 24 bond series examined by Audit.

Management admitted (February 2010) that there were frequent bond issues and attributed it to the efforts made to maintain sufficient balance between liquidity and carrying cost. It further stated that it was not possible to raise the desired amount in one issue and comparison with companies like NTPC, IRFC and HUDCO was not justified keeping in view the total fund requirement of the Company. Regarding limited investors, it stated that investment by banks/merchant bankers might be on account of investors to whom the same would be transferred in secondary market deal.

Ministry endorsed (January 2011) the views of the Management.

The argument attributing the frequent bond issues to higher fund requirement in comparison to other companies was not convincing since PFC had the flexibility of approaching more investors in private placement to meet its higher fund requirement unlike those companies which, not being PFI, were required to limit the number of investors to less than 50. As regards investors who subscribe to the bonds through merchant bankers in the secondary market rather than through direct subscription, this did not help PFC in bringing down coupon rates.

(b) Lack of proper timing

Comparison of timing of bonds issues of PFC with that of REC revealed that seven bond series of PFC were issued around the same time as REC during 2004-05 to 2008-09. Out of the seven bond series of PFC, the coupon rates of four series (for equal or lesser tenure) were higher than REC rates. The higher interest cost when compared to REC rates in the four bond series worked out to ₹ 60.33 crore. Further PFC did not take care to avoid a bond issue during the time of advance/final payment of tax, when bond rates were high. Out of the 60 bond series during the last five years, 13 bond series were around the advance /final tax payment dates. Thus PFC had to bear a higher coupon rate in nine bond series when compared to the rates prevalent on nearby dates. The resultant increase in interest cost worked out to ₹ 86.25 crore.

Ministry stated (January 2011) that all efforts were made to avoid overlapping of the issues as well as particular events like advance tax payment dates etc.

The reply was not acceptable as out of 60 bond series issued by PFC, 13 were around advance/final tax payment dates and seven were around REC bond issue dates.

(c) Engagement of Arrangers

In the selected sample of 24 cases, PFC appointed arrangers in 16 series and handled eight series without arrangers. Out of the total funds of ₹ 20822.20 crore raised through arrangers, investment by arrangers and their group companies amounted to ₹ 7552.50 crore (36.27 *per cent*). Audit observed a conflict of interest in this arrangement since the arrangers were appointed to help PFC in raising funds at the minimum possible coupon rates. When the arrangers themselves became investors, the possibility of fixing high coupon rates to get high yield could not be ruled out.

Ministry replied (January 2011) that services of arrangers were availed to reach the maximum number of investors across the country and fixation of interest rates had no relevance with the launch of a particular issue through arrangers or directly.

The fact remained that PFC could mobilize more funds, with reference to issue size, when it handled the issues on its own i.e. without engaging arrangers. Further, bond issues launched with arrangers generally had coupon rates higher than AAA rates.

(d) Underplaying of the issue size

The issue size of bonds varied from ₹ 100 crore to ₹ 500 crore even though the assessed requirement ranged from ₹ 963-9400 crore. PFC retained the excess subscription received on each bond issue by exercising the Green Shoe Option[1]. In five out of 25 instances, the funds were retained even though mobilization was more than the assessed requirement. The excess funds so mobilized were deployed in fixed deposits carrying lesser interest rate, leading to avoidable carrying cost[2] of ₹ 4.77 crore. Further, in two instances during the global financial crisis of 2008, PFC retained funds amounting to ₹ 2205 crore over and above the assessed requirement, even though the AAA rates decrease between dates of opening of issue and the date of allotment. Hence the green shoe option was not judiciously exercised in these two cases, leading to avoidable interest cost of ₹ 307.41 crore. PFC initially laid down the limit of green shoe option as equal to the issue size in its internal guidelines but later the ceiling was removed. Audit observed that PFC did not declare the limit of green shoe option at the time of floating the bond issues. In one case the limit of green shoe option was declared, but subsequently the entire funds in excess of the green shoe limit, were also retained.

Ministry replied (January 2011) that the guidelines for private placement did not prohibit any issuer to keep the green shoe option open /unspecified and that the issue size was generally kept low to ensure success of a particular issue. It further stated that the amount of subscription was not related to the issue size and any investor who wants to put money, checked directly from PFC or through arrangers and PFC at times had to pre-close the issue to avoid refunds.

The reply was not acceptable since a test check of bond issues in the debt market during December 2008 to January 2009 revealed that out of 31 issues, green shoe option was kept in seven cases. In four out of the seven issues, the green shoe option was specified indicating that the general market practice was to declare the green shoe option. Further, it was not reasonable to expect that the investors should make enquiries to know the real issue size. Overwhelming response may also be due to higher coupon rate PFC was offering.

13.2.3.2 Tenure of bonds

PFC fixed tenure of bonds based on investor appetite for a particular tenure as per the market situation and advice of arrangers. The tenure of 24 bond series examined by Audit

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[1] Green shoe option – It is the option through which the issuer of the bond declares their intention to retain over-subscription

[2] Carrying Cost is the difference in cost of borrowing and the yield from short term deployment of funds in fixed deposits.

ranged from 1.5 years to 15 years*. During 2008, there was a global financial crisis and the bond coupon rates rose to 11 *per cent* as against seven to 10 *per cent* prevalent during 2004-05 to 2008-09. PFC issued six series during this period and mobilised funds of ₹ 6733 crore (20.6 *per cent* of funds mobilised during the period from 2004-05 to 2008-09) as detailed below:

Bond series No.	Date of issue	Coupon rate	Tenure in years	Amount mobilised (₹ in crore)
51 A	15.9.2008	11.15	3	495
51 B	15.9.2008	11.10	5	594
51 C	15.9.2008	11.00	10	3024
52 A	28.11.2008	11.40	5	663
52 B	28.11.2008	11.30	7	6
52 C	28.11.2008	11.25	10	1951
TOTAL				**6733**

Had PFC fixed the tenure and coupon rates of above mentioned bonds judiciously, interest cost to the extent of ₹ 259.47 crore to ₹ 1067.41 crore could have been avoided. In the 51 bond issue, PFC offered 10 years bonds at 11 *per cent* interest along with three year bonds at a slightly higher interest of 11.15 *per cent*. The pricing was not commercially prudent since the investors were more likely to opt for the 10 year bonds in view of the high return for longer period. This was proved by the huge mobilisation from the 10 year bonds. In the 52nd bond issue, three year bonds were not offered and the pricing of five and seven year bonds was not competitive enough to attract subscription when compared to the 10 year bond rate. Both these bond series were handled by arrangers who by themselves or through their group companies subscribed to 51 *per cent* of the total mobilisation indicating undue benefit to them.

Ministry stated (January 2011) that there was more demand for longer tenure paper in spite of lower coupon as compared to three years and keeping in view the fund requirement of the Company and appetite of the investors, PFC had to launch ten year paper.

The reply was not convincing considering the meagre difference (0.15 *per cent*) between the rate of interest offered for three year and 10 year bonds and also the fact that the main subscribers were the arrangers. Ministry did not reply to the observation regarding the undue benefit given to the arrangers on these bond issues.

13.2.4 Bank Loans

During the five year period under review, PFC raised ₹ 35230 crore (45.87 *per cent* of total borrowings) through 276 loan drawals from banks of which 59 loan drawals for an amount of ₹ 9213.77 crore were examined by Audit and observations were as under:

13.2.4.1 Lack of transparency in discovery of lowest rate on bank loans

PFC sent letters to various banks every quarter calling for indicative interest rates and depending on the fund requirement, the loans were availed from individual banks after finalizing the rates with them. Audit observed that the system of rate discovery lacked

**** one bond for 1.5 year, 2 bonds for 3 years, 7 bonds for 5 years, 2 bonds for 7 years, 11 bonds for 10 years and 1 bond for 15 years.***

credibility since the offers received from banks were not firm offers. Moreover, the quotes received from banks were as per their own version since PFC did not specify its requirements. However, on one occasion, firm rates were called for from banks for availing a short term loan and among the nine quotes received, the annualized interest rate varied from 9.38 *per cent* to 11.30 *per cent*. Audit observed that there was better response when firm rates were called for and PFC could secure more competitive rates.

Ministry stated (January 2011) that the quarterly request letters were sent to all the scheduled commercial banks to raise funds in a particular quarter and PFC's requirement of funds was not restricted to a particular time frame and was an ongoing exercise throughout the year. It further stated that if firm quotes were asked, it may not be possible for the banks to hold firm rates for the quarter.

The reply was not acceptable since all financial institutions require funds throughout the year and scrutiny of the practice followed in REC by Audit revealed that bank loans were raised on the basis of firm quotes. Further, Audit observed that the inability to seek firm rates stemmed from the lack of proper assessment of fund requirement.

13.2.4.2 Raising of loans without pre-payment option during high interest rates period

During the period of global financial crisis of 2008, PFC availed three loans totaling ₹ 1000 crore from two private banks[♣] at fixed interest rate of 11.7 *per cent*. These loans were for 22 months to three years with put and call option after two years in case of three year loans.

The decision to raise these loans was not prudent in view of the following:

- The banks did not provide prepayment option on the loans and PFC had to incur higher interest cost of ₹ 51 crore considering the lower interest rates of subsequent quarter. It could have saved interest outgo to the extent of ₹ 51.70 crore had it raised the funds on floating rate basis.
- During this period PFC had an offer from Bank of Baroda for a loan of ₹ 500 crore at a floating interest rate of 13 *per cent* which was not availed. Though the interest rate at that time was higher, the eventual cost would have been lower in view of the floating rate. There was another offer of ₹ 150 crore from State Bank of Mysore at a fixed interest of 11.5 *per cent* which was not approved by the competent authority without recording reasons.

Ministry stated (January 2011) that the said loans were raised during tight liquidity conditions in the market and banks were reluctant to give prepayment option.

The reply was not acceptable since in the absence of pre-payment option, PFC could have opted for floating rate loans or short term loans. Further, even during volatile period, PFC continued with its system of seeking quarterly indicative rates instead of calling for firm quotes.

13.2.4.3 Drawal of loans from banks and placing the funds in fixed deposits (FDs)

Audit observed that PFC frequently made loan drawals from banks in excess of requirement and placed the balance funds, the same day, in fixed deposits which carried

[♣] ***Axis Bank (loan availed ₹ 700 crore) and Kotak Mahindra Bank (loan availed ₹ 300 crore)*** lesser interest. Out of 276 loan drawls made during the period 2004-05 to 2008-09, the Company made fixed deposits to the extent of ₹ 753.59 crore in 67 cases on the same day at lower rate of interest which resulted in extra cost of ₹ 7.55 crore.

Management stated (February 2010) that keeping in view the huge requirement of funds and also the uncertainty of fund required for disbursements, the amount of loan drawn may be less or more compared to the actual requirement of funds on a particular day and that sometimes loan has to be drawn before expiry of validity given by the bank.

Ministry endorsed (January 2011) the reply of the Management.

The reply was not acceptable since differential interest between borrowings and short term investments ranged from 0.91 *per cent* to 2.70 *per cent* and showed upward trend for the last three years. Hence the negative carry[1] due to drawal of bank loans should have been avoided.

13.2.5 Funds raised through United States Private Placement (USPP) at higher cost

PFC raised (July 2007) USD 180 million (₹ 732.42 crore) from the United States debt market through private placement of Senior Notes to six institutional investors at coupon rate of 6.61 *per cent*. Two arrangers[2] were appointed to handle the private placement and the notes were priced on the basis of rates for 10 year US treasury bills and the spread[3] thereon.

Audit observed that:

- Spread agreed by Indian companies which tapped the USPP market prior to PFC, ranged from 140 to 155 bps[4] as against the spread of 170 bps agreed by PFC, thus making it the costliest private placement by an Indian Company at that time.

- Historical data of US treasury bills for 10 year tenure between January 2003 and December 2007 revealed that the average annual daily rates ranged from 4.01 *per cent* to 4.78 percent. The daily rates remained relatively higher during June –July and PFC hit the US market during one such period (July 2007). Further, when PFC timed the issue, the spreads widened due to the sub-prime crisis[5] and PFC agreed for a spread of 170 bps as against the spread of 150 bps agreed by one of the CPSUs viz. IOCL, in May 2007. The higher interest cost when compared to this issue worked out to ₹ 14.65 crore.

- Arrangers were appointed on the basis of indicative spread of 125 bps quoted in April 2007. However, at the time of pricing in July 2007, PFC agreed for a spread of 170 bps proposed by the arrangers (i.e. increase of 45 bps over the spread quoted at the time of bidding). The pricing proposal was not routed through the Resource Mobilisation Committee, as per the procedure laid down, though higher

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[1] ***Negative carry – Incurring extra interest cost due to carrying higher cost borrowings.***

[2] ***Deutche Bank and Barclays Bank***

[3] ***Spread – risk premium as per market indicators***

[4] ***bps:-basis points (i.e. 1.4 per cent to 1.7 per cent over and above the rate of US Treasury bills)***

[5] ***Sub- prime crisis means default by the borrowers on the mortgaged loan and resulting reduction of securities backing such mortgaged loans and liquidity crisis. It occurred in the United States during 2007-08.***

interest cost of ₹ 32.96 crore was involved. Out of the six investors, two were group companies of one of the arrangers indicating conflict of interest.

Ministry stated (January 2011):

- Rates of other issuers were not comparable because the price was determined by numerous factors.
- The fully hedged cost of issue was comparable with the cost of funds in the domestic market.
- As firm quotes were not available in the USPP market, the indicative quotes were taken.

The reply was not acceptable because:

- Audit compared the rates with those of other companies considered by PFC and the arrangers while pricing the issue with that of other companies.
- The comparability of cost with reference to domestic rates was not convincing since PFC considered swap costs for hedging of the principal only and did not include hedging cost for interest component. Audit observed that the Company had already incurred actual exchange loss of ₹ 18 crore in interest servicing up to September 2010.
- Arrangers were selected on the basis of indicative rates but they sought a higher rate later citing worsened market conditions. Conflict of interest could not be ruled out since a significant portion (25 *per cent* of additional interest payable due to increase in spread) of benefit went to the group companies of the arrangers.

13.2.6 Initial Public Offering

PFC raised capital of ₹ 997.19 crore through its Initial Public Offering which was floated in January/February 2007 at a price band of ₹ 73-85, approved by the Board of Directors of PFC, based on the recommendation of Book Running Lead Managers (BRLMs). The issue was oversubscribed by 77.16 times and the issue price was fixed at ₹ 85 per share. On listing, the quoted price was ₹ 113 per share.

Audit observed:

- The prospectus for the IPO permitted subscription by associates of BRLMs and syndicate members. As per Accounting Standard 23 dealing with 'Accounting for investments in consolidated financial statements' notified by the Institute of Chartered Accountants of India, an associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. Audit observed that PFC permitted subsidiaries of BRLMs to subscribe to the issue and allotted them 37.37 lakh shares valuing ₹ 31.76 crore (6.37 *per cent* of QIB portion) in violation of terms of issue as per the IPO prospectus. There was a conflict of interest since the BRLMs were advising PFC about pricing while the subsidiaries might be looking for trading gains. Further, 35 out of 37 subsidiaries of BRLMs, who were allotted shares, divested their shares on the listing day or soon thereafter and made a profit of ₹ 10.93 crore (35.78 *per cent* of their investment).

- PFC floated the issue with a price band of ₹ 73-85 though SEBI guidelines permitted a difference of 20 *per cent* between the upper and lower end of the price band. PFC could have fixed the upper price band as ₹ 87 (instead of ₹ 85) which would have fetched ₹ 23.46 crore more.

Ministry stated (January 2011) that:

- Other CPSUs under the Ministry like NTPC, NHPC and PGCIL had also allowed the associates of BRLMs to subscribe to equity shares in their respective issues.
- The price band of the IPO was recommended by the IPO Pricing Committee of Directors as per the feedback received from the BRLMs based on the market conditions. The price band subsequently approved by the Board of Directors was already higher than the price initially recommended by BRLMs.

The reply was not acceptable since:

- Subsidiaries of BRLMs (not 'Associates') were allotted shares in violation of the terms of issue as per the prospectus thus depriving eligible QIBs/investors from getting the allotment of shares.
- Board of Directors approved a higher price than that quoted by the BRLMs but the fact remained that subjectivity was involved in the process. Audit observed that IPOs of NTPC (₹ 52-₹ 62), PGCIL (₹ 44-₹ 52) and NHPC (₹ 30-₹ 36) took the benefit of 20 *per cent* difference in floor and cap price of the price band.

13.2.7 Asset Liability Management (ALM)

Asset liability management can be broadly defined as the continued rearrangement of both sides of the balance sheet in an attempt to maintain reasonable profitability, to minimize interest rate risk and to provide adequate liquidity. The ALM framework of PFC included periodic analysis of long term liquidity profile of assets, receipts and debt service obligations through liquidity gap statements. Such analysis was made every month in yearly buckets and was being used for Management decisions regarding maturity profile of the borrowings, creation of new assets and mix of assets and liabilities. PFC had an Asset Liability Management Committee (ALCO) which reviewed the ALM position every month. Audit observed that the ALM framework of PFC failed to strengthen the risk management process of PFC as explained below:

13.2.7.1 Widening gap in maturity profiles of assets and liabilities

The weighted average maturity (WAM) of assets and liabilities of PFC, as on 31 March of the last six years was as follows:

Balance sheet date	Weighted Average maturity of Loan assets	Weighted Average maturity of Loan liabilities	Difference in maturity period (years)
31.3.04	4.14	3.37	0.77
31.3.05	4.35	3.49	0.86
31.3.06	4.58	4.23	0.35
31.3.07	4.85	4.09	0.76
31.3.08	5.21	4.02	1.19
31.3.09	5.64	4.15	1.49

The purpose of calculating weighted average maturities of the assets and liabilities was to have an idea of the average time within which such assets would be realized and liabilities would be settled. Widening of gap in maturity period from 0.77 (as on 31 March 2004) to 1.49 (as on 31 March 2009) indicated liquidity problems for the Company and tough borrowing decisions might be required to repay the liabilities.

Ministry stated (January 2011) that weighted average maturity of assets was more than weighted average maturity of liabilities, which was inherent in infrastructure financing particularly power sector financing. It further stated that the calculations for weighted average maturity (done by PFC) did not consider equity capital and reserves which were used to finance loan assets and which were perpetual in nature.

The reply was not acceptable since it was not prudent for a financial institution to consider its equity capital and reserves to manage ALM mismatches. The principle of ALM was to rearrange the assets and liabilities continuously in an attempt to maintain reasonable profitability, to minimize interest rate risk and to provide adequate liquidity. Regarding the claim that PFC had a strong ALM system, the touchstone for checking the efficiency of ALM system of a financial institution was its performance during a financial crisis. During the global financial crisis of 2008, PFC had to take tough borrowing decisions to repay debt obligations of more than ₹ 4000 crore by Management's own admission. The huge outflow during the financial crisis indicated failure of ALM.

13.2.7.2 Failure to monitor short term mismatches through tolerance limits

RBI prescribed (June 2001) ALM guidelines for NBFCs and emphasized the need to monitor short term mismatches and lay down tolerance limits. The methodology prescribed by RBI required the NBFCs to monitor the mismatches in short term buckets i.e. i.e. cash inflows and outflows in the next 1-31 days, 1-3 months, 3-6 months etc. were to be monitored. PFC laid down Integrated Risk Management Policy as per which negative liquidity gap up to 15 *per cent* of the cash outflows for the next 12 months was categorized as low risk, 15-25 *per cent* as medium risk and more than 25 *per cent* as high risk.

Audit observed:

- PFC did not follow RBI guidelines regarding ALM and claimed that the guidelines were not applicable to PFC. However on a reference by Audit, RBI clarified that it had not granted specific exemption to Government NBFCs regarding ALM and stated that non adherence to ALM guidelines prescribed by RBI would increase the risk for the financial institution.
- While RBI guidelines emphasized monitoring of ALM mismatches in short term buckets, and prescribed tolerance limits for the same, PFC analysed the mismatches in yearly buckets i.e. PFC knew the ALM mismatches for the next one year but not the next one month, three months, six months etc.
- These inadequacies adversely impacted PFC during the financial crisis of 2008, as already stated in para 13.2.3.2 PFC raised ₹ 6733 crore through bonds during the volatile period of September 2008 to November 2008, which was 20.60 *per cent* of total funds borrowed through bonds during last five years. Since the bonds had

tenure ranging from three to 10 years and carried fixed interest rates, PFC had to carry higher interest burden of ₹ 217 crore when compared to the average cost of borrowing for the year.

Management stated (February 2010) that:

- RBI guidelines to NBFCs on ALM were not applicable to PFC and the PFC had explained the position to RBI.
- The ALM practices of PFC were studied by M/s KPMG and the Integrated Risk Management policy was laid down as per their recommendation. PFC was managing the risk within the low risk limit laid down in the policy.
- It was to the credit of PFC that it could borrow large amount of funds through bond issues at competitive rates and comparison of the rates with average cost of borrowing for the year is not correct since each borrowing is unique.

Ministry endorsed (*January 2011*) the reply of the Management.

The reply was not acceptable since:

- PFC was sending half yearly returns to RBI earlier and as part of the returns, it was preparing and sending dynamic liquidity statements for short term buckets also. But monitoring in short term buckets was not the regular feature of ALM monitoring by PFC. Thus full facts were not presented to RBI.
- Integrated Risk Management Policy relating to ALM aspect was not in accordance with those prescribed by RBI which was the financial sector regulator. Had PFC laid down tolerance limits for short term buckets, the borrowings during the volatile period could have been curtailed. Further, Audit compared the practice with that of REC and found that the ALM policy of REC provided for short term buckets.
- Borrowing large amount of funds during a financial crisis that too mainly to repay debt obligations by itself proved failure of ALM framework. The argument that the bond issues were made at competitive rates was incorrect since in four out of six bond issues of the volatile period, the rates were higher than AAA rates. PFC incurred higher interest cost of ₹ 54.75 crore in those bond issues when compared to the AAA rates. Thus PFC was able to borrow funds to tide over the liquidity crisis, but it involved a higher cost. Regarding Management's claim that individual borrowing costs should not be compared with average borrowing cost for the year, such comparison were not out of place while assessing efficiency of ALM framework.

Conclusion

PFC was not having a sound system for assessing the requirement of funds resulting in mismatches leading to higher costs. Limited investor base, engagement of arrangers, poor timing of issues and underplaying the issue size were some of the reasons which contributed to higher coupon rates for bonds issued by PFC. Undue favour to arrangers was evident in the fixing of tenure of bonds issued during volatile period. Bank loans were finalised on the basis of indicative rates and some loans were availed at high interest rates without prepayment option. United States Private Placement of senior Notes by the Company coincided with sub-prime crisis and resulted in higher cost. Price band of Initial Public Offering was not fixed prudently and subsidiaries of BRLMs were allotted shares in violation of terms of issue. Short term asset liability mismatches were not monitored and PFC had to borrow heavily at higher cost to repay debt obligations that came up during global financial crisis of 2008. Audit assessed the total loss on these accounts during the five years from 2004-05 to 2008-09 as ₹ 1485 crore to ₹ 2293 crore.

Recommendations

- ***The mechanism for assessment of requirement of funds needs to be revisited and strengthened.***
- ***PFC should ensure resource mobilization in an economical, efficient and effective manner through judicious fixing of coupon rates for bonds, reducing dependence on arrangers, proper timing, expansion of investor base and prudent fixing of tenure and issue size of bonds.***
- ***Bank loans should be raised in a transparent and efficient manner based on firm quotes, availability of prepayment option etc.***
- ***Before opting for overseas fund mobilization due consideration should be given to exchange risk factors.***
- ***PFC should follow RBI guidelines applicable to NBFCs regarding Assets Liability Management and lay down tolerance limits for short term mismatches.***

13.3 Utilisation of Funds

Introduction

Power Finance Corporation (PFC) was set up in July 1986 as a Financial Institution dedicated to power sector financing and committed to the integrated development of the power and associated sectors. It was notified as a Public Financial Institution under Companies Act, 1956 in 1990 and was registered as a Non-Banking Financial Company (NBFC) by RBI in 1997. PFC was listed (23 February 2007) in the stock exchange after its Initial Public Offering (IPO). PFC is a Government Company within the meaning of Section 617 of the Companies Act as the President of India holds 89.78 *per cent* of the total equity. In June 2007 PFC was conferred 'Nav-Ratna' status. In July 2010, RBI granted the status of 'Infrastructure Finance Company' (a new category under NBFCs) to PFC. The share of PFC in power sector financing during the 11^{th} Five Year Plan (2007-2012) was 11.50 *per cent.*

Operational Framework

The Mission of PFC was to endure as a pivotal Development Financial Institution in the Power Sector committed to the integrated development of power and associated sectors by channeling resources and providing financial, technological and managerial services for ensuring development of economic, reliable and efficient systems and institutions. The Operational Policy Statement (OPS) of the Company stated that PFC's policy framework should be consistent with the policies and regulatory framework of the Government of India. OPS also envisaged that criteria of financial assistance should lay emphasis on financial and operational strength, capability and competence of the promoter and techno-economic viability of projects.

Scope of Audit

The audit covered various activities pertaining to utilization of funds during the period from 2004-05 to 2008-09. Sample of 182 cases (₹ 27941 crore) out of total 1764 cases (₹ 172461 crore) was selected for audit on the basis of monetary value of sanctions and stratified random sampling method.

Audit objectives

Objective of this thematic audit was to assess whether:

- Funds were utilized effectively and efficiently.
- Project appraisal mechanism was proper and internal controls relating to sanction and disbursement of loans were sound.
- Project monitoring mechanism was effective and proper end utilization of funds and timely recovery of dues was ensured.
- Prudence and transparency existed in fixing of lending rates.

Audit criteria

The following criteria were used to assess performance of the Company:

- OPS of PFC
- Disbursement procedure laid down by PFC
- Prudential norms of PFC and RBI
- Best practices followed by the Industry.

Audit Findings

13.3.1 Project Appraisal

As per clause 3.1 of Part II of the OPS of PFC, the Company was required to provide financial assistance to the projects which meet the following criteria:

- The project was techno-economically sound with financial or economic rate of return of not less than 12 *per cent* (as may be applicable);
- Project was feasible and technically sound and provide optimal cost solutions for the selected alternative;
- Project was compatible with integrated power development and expansion plans of the State/Region/Country;

Out of total 182 cases selected, 76 cases pertaining to generation, transmission, distribution and renovation and modernisation, were examined and audit findings were as under:

13.3.1.1 System of assessing reasonableness of project cost was deficient since PFC did not verify independently the cost estimates furnished by borrowers. Further, PFC did not maintain cost data of items being used in power sector utilities as such excess funding could not be ruled out.

Ministry replied (February 2011) that cost of various equipment was on the basis of recently sanctioned projects across various utilities and schedule of rates of some of the utilities. Further, it was not feasible for PFC to maintain database of current market price of each of the equipment involved in power projects across various areas of generation, transmission and distribution.

The reply was not acceptable as cost estimates should have been verified on the basis of current market prices of various components rather than the last awarded price. Going by the purchase order value also did not ensure reasonableness of cost since there was no check on inflated values considered in a purchase order resulting in adverse cumulative effect on cost estimates.

Further, Audit identified three cases♣ (out of 14 generation cases in the selected sample), where per mega watt (MW) project cost at the time of sanction was higher than the actual 10th plan per MW cost of around ₹ 4 crore mentioned in the report of Working Group on Power for XI Plan constituted by Ministry of Power. Management contention that it was not feasible to maintain database was not convincing, considering that PFC was exclusively catering to power sector and would have been benefited by maintaining data bank of current market price.

13.3.1.2 Examination of 56 cases of transmission and distribution (T & D) projects revealed that in 15 cases (including four cases with negative FIRR) FIRR was less than that stipulated in OPS i.e.12 *per cent.* This indicated managerial failure to adhere to the criteria stipulated in OPS to ensure financial viability of a project.

Ministry stated (February 2011) that consistent with its developmental role, PFC may also consider financial assistance to public sector utilities having unsatisfactory operational and financial performance provided such utilities committed themselves for improvement in their performance levels. Regarding T & D projects it stated that FIRR of individual T & D projects was often less than 12 *per cent* since the schemes could not be divided into water tight compartments and hence benefit to economy as a whole was considered through EIRR criteria. It further stated that such sanctions would normally incorporate conditionality to ensure improvement of performance of the utilities.

The reply was not acceptable as Electricity Act 2003, emphasised on financial viability of the project i.e. the project revenues should have been sufficient to meet all project costs. This could be achieved by considering financial rate of return. The onus of bringing in the transformation in the power sector was on developmental financial institutions like PFC who were to address this aspect at the appraisal stage itself. Since financial viability of projects was a key factor in sustained development of the power sector, PFC should have focused on the FIRR criteria while conducting project appraisal.

13.3.1.3 PFC sanctioned (October 2008) a loan of ₹ 1770 crore to Sasan Power Limited (Special Purpose Vehicle promoted by Reliance Power Limited) for setting up an Ultra Mega Power Project. While assessing the FIRR, Plant Load Factor (PLF) of 90 *per cent* was assumed instead of 80 *per cent* stipulated in PFC's guidelines based on CERC norms.

♣ ***(i) Loan NO. 08301004 dated 09-8-2006 - U.P.Rajya Vidyut Utpadan Nigam Limited (UPRVUNL) 2X250 MW-Project cost ₹2356 crore-Cost /MW ₹4.71 crore (ii) Loan NO.08301005 dated 09-8-2006-UPRVUNL)- 2X250 MW - Project cost ₹2605 crore -Cost /MW ₹5.21 crore (iii) Loan NO. 22101002 dated 31-3-2008 -Chhatisgarh State Electricity Board—2X500 MW- Project cost ₹ 4174 crore Cost/MW ₹4.17 crore***

The justification was that the lead financial institution assumed 90 *per cent* PLF and that the Lenders' Independent Engineer (LE) viz. Lehmeyer International (India) Pvt. Limited had stated in his due diligence report that with ' certain measures during execution and best international O & M practices, 90 *per cent* PLF can be achieved'.

Audit observed that 90 *per cent* PLF was an unduly positive presumption since the borrower intended to bring in Chinese equipment for the main plant which had not achieved 90 *per cent* PLF under domestic conditions. Further, at the time of sanction, PFC was having only the sanction letter of the lead financier while as per norms, it should have reviewed the appraisal report of the lead financier before granting sanction for financial assistance. Project FIRR as per PFC's norms was 3.78 *per cent* but considering a newspaper report, stating that the developer was permitted to use surplus coal from the coal block allotted for the project to its other projects, the FIRR was brought, with liberal assumptions, up to the level of 11.72 *per cent* and sanction of financial assistance to the project was justified. Moreover, instead of waiting for the required permission letter of Coal Ministry PFC relied on media reports to justify sanction of loan for the project. Thus necessary documents were not examined and undue haste was shown in sanctioning loan for the project.

Ministry stated (February 2011) that while concerns exist around use of Chinese equipments, the LE was aware of the use of Chinese equipment when the opinion with regard to achievement of a PLF of 90 *per cent* was given. It further stated that the LE had sufficient technical knowledge and expertise to provide its opinion with regard to 90 *per cent* PLF.

The reply was not acceptable since the lender's engineer had given a conditional opinion which stated that 90 *per cent* PLF was achievable provided the best international O & M practices were followed. PFC had little control over the O & M practices to be followed by the borrower after the funds were disbursed and the plant would be commissioned. CERC norms were fixed after considering the PLF trend over the years including competitive bid for Independent Power Projects. It was prudent to rely on regulatory norms rather than to rely on subjective presumptions of the lender's engineer. Further, competitive bidding did not guarantee higher PLF unless the track record of machines proved as desired.

13.3.1.4 It was observed that in 26 cases (out of 76 mentioned above), extensions in date of completion, date of validity of sanction, date of loan closure etc. were accorded without assessing FIRR of the projects at the time of granting such extension.

Ministry stated (February 2011) that request for extension of project completion date was generally received by PFC at a time when more than 50 *per cent* of the loan amount had already been disbursed and at such a stage stopping of funds would not only hinder completion of the project but would also be detrimental to the interests of PFC.
From the reply it was clear that both PFC and the entities were creating a vicious cycle of delays and extensions.

13.3.2 Disbursement – Collateral Security Requirements

13.3.2.1 According to collateral security requirements laid down (March 2007) by PFC for various categories of borrowers, the requirement for Category 'B' borrower was as follows:

- Pledge of shares of atleast 51 *per cent* of project equity till full repayment of PFC loan.
- Debt Services Reserve Account (DSRA) for at least two quarters.
- Personal guarantee of two promoter directors, who were participating in equity contribution.

The policy further provided that in cases where PFC was not the lead financial institution, the collateral security requirements were to be considered on a case to case basis depending upon the securities prescribed by the lead financial institution/bank. Audit observed that in respect of loan of ₹ 1770 crore sanctioned to Sasan Power Limited, collaterals prescribed by the lead financial institution (SBI) were taken, which did not include personal guarantees of two promoter directors.

Ministry replied (February 2011) that as per policy guidelines, in cases where PFC was not the lead financier, collateral security requirements were to be considered on case to case basis, depending upon collateral securities prescribed by the lead financial institution. As the entire equity was to be contributed by Reliance Power Limited and not by any individual, requirement of personal guarantee of promoter directors was not applicable.

The reply was not acceptable as the above policy was open ended as it provided for security requirements to be decided on a case to case basis. Further, the policy did not prescribe corporate guarantee in cases where instead of individuals, promoter companies were required to contribute the equity.

13.3.2.2 Test check of 32 Short Term Loan cases (out of total 284 cases) showed that authenticated utilization certificates from the auditors of the utilities were not obtained as the same was not prescribed in the Procedure for Disbursement.

Ministry stated (February 2011) that utilization certificates were signed by high level officers of the borrowers and in case certificate from the Auditors is insisted, the borrower would have to pay fee to the Statutory Auditors and thus the borrower would prefer to obtain loan from other institutions.

The reply was not acceptable since independent verification by statutory auditors was necessary to ensure proper end utilization of funds.

13.3.3 Project Monitoring

Monitoring of projects was necessary to ensure that funds disbursed were utilized effectively and efficiently. Besides, project monitoring helps to ensure that disbursement of funds was commensurate with the progress of the projects. Review of project monitoring mechanism followed by PFC revealed as under:

13.3.3.1 PFC did not develop an information system to get feedback of utilisation of funds so that proper end utilization of funds could be ensured. Besides, monitoring of projects by the State Coordinators was also not being carried out regularly and periodical returns required to be furnished as per sanction letter of each project were not obtained. On the suggestion (May 2009) of PFC's Risk Management Committee for creation of post sanction unit to strengthen project monitoring, the Company established Project Monitoring Unit in June 2009.

13.3.3.2 Out of 129 projects financed by PFC during 2004-2009, 96 projects were scheduled to be completed by November 2009. It was, however, observed that only 28 projects were commissioned as per schedule, 39 projects were commissioned with delays ranging from two to 28 months and 29 projects were yet to be commissioned (February 2010). Thus, completion of projects as per schedule in 29 *per cent* cases only indicated poor project monitoring and follow-up.
Ministry stated (February 2011) that the quarterly progress reports on PFC formats for most of the major generation projects had since been obtained from the borrowers since 1st April, 2007 onward. Status in terms of major milestones affecting the progress for individual projects were being analysed and put up to the Management as well as posted on the intranet for needful action by the concerned States in-charge.

13.3.4 Prudential norms

Reserve Bank of India (RBI) laid down in 1998 prudential norms to be followed by all NBFCs and exempted (January 2000) Government companies from the ambit of these norms. Subsequently, RBI decided (December 2006) to bring all systemically important NBFCs♦ (including Government NBFCs) under a more comprehensive regulatory purview and sought a roadmap from such NBFCs in the Government sector. PFC being a systematically important NBFC submitted (June 2008) a roadmap for adopting the RBI norms by 2017 but requested that it may be kept out of the prudential norms in view of the requirements of Power sector. Considering the above request the PFC was exempted of adopting the RBI norms till March 2012 and thus it was following its own prudential norms approved by the Administrative Ministry.

Audit observations related to prudential norms were as under:

13.3.4.1 Infrastructure sector NBFCs for housing viz. HUDCO and for power viz. IREDA had already adopted NHB/RBI prudential norms yet PFC was allowed to remain outside the ambit.

Ministry stated (February 2011) that the comparison was not appropriate since the size of projects financed, nature of borrowers etc. were different.

The reply was not acceptable since prudential norms had no relevance to size, nature etc. of the projects.

13.3.4.2 Comparison of provision for non performing assets (NPAs) as per PFC's prudential norms and RBI norms done by the Ministry in September 2005 revealed that the provision for NPAs as per PFC norms was ₹ 36.81 crore as against the provision of ₹ 1859.84 crore as per RBI norms.

Ministry stated (February 2011) that PFC had already apprised the RBI about the existing prudential norms including the norms relating to R/R/R and that RBI allowed exemption from applicability of its prudential exposure norms in respect of lending to State/Central Government entities in power sector till March 2012.

The reply of the Ministry has to be viewed in the light of the limited exemption time available till March 2012 and the very wide gap between the provision required to be made as per PFC and RBI norms.

♦ ***Systematically important NBFCs means NBFCs with an asset size of ` 100 crore or more.***

13.3.5 Lending Rates

As per the Operational Policy Statement (OPS) of the Company, structure of interest rates to be charged by the Company would be as attractive as possible without endangering its own operations or overall objectives. The OPS further stated that the structure would in general be dependent on cost of raising resources and state of financial markets and that the interest rate structure would be reviewed from time to time.

13.3.5.1 Absence of periodical review

Periodical review of interest rates by an NBFC like PFC was essential for effective interest rate risk management. PFC's Standing Committee for Policy reviewed interest rates from time to time but there was no specified period for such review. Interest rates were revised on 15 occasions during the period of five years under review. The Company revised interest rates within 15 days of previous revision on one occasion and within two months of previous revision on four occasions. The interest rates were not revised during the period from 1 March, 2007 to 6 July, 2008, though the market rates varied during this period. Audit noticed that the trigger point for an interest rate review was often a demand for reduction of interest from power utilities citing downward trend in the market. Audit further observed that being a term lending institution, PFC should have reviewed its interest rates every quarter.

Ministry accepted (February 2011) the audit recommendation stating that interest rates were now being reviewed at least once in every quarter.

Conclusion

PFC's criterion for assessing financial viability of projects was not as per their operational policy statement. The Company lowered equity contribution by private sector borrower in contravention of its norms. The Company's monitoring of utilization of funds was not effective when viewed from the number of projects commissioned as per schedule. Prudential norms were liberal when compared to RBI norms.

Recommendations

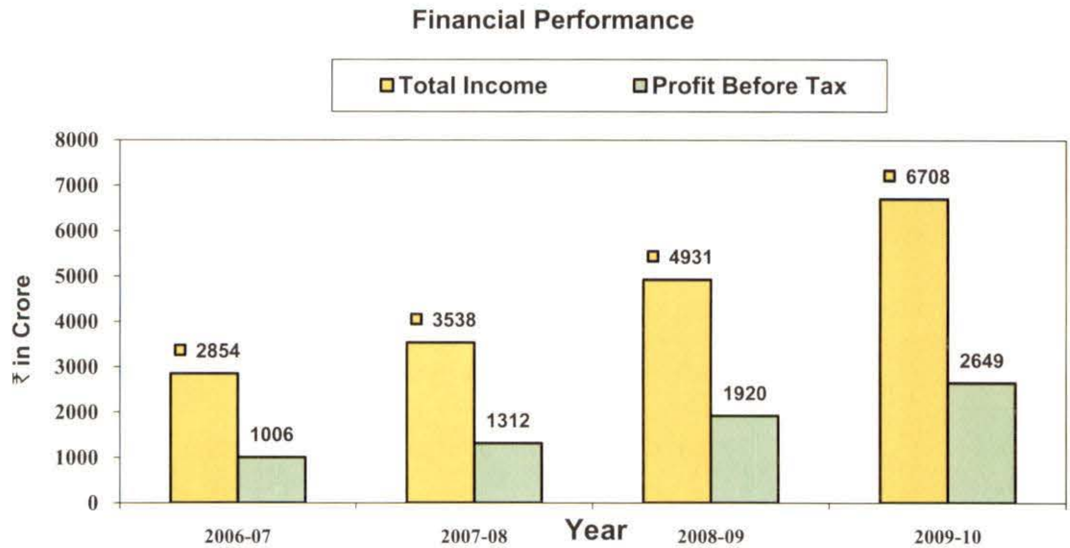
- ***PFC should focus on financial viability of projects through appropriate parameters and independent evaluation should be made even in consortium lending.***
- ***Utilization of funds should be ensured through effective project monitoring system.***
- ***Prudential norms should be progressively brought at par with RBI norms for effective risk management.***

Rural Electrification Corporation Limited

13.4 Mobilisation of Funds

Introduction

Rural Electrification Corporation Limited (Company), a Government of India Public Sector Enterprise, was incorporated on July 25, 1969 under the Companies Act 1956. It is a key Non-Banking Financial Company (NBFC*) providing finance for development of the Indian Power Sector. It mobilizes funds from various sources including raising of funds from domestic and international agencies and sanctions loans to the State Electricity Boards, Power Utilities, State Government and private power developers. The domestic debt instruments of the Company continued to enjoy 'AAA' rating while its international credit rating from International Credit Rating Agency Moody's was 'Baa3' and from FITCH 'BBB-'. In the year 2008-09, the Company's turnover (total income) and profit before tax were ₹ 4931 crore and ₹ 1920 crore respectively, while in 2009-10 the Company's turnover and profit were ₹ 6707.60 crore and ₹ 2649.19 crore respectively.



Scope of audit

The study covered funds management of the Company including mobilization of funds from various sources and loan management which included assessment of requirement, preparation of cash flows, borrowings from banks/ financial institutions, bonds and external commercial borrowings, disbursal, recovery and repayment of borrowings during the four years ending 2008-09. The study was conducted during January–December 2009 and report was issued to the Management in January 2010. On the basis of replies of the Management of April 2010 the coverage was reduced and modified report on mobilization of funds was issued to the Ministry in August 2010.

Audit objectives

The study was conducted to examine whether:

***** *A non-banking financial company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.*

- funds were raised after proper financial planning and commensurate with business requirements; and
- economy in borrowings was given due consideration.

Audit findings

The total inflow of funds during last four years up to 2009-10 was as tabulated below:

(₹in crore)

Particulars	2006-07	2007-08	2008-09	2009-10
Opening Balance	1,913.64	2,297.27	1,253.04	1886.04
Loan from Banks/Financial institutions	1199.80	2,228.00	2,750.00	3485
Taxable Bonds	314.80	2,568.30	8,930.20	13529.50
Capital Gain Bonds	7,352.88	3,402.74	2,525.23	3057.77
ECB	872.09	166.76	456.65	605.97
Commercial Paper	0	0	1295.00	3150.00
Redemption of Investment	141.48	47.16	141.48	94.32
IPO	0	797.86	0	2627.98
Recovery of loan	4,034.44	5,600.24	5,119.36	5806.54
Operating Profit	1,014.20	1,360.96	1,913.35	2649.77
Total Inflow	**16,843.33**	**18,469.29**	**24384.31**	**36892.89**

Audit observed that overall margin between the cost of borrowing and lending remained at a healthy three *per cent* plus as detailed below.

(Figures in per cent)

Year	Cost of Borrowing	Weighted average lending rates	Margin
2006-07	5.97	9.95	3.98
2007-08	7.52	10.91	3.39
2008-09	9.30	12.46	3.16
2009-10	7.31	11.00	3.69

The Management stated (April 2010) that figures taken by audit were average annualized rates which could not be used for computing borrowing cost, lending rates or margins and that the actual figures relating to the above were as under:

(Figures in per cent)

Year	Cost of Borrowing	Yield	Spread	Net Interest margin
2005-06	6.25	9.03	2.78	3.08
2006-07	6.40	9.51	3.11	3.26
2007-08	6.39	9.69	3.30	3.78
2008-09	7.31	10.67	3.36	4.17

Note:

1. ***Yield represents the ratio of interest income to average interest earning assets.***
2. ***Cost of borrowings represents the ratio of interest expense and other charges (including resource mobilization expenses) to average interest bearing liabilities.***
3. ***Spread is the difference between yield and cost of borrowings.***
4. ***Net interest margin is the ratio of net interest in income to average interest earning assets.***

The difference in figures was due to the fact that audit compared the cost of funds raised during the year with the lending rate of that year to assess the performance of the Company during the years covered in audit and observed that there was a healthy margin while the Management referred to the average interest earnings and the average interest earning outstanding assets.

Audit assessed performance of the Company and found that certain system and compliance deficiencies, discussed in succeeding paragraphs, needed to be addressed to ensure robust performance.

System deficiencies:

13.4.1 Assessment of requirement of funds

With a view to ensure effective fund management timely disbursement of funds and minimize the amount of surplus funds at any point of time, the Company implemented Treasury Management Policy w.e.f. August 2006. As per the policy, Generation and Transmission and Distribution (T&D) Divisions were required to assess the requirement of funds and prepare monthly, quarterly and annual assessment of funds and forward it to Resource Division to arrange funds on time and at an economical rate.

Audit observed that Generation and T&D divisions did not provide monthly/quarterly requirements of funds in 2006-07 and 2007-08. In absence of required information from the respective divisions, the Company assessed the requirement of funds based on the interaction with Generation, T&D and project offices of the Company. Subsequently, these divisions prepared annual assessment of funds for 2008-09 and onwards with monthly/quarterly breakups. Audit further observed that in respect of Generation Division while actual disbursement during May 2007, July to September 2007 and October to December 2008 was more than assessment made and ranged between 152 *per cent* and 206 *per cent*, during the remaining period assessment made was higher than the actual disbursement and ranged between 115 *per cent* and 184 *per cent.* Similarly, in respect of T&D Division, actual disbursement during the period from October 2007 to March 2009 was more than the assessment by 113 *per cent* to 266 *per cent* (except during February 2008). This was an indicator of improper assessment of funds leading to deficit/surplus funds.

The Management accepted (April 2010) the audit observation and assured further strengthening of the system of assessment of funds.

13.4.2 Deficient cash flow statements

While preparing monthly cash flow statements during 2006-07 to 2009-10, the opening balance of cash available and tentative funds to be raised through taxable bonds for which the issue had already been launched were not considered by Management to work out the cash deficit. This resulted in frequent drawals from banks at higher rates.

The Management stated (April 2010) that before launching a bond/drawal of funds from banks, cash flow was prepared as realistically as possible to minimize the cost of borrowing and carrying cost and funds were drawn based on the actual requirement to avoid idling of funds or investing for short term at a lower rate of interest. They further added that considering the volatility in the market loans were raised for short term during 2008-09 to minimize the cost of borrowing.

The reply is not acceptable as the Management was silent on not considering the opening balance and funds to be raised through bonds. Further, the Management contention of avoiding short term investment at lower rates was also not correct as the proceeds from the Bonds Series 87 C/ Commercial Paper II raised in November 2008 at the rate of 11.5 *per cent* and in February 2009 at the rate of 6.77 *per cent* respectively were invested in fixed deposits for periods ranging from 24 to 45 days at substantially low rates of interest. Thus, failure of the Company to assess its requirement accurately and retention of unutilized funds during November 2008 to February 2009 resulted in extra cost of ₹ 1.48 crore.

Recommendation

The Company should institute a proper system for assessment of funds on a realistic basis involving accountability to avoid deficit/surplus funds.

13.4.3 Higher cost of borrowing as compared to other PSUs

Table below indicates the average annualized cost of mobilisation of funds to the Company, Power Finance Corporation (PFC) and Indian Rail Finance Corporation (IRFC) for the four years up to 2009-10.

(Figures in per cent)

Particulars	**2006-07**	**2007-08**	**2008-09**	**2009-10**
REC (with Capital Gain Bonds)	5.97	7.65	9.30	7.31
REC (without Capital Gain Bonds)	7.96	9.12	9.95	7.47
PFC	7.44	8.26	8.99	8.80
IRFC	Not available	9.33	8.98	7.70

It would be seen from the above table that the annualized cost of borrowings of the Company without Capital Gain Bonds was higher than that of PFC in all the years except 2009-10. Further, its borrowing cost was higher than that of PFC and IRFC in 2008-09 despite cost advantage of Capital Gain Bonds, which had resulted in reduction of the Company's margin.

The Management replied (April 2010) that audit had taken average annualized rates and if the figures given in prospectus for Follow on Public offer (FPO) were considered, the cost of borrowing of the Company would be lower than PFC and IRFC.

The reply is not tenable because the annualized cost of borrowing of REC as provided by the Company was compared with the annualized cost of borrowing of other PSUs and figures given in FPO were not comparable with the cost of borrowing of other Companies as the figures given in FPO prospectus was ratio of interest expenses and other charges to average interest bearing liabilities.

13.4.4 Non-utilization of opportunity to prepay the costlier loan

The Company raised 23 term loans of ₹ 9662.80 crore from various banks during 2006-07 to 2009-10. Out of these 23 term loans, audit observed that the Company took a short term loan (one year) of ₹ 300 crore in June 2008 at a rate of 9.30 *per cent* from Punjab & Sindh Bank. The Company received (March 2009) an offer from Union Bank for ₹ 300 crore at the rate of 7 *per cent* under repo window, but the opportunity for prepaying the higher cost loan drawn during June 2008 was not availed of despite no penalty for prepayment. This resulted in payment of additional interest of ₹ 1.19 crore.

The Management stated (April 2010) that offer received from Union Bank under repo window was available for only two days.

The reply is not acceptable because the Company could have decided to avail of the opportunity before the validity of the offer of Union Bank expired.

Recommendation

The Company should be more vigilant and avail of opportunities available to prepay higher cost loans.

13.4.5 Non-matching of borrowing and lending as per tenure

Audit observed that the Assets-Liability Committee (ALCO) was not linking its borrowing with disbursement as per the maturity period of respective assets and liabilities. The majority of loans financed by the Company were of long term nature i.e. more than 12 years but the Company was borrowing funds for three years, five years and 10 years period. Thus, the composition was such that over 60 *per cent* market borrowing or 43 *per cent* of total external borrowing was payable within three years. There is, hence, a serious mismatch of funds exposing the Company to liquidity and interest rate risk.

The table below shows the details of repayment of borrowings and recovery of loans outstanding during the period from 2006-07 to 2012-13.

(₹ in crore)

Year	Repayment of borrowings	Recovery of loans outstanding	Mismatch
2006-07	3481.83	4034.44	552.61
2007-08	4273.62	5600.24	1326.62
2008-09	5142.49	5119.36	-23.13
2009-10	12819.83	5806.54	-7013.29
2010-11 (projected)	10119	6810	-3309.00
2011-12 (Projected)	8159	6492	-1667.00
2012-13 (Projected)	10342	6616	-3726.00

The Management stated (April 2010) that the life of a power project was higher whereas the loan period was much lower. The Company was mobilising resources from the market depending upon the requirement, interest rate and Asset, Liabilities Management (ALM).

The reply is not acceptable as the wide gap between the maturity of loan assets and liabilities from 2009-10 and onwards would lead to borrowings at higher cost for repayment of loan liabilities and consequently increase the interest burden unless adequate corrective measures are taken by the Company.

Compliance deficiencies

13.4.6 Asset Liability Management Policy

13.4.6.1 All NBFCs having an asset base of more than ₹ 100 crore were instructed (June 2001) by RBI to implement Asset Liability Management (ALM) system by the year ending 31 March 2002 as part of their overall system for effective risk management and start reporting/submitting the returns to RBI. ALM provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rate risks of the Company. The Company is exposed to credit risk, interest rate risk, liquidity risk and operational risks and therefore has to put in place systems and internal control mechanisms to manage these risks.

The ALM Policy approved (April 2007) by the Board was to be made fully operational from January 2008 but till date no return has been submitted to RBI. Audit observed that even after 30 months of adoption, the ALM Policy was not properly implemented as it did not address the issues of liquidity risk, interest rate gap analysis and matching of maturity profiles of assets and liabilities.

The Management stated (April 2010) that prudential norms prescribed by RBI were not applicable to Government NBFCs, however, the Company had developed ALM system which was being reviewed by Asset Liability Management Committee (ALCO). They further added that ALCO meets on quarterly basis and reviews the liquidity risk, matching of maturity profiles of assets and liabilities and interest gap analysis etc.

The Management reply is not relevant regarding applicability of prudential norms of RBI. Though, ALCO has started analyzing risks from September 2009 no return was filed (July 2010) with the RBI as prescribed for NBFCs.

13.4.6.2 Absence of interest gap analysis

For interest rate gap analysis, the asset/liability in respect of which the interest rate reset/repricing has to take place contractually during the interval (in different time buckets) is to be considered as rate sensitive. Data regarding interest due for reset on different loans in different time buckets is crucial for preparation of Interest Rate Sensitivity Statement. Audit observed that the ALCO was not preparing the Interest Rate Sensitivity Statement, and had prepared the first statement in July 2009 only. Further, the statement prepared in July 2009 contained data pertaining to one year only, which would not serve the desired purpose of long term liquidity analysis.

The Management stated that the ALM section had started preparing interest rate sensitivity statement from September 2009 and with the support of proposed ALM software, the ALM statement would be readily available in future.

Conclusion

The Company mobilized funds aggregating ₹ 9662.80 crore, ₹ 2101.47 crore and ₹ 46126.42 crore through loans from banks/financial institutions, External Commercial Borrowings (ECB), Bonds and Commercial Papers during 2006-07 to 2009-10 respectively. Though, the Company had a healthy margin between cost of borrowing and lending, still there was ample scope for improvement. However, the cost of borrowing of the Company was comparatively higher when compared with other similar PSEs.

System of assessment of requirement of funds and preparation of cash flow statement was deficient in the Company which led to surplus/deficit funds on many occasions. Excess funds mobilized through bonds remained unutilized during November 2008 to February 2009 resulting in extra cost of ₹ 1.48 crore. The Company also failed to avail the opportunity to repay the short term loans of ₹ 300 crore taken at a higher rate of interest which resulted in an additional burden of ₹ 1.19 crore. Further, lack of linking its borrowings with maturity period of its assets and liabilities, non implementation of ALM policy, pointed to serious mismatch of funds exposing the Company to liquidity and interest rate risk.

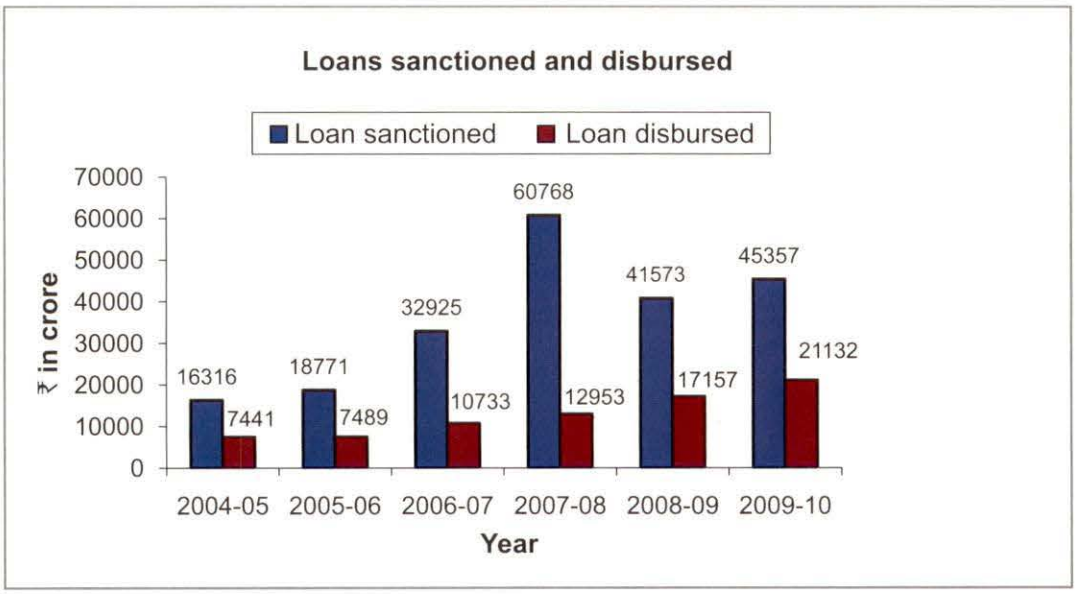
Thus, it is essential for the Company to thoroughly review and improve its existing systems, in the light of audit observations to maintain sound financial health.

The matter was reported to Ministry in August 2010; reply was awaited (February 2011).

13.5 Loan Management

Introduction

Rural Electrification Corporation Limited (Company), a Government of India Public Sector Enterprise, was incorporated on July 25, 1969. It was a key Non-Banking Financial Company (NBFC*) providing finance for development of the Indian Power Sector. It mobilizes funds from various sources including raising of funds from domestic and international agencies and sanctions loans to State Electricity Boards, Power Utilities, State Government and private power developers. The domestic debt instruments of the Company had 'AAA' rating while its international credit rating from International Credit Rating Agency Moody's was 'Baa3' and from FITCH 'BBB-' The Company's turnover (total income) and profit were ₹ 6707.60 crore and ₹ 2649.19 crore respectively during 2009-10. The Company sanctioned loans aggregating to ₹ 215,203.23 crore and disbursed ₹ 76,905.41 crore during 2004-05 to 2009-10. Year wise position of loans sanctioned and disbursed is given below:



* *A non-banking financial company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.*

Audit Objectives

The study was conducted to examine whether controls relating to appraisal of applications, sanction and disbursement of loans were sound, effective and adequate to cover the risks of lending.

Scope of Audit

The study covered funds management of the Company i.e., mobilization of funds and loan management which included preparation of cash flows, assessment of requirement, raising funds from banks/ financial institutions, through bonds and external commercial borrowings, disbursal, recovery and repayment of borrowings. The study was conducted during January 2009 to December 2009 and report was issued to the Management in January 2010. On the basis of the Management's reply (April 2010) the coverage was reduced and modified thematic report on loan management was issued to the Ministry in August 2010.

The loans disbursed to power projects have a moratorium period of two to three years. Therefore, this study on loan management covers a period of six years from 2004-05 to 2009-10. Sample size taken for Generation Projects was 25 *per cent*, 50 *per cent*, 75 *per cent* and 100 *per cent* in cases where disbursement of loan was in the range of up to ₹ 50 crore, ₹ 50 to ₹ 100 crore, ₹ 100 to ₹ 300 crore and exceeding ₹ 300 crore respectively based on stratified sampling method. Audit test checked the records relating to sanction of loans for 12 generation projects (Private Sector: five and State Sector: seven) out of 19 projects. For Transmission & Distribution projects Audit test checked 77 out of 111 completed/identified for closure projects in Project office, Jaipur on random sampling basis.

Audit findings

The Company's Non-performing Assets (NPAs) came down from 10.63 *per cent* in 2003-04 to 0.03 *per cent* in 2009-10. Prior to 2003-04, the State Electricity Boards (SEBs) were the only borrowers of the Company and the NPA percentage was high due to the poor financial health and Aggregate Technical & Commercial (AT&C) losses (earlier called Transmission and Distribution losses) of its borrowers. The Company rescheduled loans of four SEBs during the period from 2004-05 to 2007-08, which also helped to improve the recovery rate to 99.97 *per cent.* However, Audit observed that performance of the Company could improve by strengthening the guidelines for appraisal of projects and standardising the loan agreements as discussed in subsequent paragraphs.

13.5.1 Project Appraisal - Generation Projects

13.5.1.1 Deficiency in Guidelines: The Company followed CRISIL guidelines for appraisal of generation projects up to December 2007 and thereafter, its own guidelines approved (January 2008) by the Board of Directors. Audit observed that the Company's guidelines were silent on discounting rate to be considered for calculating levellised tariff♥ and interest on working capital and on standardization of parameters for assigning marks in respect of industry analysis, Management analysis, consultant for Detailed Project Report, promoter's experience etc.

♥ ***Levellised Tariff refers to the average fixed and variable tariff over the entire term of the Power Purchase Agreement adjusted for inflation.***

The Ministry assured (January 2011) that the Company would take necessary action to review and revise guidelines so as to follow best practices in the industry.

13.5.1.2 Deficiencies in appraisal: Scrutiny of records of 12 generation projects test checked revealed the following deficiencies in appraisal of projects:

- Policy circular of the Company (September 2004) stipulated that interest rate of eight *per cent* was applicable in respect of mega generation projects of private sector borrowers i.e where the disbursement amount was above ₹ 500 crore and 8.75 *per cent* in respect of large generation projects of private sector borrowers i.e. where the disbursement amount was ₹ 300 crore to ₹ 500 crore. In Pathadi Thermal Power project, the Company sanctioned (March 2005) a loan of ₹ 516.57 crore and charged interest at the rate of 8 *per cent* i.e. 0.75 *per cent* below the normal rate of interest (applicable to a loan over ₹ 500 crore) though the borrower drew only ₹ 375.53 crore.

- A project appraisal of Anpara Thermal Power was done based on the project cost provided by the borrower wherein there was an increase in cost of land by 20 *per cent* without any basis. The borrower while furnishing the cost of project to the lender's engineer, increased the cost of non-engineering procurement and construction (Non-EPC) contract from ₹ 138.40 crore to ₹ 265 crore without making any change in the overall project cost.

The Ministry stated (January 2011) that the cost of land was not seen in isolation when the capacity of the project changed from 1000 MW to 1200 MW as it was coupled with site development activities also. Further, the changes in EPC/Non-EPC costs were made subsequent to the actual award of contracts.

The Ministry's reply was not convincing as increase in cost of land was without any basis and fluctuation of more than 90 *per cent* in the cost of Non-EPC contract indicated inaccuracies in estimation of project cost.

- As per the entity appraisal guidelines, entities having average score of 2.5 to 3.00 should be categorised as Grade III and accordingly loan should be sanctioned in the debt equity ratio of 70:30. RKM Power Generation Company was categorized as Grade III as per the guidelines but sanctioned a loan of ₹ 270 crore with debt equity ratio of 80:20 as against the admissible ratio of 70:30, and loan was disbursed on the basis of self certification given by the borrower (without ensuring compliance of pre-disbursement conditions such as creation of securities, execution of power transmission agreement, signing of power purchase agreement etc.).

The Ministry stated (January 2011) that the Company sanctioned the loan in line with the approval of lead financial institution i.e. PFC, and further PFC had confirmed compliance of pre-disbursement conditions and that in the present case, the Company had checked the pre disbursement conditions at their end.

This reply was not acceptable because the Company violated its own appraisal policy.

- In Teesta Hydro Electric Project, depreciation of ₹ 3571.69 crore was considered against the depreciable project cost of ₹ 2700 crore which resulted in incorrect

Internal Rate of Return (IRR), an important basis for determining viability of the project.

The Ministry admitted (January 2011) that the mistake was due to oversight.

- As per the loan policy circular of the Company, the exposure limit for 'A' category company was 75 *per cent* of the company's networth. Accordingly, admissible exposure limit of Maharashtra Generation Company for Bhusawal project was ₹ 3148 crore but the Company sanctioned a loan ₹ 3693 crore.

The Ministry stated (January 2011) that higher loan was sanctioned considering the projected net worth but disbursement was linked to actual net worth, thus, restricting to admissible exposure.

The Ministry's reply was not convincing as the amount to be sanctioned should be strictly based on the present net worth as per the Company's policy.

- Debt Refinancing: The Company sanctioned (October 2005) debt refinancing and long term loan of ₹ 1527.43 crore and ₹ 332.57 crore respectively to Tehri Hydro Development Corporation (THDC) for implementation of Tehri Hydro Electric Project (Stage I). THDC anticipated that the project would be completed by March 2006. Audit observed that while seeking ex-post facto approval of Board of Directors, it was informed that THDC had applied for a term loan of ₹ 1460 crore for project financing including interest during construction period and ₹ 400 crore for refinance of outstanding amount under supplier's credit which was factually incorrect as THDC applied for a loan of ₹ 332.57 crore only for project financing. In case of debt refinancing, repayment period should have been restricted to remaining loan repayment period but the Company in violation of the policy treated entire amount of loan as a fresh loan for project execution. Further, THDC was given option to pay upfront fee of 0.1 *per cent* or commitment charges at the rate of 0.25 *per cent per annum* on undrawn amount of the committed loan. The Company should have insisted for upfront fee of 0.1 *per cent* of loan amount of ₹ 1860 crore, as the major portion of loan was for repayment of loan raised by THDC. This resulted in loss of revenue of ₹ 1.86 crore as the borrower opted to pay commitment charges.

Recommendation

The Company should devise internal control system to ensure compliance of its policy and proper reporting to Board.

13.5.2 Project appraisal - Transmission and distribution projects

13.5.2.1 Deficiency in guidelines:

Prior to approval of guidelines by the Board in June, 2007 the appraisal of T and D projects was governed by circulars issued from time to time. Review of guidelines revealed that operational guidelines for system improvement schemes provided that the scheme would be considered viable if it yielded internal rate of return of at least 12 *per cent* on investments made under the scheme. The guidelines exempted the schemes for introduction of innovative technology or transmission schemes sent for approval of regulatory commission from calculation of IRR. Accordingly, the Company did not calculate IRR of T and D schemes sent for approval to the State Electricity Regulatory Commissions (SERC) to ensure viability of the projects.

The Ministry stated (January 2011) that most of the borrowers of T and D schemes were state sector utilities and SERC generally took considerable time to approve the schemes and if the sanction was delayed till SERC approval, the Company had the risk of losing its business to other financial institutions. It further stated that a new clause was incorporated in the standard sanction letter issued to borrowers which stipulated that in case scheme cost approved by the Regulator was less than the scheme cost as envisaged at the time of sanction of loan, the loan would be reduced accordingly and in case scheme cost approved by Regulator was more, decision would be taken at that time depending upon the merits of the case. The reply further added that, T and D guidelines stipulated technical and financial viability of the projects only, which was ensured during detailed appraisal.

The Ministry's reply was not acceptable because detailed appraisal was based on the T and D guidelines and deficiency in the guideline may result in sanction of loan to unviable schemes.

13.5.2.2 Disbursement of loan without adequate security

The Company sanctioned (October 2004) term loan of ₹ 1285 crore to NTPC-SAIL Power Company Private Limited (NSPCL), erstwhile Bhilai Electric Supply Company Limited. Out of this, the Company disbursed ₹ 1185 crore to NSPCL. As per loan agreement, the borrower was required to secure the principal, interest and other charges payable by way of creation of mortgage of immovable assets and hypothecation of all movable assets of the project in favour of the Company. Audit observed that the borrower did not create mortgage of land in favour of the Company so far (December 2010). Further, there was no escrow cover on main revenue account.

The Ministry stated (January 2011) that the Company was in the process of creating security as land mutation was taking time with the state government and that the Company had started charging one *per cent* additional interest for not creating security as per policy.

This reply was not acceptable because increase in the rate of interest would not secure the loan amount.

13.5.3 Deficiencies in Loan Agreements

13.5.3.1 Deficiency in Loan Agreements of Generation Projects

Audit noticed in the 12 Generation projects test checked, that largely loan agreements were not standardized and were deficient in the following aspects.

- Loan agreements with private sector borrowers did not have a clause for commitment charges;
- Agreements with Punjab State Electricity Board, Jaypee Industries Limited and GSPC Pipavav Power Company Limited did not have clause for draw-down schedule;
- Agreements with THDC, MSPGCL, PSEB and GSPC Pipavav Power Company Limited did not have a clause for insurance of assets;
- Interest reset clause was not available in agreements with MSPGCL and PSEB;

- Mortgage of land and building and hypothecation of immovable assets of the projects were not made a pre-disbursement condition in agreements with THDC, Bhilai Power Supply Company, PSEB, MSPGCL and GSPC Pipavav Power Company Limited;
- Clause for opening escrow account, tripartite agreements between borrower, banker and lenders for creating charge on receivables of borrowers for each loan was not available in loan agreement with Bhilai Power Supply Company;
- The loan agreements with Bhilai Power Supply Company and Punjab State Electricity Board did not authorize the Company to have first charge on escrow account of borrower.
- Loan agreement provided for reset of the rate of interest at the end of every third year beginning with the date of first disbursement whereas the Company was resetting the interest rate for each disbursement every third year resulting in different interest rates for each disbursement, which may lead to legal problems in future due to different provisions in the sanction letter and loan agreement.

The Ministry stated (January 2011) that provision of commitment charges was not there in some of the private sector project as upfront fee was charged from them as per Industry practice; draw down schedule was obtained from state sector borrowers who had opted for commitment charges; interest rates were charged on the basis of REC Loan policy circular and accordingly reset clause was applicable and that it would be ensured in future that interest reset clause was included in the agreement; that disbursements were made on creation of necessary security/approval of competent authority; clause for opening escrow account was not insisted in case of Bhilai Power Supply Company in view of the business potential available with them; and assured that in future insurance of security would be included in loan agreements.

The Ministry's reply was not acceptable because for proper assessment of requirement of funds, draw down schedule was essential; financial interest was not safeguarded in the absence of security as a pre disbursement condition.

13.5.3.2 Deficiency in Loan Agreements of T & D Projects

In case of loan agreements of T&D Projects, it was noticed that the Company was disbursing loans on three year interest reset basis and 10 year interest reset basis, but the loan agreements and sanction letters were silent about the interest reset period.

The Ministry stated (January 2011) that a "Standard Sanction Letter' was being followed uniformly since July 2009 and loan agreement format was also standardized.

13.5.4 Borrower's Profile

Audit observed that the Company did not maintain borrowers' profile relating to AT & C losses, return on capital employed and financial performance of state sector borrowers. The exposure limits fixed by the Company for borrowers were based on PFC's exposure limits or the Company's prudential exposure limits, whichever was higher in respect of 'A' category borrowers and as per PFC's exposure limit in respect of other category of borrowers. The exposure limits fixed by the Company, ranged from 50 *per cent* to 250 *per cent* of the Company's owned funds and were not based on either the financial health of the borrower or reduction in AT&C losses. Default by these SEBs/State utilities may have serious consequences.

The Ministry stated (January 2011) that the Company was following the PFC's grading and exposure limits who took into account important factors like financial health, AT&C losses default status etc. and during entity appraisal all the factors were again analysed for Generation projects and necessary checks and conditions stipulated in the sanction letter.

The reply was not acceptable because the Company had fixed the exposure limit as fixed by PFC or REC Prudential norms and had taken further exposures even in cases where the profit and return on capital employed were negative and AT&C losses had recorded an increasing trend.

Recommendation

The Company should put in place a system of its own for fixing exposure limits considering the financial health, reduction in T&D losses, etc. of the borrowers.

Conclusion

The Company's guidelines for appraisal of the projects were deficient on many aspects as discussed in the preceding paras.

Test check of records relating to 12 generation projects revealed deficiencies in the system of appraisal of projects. Further, the Company could not evolve its own system of fixing exposure limits for state sector borrowers considering their financial health, reduction in T & D losses, defaults etc. The Company did not have standardized loan agreements with the borrowers for generation projects resulting in non inclusion of some of the terms and conditions necessary to protect its interest. It was also noticed that Company deviated from its own policy regarding repayment period in case of debt refinancing.

CHAPTER XIV: DEPARTMENT OF PUBLIC ENTERPRISES

Bharat Heavy Electricals Limited, Bharat Petroleum Corporation Limited, Coal India Limited, Container Corporation of India Limited, Dedicated Freight Corridor Corporation of India Limited, Fresh & Healthy Enterprises Ltd., GAIL India Limited, Hindustan Petroleum Corporation Limited, Indian Railway Catering and Tourism Corporation Limited, IRCON International Limited, NMDC Limited, Oil India Limited, Oil and Natural Gas Corporation Limited, Rail Vikas Nigam Ltd., Railtel Corporation of India Limited, Rashtriya Ispat Nigam Limited, RITES Limited, Steel Authority of India Limited

14.1 Non-recovery of perquisite tax

The Management of eighteen public sector enterprises authorized payment of perquisite tax of ₹ 363.38 crore for providing housing accommodation, which was beyond the delegated powers of respective Boards.

Section 17 of the Income Tax Act 1961, as amended (November 2007) with retrospective effect from 1 April 2006 defines value of concession in the matter of rent for accommodation provided by the employer. As per the said amendment, value of concessions of employees other than Central/State Governments, i.e., Public Sector Undertakings (PSUs) etc. is specified as 15 *per cent* or 10 *per cent* or 7.5 *per cent* of the salary depending upon population of the cities where accommodation was provided. Accordingly perquisite tax was to be computed.

A number of writ petitions were filed by the different employees association of PSUs in different High Courts challenging the constitutional validity of the aforesaid amendment which were dismissed by the Hon'ble Courts. However, the Board of Directors of the following eighteen PSUs decided to absorb the perquisite tax in the matter of rent for accommodation provided by the employer.

It was observed in Audit that such payments were beyond the delegated powers of the Board as there was no specific approval of the Government validating such payments amounting to ₹ 363.38 crore as detailed below:

Sl. No.	Name of the Ministry	Name of the Company	Period	Amount (₹ in crore)
1	Ministry of Steel	Steel Authority of India Limited (SAIL)	April 2007 to March 2010	114.96
2	Ministry of Steel	Rashtriya Ispat Nigam Limited (RINL)	April 2007 to March 2009	14.40
3	Ministry of Steel	NMDC Limited (NMDC)	April 2007 to March 2010	2.47
4	Ministry of coal	Coal India Limited (CIL)	April 2007 to March 2009	113.30
5	Department of Heavy Industries	Bharat Heavy Electricals Limited (BHEL)-	April 2007 to March 2010	36.72
6	Ministry of Petroleum and Natural Gas	Oil India Limited (OIL)	April 2007 to March 2010	29.11

7	Ministry of Petroleum and Natural Gas	GAIL (India) Limited. (GAIL)	April 2007 to March 2010	14.72
8	Ministry of Petroleum and Natural Gas	Hindustan Petroleum Corporation Limited (HPCL)	April 2007 to March 2010	10.54
9	Ministry of Petroleum and Natural Gas	Bharat Petroleum Corporation Limited (BPCL)	April 2007 to March 2010	15.55
10	Ministry of Petroleum and Natural Gas	Oil and Natural Gas Corporation Limited (ONGC)	April 2007 to March 2010	5.60
11	Ministry of Railways	RITES Limited	April 2007 to March 2010	1.07
12	Ministry of Railways	Indian Railway Catering and Tourism Corporation Limited	April 2006 to March 2010	0.51
13	Ministry of Railways	Container Corporation of India Limited	April 2006 to March 2010	1.59
14	Ministry of Railways	Fresh & Healthy Enterprises Limited	April 2006 to March 2010	0.01
15	Ministry of Railways	Dedicated Freight Corridor Corporation of India Limited	April 2007 to March 2010	0.42
16	Ministry of Railways	Rail Vikas Nigam Limited	April 2007 to March 2009	0.40
17	Ministry of Railways	IRCON International Limited	April 2006 to March 2010	1.39
18	Ministry of Railways	Railtel Corpration of India Limited	April 2006 to March 2010	0.62
Total				**363.38**

The Management of RINL, HPCL, BPCL, ONGC in their replies mainly contended that considering the spirit behind granting navaratna/mini-ratna status for PSUs, certain amount of autonomy including providing financial packages for their employees was treated as appropriate and permissible and the expenditure was very little compared to the net profit earned/ dividend paid to Government of India by the Company. The replies were not convincing as the approval given by the Boards were clear departure from DPEs guidelines and were found beyond the delegated powers of the Board.

The Management of SAIL, BHEL (HPBP & HPEP), Railway Companies in their replies contended. that in view of Section 10 (10CC) of the Income Tax Act, 1961 such payment of Income Tax on non-monetary perquisite, although paid by the Company on behalf of the employees, is not to be included in taxable income of the employee notwithstanding anything contained in Section 200 of the Companies Act, 1956. The reply is not tenable as the Supreme Court has ruled that payment of taxes to the Government can not be excluded under Section 10(10CC).

The Management of CIL contended that CIL Board in which Government and Independent Directors were also present decided to pay this amount after obtaining legal opinion. The reply is not tenable as the Management approved the payment despite different High Courts dismissing writ petitions filed by several associations on the subject.

The Ministry of Petroleum & Natural Gas contended that payment being made by GAIL on account of bearing the perquisite tax liability of its employees for various housing facilities had been kept outside the ceiling of 50 *per cent* of Basic Pay, as same is incidental to providing of residential/ leased accommodation to them. The reply is not tenable as DPE guidelines clearly list out the allowances/perks outside the purview of ceiling of 50 *per cent* of the basic pay and the list does not cover payment of tax on perquisite.

Thus, payment of perquisite tax of ₹ 363.38 crore to the employees by the Management of above PSUs was beyond the delegated powers of the Board.

Recommendation

The Administrative Ministry should ensure that the decisions taken by the Board of Directors of PSUs are as per delegation of powers and DPEs guidelines.

The matter was reported to the Ministry in February 2011; reply was awaited (February 2011).

Dredging Corporation of India Limited, Hindustan Petroleum Corporation Limited, Visakh Refinery, Rashtriya Ispat Nigam Limited

14.2 Irregular excess payment of house rent to employees

Three CPSEs irregularly paid HRA to its employees at higher rates in violation of DPE guidelines amounting to ₹ 9.38 crore during the period 1 April 2004 to 31 March 2010.

As per instructions (June 1999) of Department of Public Enterprises (DPE), House Rent Allowance (HRA), as a percentage of basic pay, was payable to the employees of central Public Sector Enterprises (CPSEs) at the rates applicable to Central Government employees based on the reclassified list of cities notified by the Government of India (GoI). In January 2001, DPE clarified that the CPSE employees would be allowed to draw the earlier rates of HRA on the revised pay wherever HRA rates were lower than the earlier rates as per new classification of cities.

Audit scrutiny of the records revealed the following:

- Rashtriya Ispat Nigam Limited (RINL) paid HRA to its non-executives stationed at Visakhapatnam at the rate of 17.5 *per cent* with effect from 1 July 2001 violating the DPE guideline as admissible rate of HRA was only 15 *per cent*. The executives were, however, paid at 15 *per cent* during 1 April 2004 to till 25 November 2008.
- Hindustan Petroleum Corporation Limited, Visakh Refinery (HPCL) paid HRA to its employees, both executives and non-executives, stationed at Visakhapatnam at the rate of 22.5 *per cent* with effect from 1 July 1997 violating the DPE guideline as admissible rate of HRA was only 15 *per cent*. Subsequently, the HRA rates were revised (June 2009) to 20 *percent* in light of the DPE Office Memorandum

(OM) dated 26 November 2008[♣]. The excess HRA paid (2.5 *per cent*) to the executives was recovered from the arrears on revision of pay scales. However, no recovery has been effected in respect of non-executives and they were still paid (November 2010) at 22.5 *per cent.*

- Dredging Corporation of India (DCI) paid HRA to its employees stationed at Visakhapatnam at the rate of 17.5 *per cent* with effect from 1 January 1997 violating the DPE guideline as admissible rate of HRA was only 15 *per cent.*

Thus, the payment of HRA at higher rates in violation of the DPE guidelines resulted in irregular payment of ₹ 9.38 crore (RINL- ₹ 7.46 crore, HPCL- ₹ 1.37crore and DCI- ₹ 0.55 crore) to the employees for the period from 1 April 2004 to 31 March 2010.

The Management of RINL in its reply contended (October 2009) that while revising the wage structure effective from 1 January 1997 and other benefits for non-executives, the earlier rates of HRA were considered to be retained and accordingly, Memorandum of Settlement dated 27 September 2001 was reached.

The Management of HPCL in its reply contended (April 2010) that HRA was paid at the rate of 22.5 *per cent* on basic pay as per the Corporation's housing policy applicable to Visakhapatnam in line with its pay revision for the officers for the period 1 January 1997 to 31 December 2006.

The Management of DCI in its reply contended (October 2010) that while revising the wage structures effective from 1 January 1997, the earlier rates of HRA were considered to be retained and accordingly, HRA was paid.

The contention of the Managements of RINL, HPCL and DCI are not convincing in view of the fact that the wage agreements of RINL, HPCL and DCI were signed on 27 September 2001, 26 August 2002 and 23 November 1999 respectively, that is, after DPEs OM (July 1995/ October 1996). The said DPE OM inter-alia stipulated the conditions, applicability of HRA and ceiling limits to all further wage/ pay revision settlements. As the agreements were entered into after July 1995, the employees should have been paid HRA at the rate of 15 *per cent.* However, the Managements of RINL, HPCL and DCI failed to incorporate the said ceiling limits of HRA rates in their wage/pay revision settlements.

Further, in case of companies like Bharat Heavy Electricals Limited (Tiruchirapalli) and Hindustan Shipyard Limited (Visakhapatnam), CPSEs under the Department of Heavy Industries and Ministry of Defence respectively, HRA was paid to the employees at the rate of 15 *per cent* stationed in these places, classified under B1/B2 cities as perDPE guidelines.

Thus, the Companies made irregular excess payment towards HRA amounting to ₹ 9.38 crore to their employees violating the DPE guidelines.

[♣] ***Visakhapatnam was eligible for 20 per cent HRA with effect from 26 November 2008 as per classification of cities on the basis of population.***

Recommendation

The Administrative Ministry should effectively monitor implementations of conditions stipulated in DPE's guidelines in their periodic review.

The matter was reported to the Ministry in September 2010; reply was awaited (February 2011).

Bharat Heavy Electricals Limited, eight Rail Companies under Ministry of Railways

14.3 Compliance of DPE Guidelines on Perquisites and allowances by CPSEs

Introduction

The Department of Public Enterprises (DPE) acts as a nodal agency for all Central Public Sector Enterprises (CPSEs) and assists in policy formulation pertaining to the role of CPSEs in the economy as also in laying down policy guidelines on performance improvement and evaluation, financial accounting, personnel management and in related areas. Accordingly, DPE issues from time to time guidelines on the wages and allowances for employees of CPSEs.

Scope of Audit

The scope of this thematic audit was limited to examine the extent of adherence to some of the guidelines of DPE, related to perquisites and allowances of employees of CPSEs such as (i) ceiling on perquisites and allowances and (ii) encashment of earned leave in nine CPSEs namely BHEL, Container Corporation of India Limited (CONCOR), RITES Limited (RITES), Rail Vikas Nigam Limited (RVNL), IRCON International Limited (IRCON), Railtel India Corporation Limited (RCIL), Indian Railway Catering and Tourism Corporation Limited (IRCTC), Kutch Railways Corporation Limited (KRCL) and Fresh & Healthy Enterprises Limited (FHEL) and (iii) guidelines on residential accommodation and recovery of rent thereof in the above mentioned eight CPSEs under Ministry of Railways over the last few years.

Audit Objectives

Objective of this audit was to make an assessment of extent of adherence to DPE guidelines relating to perquisites and allowances by the nine CPSEs mentioned under scope.

Audit Criteria

Guidelines relating to perquisites and allowances issued by DPE from time to time, internal policies of the Companies on pay and allowances, agenda/minutes of meetings of Board of Directors of the companies were used as benchmark for arriving at the audit conclusions.

Audit Findings

14.3.1 Ceiling on perquisites and allowances

The DPE while issuing (25 June, 1999) guidelines for pay revision of employees of CPSEs with effect from 1 January, 1997 stipulated therein a ceiling of 50 *per cent* of the basic pay on payments made to employees towards perquisites and allowances. The above guidelines also stipulated that payments over and above the ceiling of 50 *per cent* of the basic pay were required to be entirely in the nature of Performance Related Payments and put a further ceiling of five *per cent* of the distributable profits of an enterprise which could be utilised towards such payments. The DPE further on 27 March 2000 clarified that basic pay (BP), dearness allowances (DA), house rent allowance (HRA) /leased accommodation, city compensatory allowance (CCA) and professional allowances like non practicing allowance/non teaching/ location allowance/ difficult area positing allowance and retiral benefits etc. were outside the purview of the ceiling of 50 *per cent* of basic pay. All other allowances including Performance Linked Incentives (PLI), Domiciliary Medical Expenses would be within 50 *per cent* ceiling of perquisites (i.e. 50 *per cent* of basic pay).

Audit observed (August 2010) that BHEL incurred an excess expenditure of ₹ 359.55 crore ***(Annexure-VIII),*** in contravention of above guidelines during the period 2001-02 to 2008-09 on perquisites and allowances (excluding different incentive payments, canteen subsidy, tax on housing perquisites and subsidy to education institutions) for executives and non unionised supervisors. As the Management showed (December 2010) its inability in providing data relating to expenditure incurred on basic pay and perquisites and allowances of executives and supervisors for the year 2009-10, the audit was unable to comment on the same.

The Management stated (September 2010) that (i) DPE guidelines dated 25 June 1999 read with clarification dated 27 March 2000 were applicable for revision of pay scales with effect from 1 January 1997 to 31 December 2006, hence were not applicable for the financial year 2007-08 and onwards, (ii) concept of perquisites and allowances to the tune of 50 *per cent* was made applicable for all classes of employees and not exclusively for executives and supervisors as observed by audit and (iii) some of the benefits, namely medical expenses, payment to empanelled doctors, other expenses on medical facilities etc. were in the nature of social overheads and as such not required to be included in perks and allowances.

The reply was not acceptable as the aforesaid guidelines of June 1999 did not contain any fixed period during which these were to remain effective. As DPE also did not revise these guidelines they were still (February 2011) in force. It is a fact that these guidelines were applicable to all classes of employees, however, the audit observation is focussed on the perquisites and allowances of executives and non unionised supervisors. Further, the contention of the Management to consider some of the perquisites and allowances as social overheads being not in line with DPE's clarification dated 27 March, 2000, hence was not acceptable.

As regards companies under Ministry of Railways, no such issue was observed in any of the eight companies selected for audit.

14.3.2 Residential accommodation and recovery of rent thereof

DPE's instructions issued in March 1992 stipulated that wherever leased accommodation was provided by the CPSEs to their executives, rent at the rate of 10 *per cent* of the basic pay was to be recovered. In respect of township accommodation arranged by CPSEs, the recovery was to be made at 10 *per cent* of the basic pay or the standard rent whichever was lower. After revision of pay scales of employees of CPSEs with effect from January 1997, DPE clarified (June 1999) that the rent recovery on revised pay would be computed at the percentages in practice before 1 January 1997 or on the basis of standard rent to be fixed by the Companies.

Audit observed (July 2010 to September 2010) that in respect of the leased accommodation provided to employees, CONCOR, RITES, RVNL, IRCON, RCIL KRCL, IRCTC and FHEL were recovering rent at the slab rates fixed by them and not at the rate of 10 *per cent* of the basic pay, as stipulated vide DPE instructions resulting in short recovery of rent of ₹ 6.61crore as under:

Sl. No.	**Name of CPSE**	**Amount short recovered (₹ in crore)**	**Information made available to Audit for**	
			Whole company/Unit	**Period**
1	RITES	2.30	Company as a whole	April 2007 to March 2010
2	CONCOR	0.24	Corporate Office only	April 2009 to March 2010
3	IRCON	2.63	Company as a whole	April 2007 to March 2010
4	RVNL	0.21	Corporate Office only	March 2010 only
5	RCIL	0.22	-do-	April 2007 to March 2010
6	KRCL	0.02	Company as a whole	-do-
7	IRCTC	0.93	-do-	-do-
8	FHEL	0.06	-do-	-do-
	TOTAL	**6.61**		

The Management of IRCON, IRCTC and CONCOR stated (August and November 2010) that DPE in its OM dated 25 June, 1999 instructed that rent recovery on revised pay would be computed from the date of implementation of the guidelines at the percentages in practice before 1 January 1997 or on the basis of standard rent to be fixed by the Companies. The Management of these Companies further contended that in line with the above instructions of DPE the standard rent fixed for various classes of employees were got approved from their respective Boards and recovery of rent from employees was being made accordingly.

The reply was not acceptable as the standard rent was applicable only in case of accommodations owned by these Companies. However, in case of leased accommodation, which was the subject matter of the audit observation, house rent at the rate of 10 *per cent* was to be recovered from the employees in terms of DPE instructions issued from time to time. The DPE further made it clear recently (December 2010) that wherever accommodation was arranged by a PSE by taking the premises on lease basis, the rent would be recovered by the PSE from the executives including the incumbents of the top posts at 10 *per cent* of the revised basic pay. As such contention of the Management of these companies that the recovery was to be made from the employees as per standard rent fixed by them, was not acceptable.

Reply of RITES, RVNL, RCIL, KRCL and FHEL was awaited (February 2011).

14.3.3 Encashment of earned leave

According to the DPE instructions of April 1987, an individual public enterprise may frame leave rules for its employees keeping the broad parameters of the policy guidelines laid down in this respect by the Government of India (GOI). CONCOR and FHEL adopted 26 days as a month for the purpose of computing earned leave encashment instead of 30 days though no such provision existed in the Central Civil Service (Leave Rules), 1972. DPE issued (December 2008) instructions to these Companies that they should adopt 30 days month for the purpose of calculating leave encashment. The DPE also advised (December 2008) administrative Ministries/Departments concerned with PSEs to adopt 30 days as month for the purpose of leave encashment. However, violating the instructions of DPE, these companies continued to adopt 26 days a month instead of 30 days for the purpose of leave encashment. Resultantly, excess payment of ₹ 0.59 crore was made to the employees of the two companies between April 2003 and March 2010.

The Management of CONCOR stated (March 2010) that guidelines of DPE were subject to broad parameters of policy guidelines and such guidelines neither have any intention nor authority and jurisdiction to override the statutory provisions otherwise provided in various laws. It further stated that monthly wages in respect of workmen under various labour laws is exclusive of weekly rest. Minimum Wages Act, 1948 and Payment of Gratuity Act, 1972 define wages therein for 26 days.

The reply of the Management was not acceptable as DPE being the nodal department for CPSEs, its guidelines were applicable to these CPSEs. DPE's instructions (December 2008) reiterated that the companies should adopt 30 days month for the purpose of calculating leave encashment. The DPE further clarified vide its letter dated 8 December 2010 to Ministry of Railways (Railway Board) that definition of a month may differ under different labour laws, but for the purpose of encashment of earned leave it is to be treated as 30 days.

Reply from FHEL was awaited (February 2011).

In case of the remaining six railway companies, no such issue was observed. As regards BHEL, the issue was already highlighted vide Para 11.1.2 of Report No. 11 of 2007. The Management of BHEL stated (September 2010) that pending judicial decision in major units of the Company, effecting the change in respect of workmen who joined prior to 1 January 2010 was not possible. However, the Company effected 30 days month in case of employees who joined on or after 01 January 2010.

Conclusion

In violation of DPE Guidelines, the companies incurred excess expenditure of ₹ 366.75 crore on payment of perquisites and allowances to their employees.

Recommendation

The companies should approach DPE before deviating from Guidelines on wages and allowances to employees.

The matter was reported to the Ministry in October 2010; reply was awaited (February 2011).

Bharat Heavy Electricals Limited, Bharat Earth Movers Limited, Bharat Sanchar Nigam Limited, Food Corporation of India, Hindustan Paper Corporation Limited, The New India Assurance Company Limited and United India Insurance Company Limited

14.4 Recoveries at the instance of Audit

During test check, several cases relating to non-recovery, short recovery, non-billing of rentals, excess payment, short charging of premium etc. by central public sector undertakings

(PSUs) were pointed out. In 14 such cases pertaining to 7 PSUs, Audit pointed out that an amount of ₹ 7.85 crore was due for recovery. The Management of PSUs had recovered an amount of ₹ 7.21 crore during the year 2009-10 as detailed in ***Appendix-I.***

Bharat Heavy Electricals Limited, Food Corporation of India, MECON Limited, Rashtriya Chemicals and Fertilizers Limited and Steel Authority of India Limited

14.5 Corrections/rectifications at the instance of Audit

During test check, cases relating to deficiencies in the systems, policies and procedures etc were observed and brought to the notice of the Management. Details of cases where the changes were made by the Management of the PSUs in their policies/procedures at the instance of audit are given in ***Appendix-II***.

CHAPTER XV: DEPARTMENT OF ROAD TRANSPORT & HIGHWAYS

National Highways Authority of India

15.1 Loss of revenue due to non-implementation of rates of user fees

National Highways Authority of India did not comply with the directions of the Government of India to implement revised rates of user fee after expiry of moratorium period of one year resulting in loss of ₹ 42.56 crore to exchequer.

The GOI notified, between November 2007 and May 2008, revised rates of the user fee in respect of nine[*] stretches of highway projects controlled and managed by National Highways Authority of India (NHAI), in exercise of powers conferred by National Highways Act, 1956 and National Highways (Rates of Fee) Rules, 1997 made there-under. In protest of increase in the rates of user fee, the All India Motor Transport Congress (AIMTC) called a nationwide strike. Consequently, the enhanced rates were not levied as per an agreement dated 3 July 2008 signed between the representative of AIMTC and the Department of Road, Transport and Highways (DoRTH), Government of India (GOI). It was further agreed that there would be no increase in toll for a period of one year for the said stretches from the date of signing of the aforesaid agreement. Later on, the GOI in supersession of National Highways (Rates of Fee) Rules, 1997, notified National Highways Fee (Determination of Rates and Collection) Rules, 2008 in the Gazette of India dated 5 December 2008. These rules were however not applicable to agreements, contracts executed and bids invited prior to notification of these rules.

Instead of levying revised rates in the above mentioned road stretches, after expiry of one year (2 July 2009) from the date of signing of the aforesaid agreement, the NHAI recommended (15 July 2009) to the GOI to defer levy of revised rates on the ground that draft notifications for all the existing public funded projects (where fee collection was being made as per 1997 rules) were already submitted by it as such the rates may be revised only after publication of these fee notifications. The GOI did not respond (October 2010) to the above proposal of NHAI.

It was observed in audit that:

- Despite knowing the fact that the contract or projects in respect of these nine stretches were executed prior to December 2008 as such these were not covered under new fee notification dated 5 December 2008, the NHAI made a reference to the GOI in July 2009 recommending to defer levy of enhanced user fee rates.

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[*] ***One in November 2007 Gurgaon-Kotputli, seven in January 2008 (i)Panipat-Ambala (ii) Ambala-Khanna (iii) Khanna-Jalandhar (iv)Badarpur-Kosi(v)Kosi-Agra(vi)Ghaziabad-Hapur & Hapur Bypass (vii)Barwa Adda-Panagarh and one in May 2008 i.e. Manor-Dahisor. Out of these, five stretches viz. (i) Ambala-Khanna (ii) Gurgaon-Kotputli (iii) Khanna-Jalandhar (iv) Manor-Dahisor (v) Panipat-Ambala were transferred before July 2009 to BOT Concessionaires for six laning and the rest were controlled by NHAI.***

- Immediately after elapse of period of one year of the date of agreement (3 July 2008) entered between AIMTC and GOI, the NHAI was required to implement enhanced rates in respect of nine road stretches as per notifications published between November 2007 and May 2008 but it did not act as per agreement and eventually failed to comply with the GOI directions to levy enhanced user fee on these stretches.
- Based on the traffic data provided by NHAI for the period August 2009 to September 2010, in respect of four toll plazas/stretches controlled and managed by NHAI, shortfall in collection of differential revenue works out to ₹ 42.56 crore[♠].

Management in its reply (July 2010) stated that:

- Proposal to postpone levy of enhanced user fee, till notification of revision of rates in respect of all public funded projects was sent (15 July 2009) to the Ministry of RT&H, to have conducive environment for tolling throughout the country.
- As per the agreement dated 3 July 2008, the Ministry of RT&H constituted two committees the first to review all toll related issues and second for monitoring, reviewing and overseeing the function of toll system, respectively.
- To create awareness among users, some sort of deviations might occur which could not be considered as loss, because it is the Government to decide to levy or not to levy the toll at prescribed rates.

Reply of the Management was not acceptable as:

- The authority to take a decision to levy /not to levy toll vests in the GOI and NHAI is only an implementing agency of Government. As such contention of the Management that to have conducive environment for tolling throughout the country, levy of enhanced user fee was postponed was not acceptable and the NHAI should have implemented the agreement dated 3 July 2008.
- The recommendations of the Committees did not have any bearing on the rates notified in Fee Rules 1997/2008.
- The contention of the Management that some sort of deviations might occur which could not be considered as loss was not acceptable in view of the fact already mentioned above, that the NHAI does not have the authority to deviate from the directions of the GOI.

Thus, the decision of NHAI to continue levying the user fee during August 2009 to September 2010 at pre-revised rates, led to revenue loss of ₹ 42.56 crore to the exchequer and the same is likely to continue till the revised rates are levied by NHAI.

The matter was reported to the Ministry in September 2010; reply was awaited (February 2011).

[♠] ***Dasna Toll Plaza at Ghaziabad-Hapur & Hapur Bypass Section: ₹ 3.50 crore, Srinagar toll plaza at Badarpur-Kosi Section: ₹ 14.96 crore, Mahuvan Toll Plaza at Kosi-Agra Section: ₹ 14.65 crore and Garui Toll Plaza at Barwa Adda-Panagarh Section: ₹ 9.45 crore***

CHAPTER XVI: DEPARTMENT OF SHIPPING

Dredging Corporation of India Limited

16.1 Delay in acquisition of trailer suction hopper dredgers and its impact on the performance of the Company

Introduction

Dredging is primarily of two types, namely, maintenance dredging, which is a regular activity that ensures that channels and berths are maintained at the required depth and capital dredging, which involves channel deepening and widening to accommodate larger vessels. Maintenance dredging is carried out by Trailer Suction Hopper Dredgers (TSHDs) and capital dredging is mainly carried out by Cutter Suction Dredgers (CSDs). Maintenance dredging is the core activity of Dredging Corporation of India Limited (the Company). The turnover from maintenance dredging activity of the Company ranged between 70 *per cent* and 97 *per cent* of the total turnover of the Company during the last five years ended 31 March 2010.

The Company's clients are the major ports, Indian Navy and shipyards. There are 12 major ports in the country functioning as autonomous bodies/ corporate body under the Ministry of Shipping (Ministry). All major ports, except Tuticorin, which has a rocky sea-bed, hire dredgers for carrying out maintenance dredging. Besides these, there are 187 non-major ports, the maintenance of which is carried out by indigenous dredging companies.

The Company had 10 Trailer Suction Hopper Dredgers (TSHDs) as on 31 March 2010 with an annual dredging capacity of 73.60 M cum. The economic life of the dredger was assessed as 19 years♦ . Of the 10 dredgers, five dredgers were of age exceeding 19 years and as such served their full economic life as of 1 April 2005 and the oldest being 31 years old as of 1 April 2005.

Scope of Audit

The thematic draft paragraph covers examination of records relating to planning for replacement of dredgers and whether the replacements were made in time and its impact on the working of the Company in terms of profitability and turnover during the period 2005-06 to 2009-10.

Audit findings

16.1.1 Acquisition/ replacement plan

16.1.1.1 Dredger is a highly specialized vessel with increasing degree of technological sophistication. It is observed in Audit that the Company had not been able to meet the Five Year Plan (FYP) projections in respect of acquisition/ replacement of dredgers set for the Company as indicated below:

♦ ***The life of dredger is taken as 19 years for IRR calculation during the DPR prepared in 2004.***

Plan & Period	Targets for the Company	Compliance by the Company
Eight FYP (1992-1997)	➢ Decommission and replace four dredgers of the Company.	➢ No dredger was decommissioned or replaced.
Ninth FYP (1997-2002)	➢ Replacement of dredgers which are more than 15 years old.	➢ Three TSHDs only were procured as against five TSHDs which had completed 15 years by the end of the plan period.
Tenth FYP (2002-2007)	➢ To procure one TSHD.	➢ No TSHD was procured.
Eleventh FYP (2007-2012)	➢ The Company to procure four TSHDs. ➢ To carry out retrofit to old dredgers	➢ Order placed for procurement of only two TSHDs (April 2010). These two dredgers would be joining the fleet of the Company by December 2012 & June 2013. ➢ Even though approval was accorded for ₹ 450.00 crore for retrofits, no retrofits were carried out.

16.1.1.2 The Management in its reply (October 2010) stated that the Company has a 'Dredger Procurement Policy' as reflected in the FYP outlays of the Company. The FYP outlays are proposed taking into consideration the prevailing conditions in the market like the capacity and type of dredgers required by different ports, procurement cost of dredgers, financial position of the Company, the expected/ planned maintenance etc.

16.1.1.3 The fact remained that the Company did not achieve the targets fixed as reflected in the FYP. The Company could initiate procurement action only for 2 TSHDs as against the targets of 4 TSHDs by April 2010. No procurement action has been initiated for balance 2 TSHDs till date (November 2010).

Recommendation

The Company needed to make a comprehensive plan for acquisition with timeframe and milestones so as to achieve the FYP targets.

16.1.2 Acquisition process and delays

16.1.2.1 The Company initiated action for procurement of one TSHD in April 2002 but the procurement action was completed successfully only in April 2010, after a period of eight years, when the order was placed on IHC Holland for two 5000 cum TSHDs. The details of tenders floated by the Company and the reasons for their cancellation are given below:

Sl. No.	Tender Date, Type & Quantity tendered	Details of parties qualified	Reasons for cancellation
1.	22 July 2002, Global Notice Inviting Tender (GNIT), one 5000 cum TSHD	➢ IHC Holland, Netherlands (IHC) ➢ Volharding shipyard, Netherlands	➢ The Company decided to discharge the tender, disregarding the recommendation ➢ of the Tender Scrutiny Committee on the pretext that competitive rates might not be obtained. Pre-Qualification Criteria (PQC) was relaxed.
2.	28 September 2002, GNIT, one 5000 cum TSHD	➢ IHC	➢ To ensure competition, GNIT was cancelled and PQC was further diluted.

3.	7 November 2002, GNIT, one 5000 cum TSHD	➢ IHC ➢ Mitsubishi Heavy Industries, Japan (MHI) ➢ IZAR Gijon, Spain (IZAR) ➢ Peene-Werft GMBH, Germany	➢ In light of CVC guidelines (December 2002) on PQC criteria, the company decided to review and reframe the PQC criteria and the tender was cancelled.
4.	18 February 2003, GNIT, one 5000 cum TSHD (Additional safeguards were included (April 2003) and tender documents re-issued in September 2003)	➢ IHC ➢ MHI ➢ IZAR ➢ Mazagon Dock Limited, Mumbai (MDL) ➢ Peene-Werft GMBH, Germany (qualified but did not submit the bid)	➢ All the four parties did not accept (October 2003) the 'Consequential Losses' clause leading to cancellation of tender (February 2004).
5.	31 March 2004, Limited Tender Enquiry (LTE) to only five qualified parties in response to GNIT issued on 18 February 2003	➢ IHC ➢ IZAR ➢ MDL	➢ IHC, IZAR and MDL submitted their bids in May 2004. Price bids were opened in September 2004. ➢ The bid of MDL was rejected as the yard did not agree for Performance Guarantee. ➢ The Company decided to place order on IHC (L1) at an evaluated price of ₹ 292.07 crore (January 2005). ➢ Tender was discharged (December 2005) based on the advice received (November 2005) from Solicitor General of India.
6.	26 February 2006, GNIT, three 5000 cum TSHDs (Based on M/s. Price Waterhouse Cooper's estimation (November 2004) of additional capacity required)	➢ IHC	➢ The price offer of IHC received on 10 May 2006 was valid only up to 30 November 2006 and was extended until 17 December 2006. However, the price bid was opened on 17 December 2006. The price validity was extended five times till 17 July 2007. ➢ The Company initially submitted the proposal to Public Investment Board (PIB) on 8 February 2007. Further information sought by PIB was provided by the Company only on 14 June 2007. PIB forwarded the proposal to Cabinet Committee on Economic Affairs (CCEA) on 3 July 2007. CCEA cleared the proposal on 20 July 2007. ➢ Inspite of the Company reminding the Ministry of the status on 13 July 2007 and 17 July 2007, the Ministry approval was received only on 27 July 2007. ➢ IHC declined (2 August 2007) to extend validity of offer leading to cancellation of tender.
7.	24 September 2007 LTE to five PSU yards, three 5000 cum TSHDs	➢ Cochin Shipyard Limited, Cochin (CSL) in collaboration with IHC	➢ CSL submitted the offer in October 2007. ➢ CSL, however, did not agree to provide bank guarantees for release of stage payments and Security Deposit/ Performance Guarantee as insisted by the Company. ➢ Tender was discharged in January 2008.

8.	1 September 2008, GNIT, three 5000 cum TSHDs	➢ IHC	➢ IHC submitted its offer in November 2008 and price bid was opened in February 2009. ➢ The Detailed Project Report (DPR) and PIB note were forwarded by the Company in May 2009. ➢ PIB during meeting held in (August 2009) directed the Company to initially procure two TSHDs although approval was sought for three TSHDs, as no budgetary support was being sought from the Government and the cost was to be borne from internal resources of the Company. ➢ Cabinet Committee on Infrastructure (CCI), however, approved (February 2010) the capital outlay of ₹ 1570.21 crore (estimated cost - ₹ 1455.89 crore) for three TSHDs. ➢ The Company eventually placed order on IHC (April 2010) at a cost of ₹ 916.68[1] crore, which was found to be higher by ₹ 265.76 crore[2], as compared to the previous quote of May 2004.

16.1.2.2 In this regard, the following observations are made:

- The decision of the Company to cancel the tenders floated in July 2002, lacked justification in view of the following:
  - (i) having floated global tenders, the number of bids received could not be a limiting factor for going ahead with the procurement; and
  - (ii) all the previous procurements were from IHC Holland only substantiating the fact that this was a reliable source.

This cancellation led to inordinate delay extending to eight years.

16.1.2.3 The Management in its reply (October 2010) contended that the Company was striving to obtain better response by relaxing PQC initially in 2002. The tenders floated from 2003 to 2007 were cancelled for reasons beyond the control of the Company.

16.1.2.4 The contention of the Management was not acceptable as the Company floated GNIT and then ignored the recommendation of the Tender Scrutiny Committee in 2002 of opening the price bids. In respect of subsequent periods, apart from the reasons beyond the control of the Company, there was also delay on the part of the Management in finalising tenders floated.

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[1] ***Euro 145945000 (Euro 75480000 + Euro 70465000) at the rate of ₹62.81 per Euro (rate applicable as of 6 February 2009 (date of opening bid))***

[2] ***₹916.68 crore – ₹650.92 crore (₹325.46 * 2), that is, Euro 47.30 million per dredger at the rate of ₹56.40 per Euro as on 7 September 2004 (date of opening bid) after loading 22 per cent for change of technology from Single Tube to Double Tube.***

16.1.3 Impact of using old dredgers

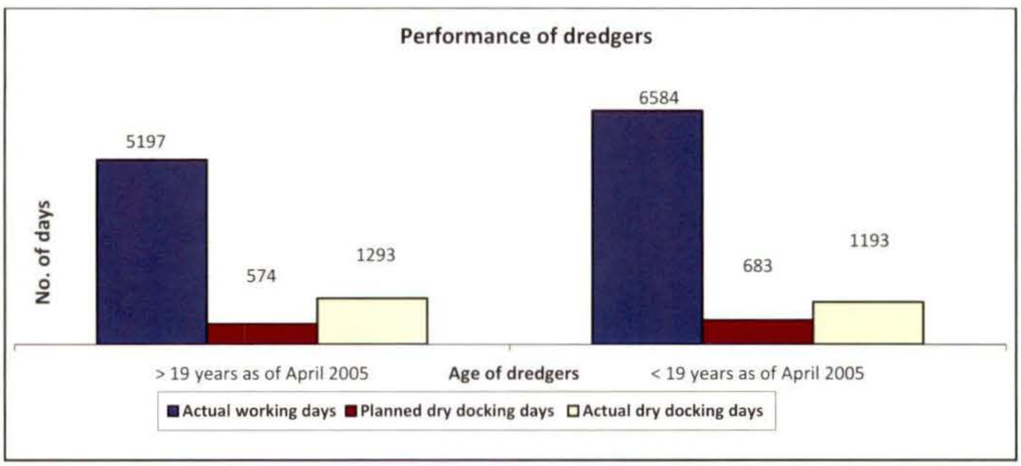
16.1.3.1 Increase in dry dock (maintenance) expenditure

It was observed in Audit that the turnover of the Company from maintenance dredging activity remained static but the profit decreased from ₹ 156.00 crore during 2005-06 to ₹ 83.15 crore during 2009-10. One of the main factors for decrease in profit, the turnover remaining constant, was the dry dock expenditure. The dry dock expenditure during 2005-06 was ₹ 40.96 crore as against ₹ 85.01 crore during 2009-10.

It was further observed in Audit that during 2005-10, the dry docking expenditure in respect of dredgers which had completed 19 years as of 1 April 2005 was ₹ 159.52 crore whereas the dredgers aged below 19 years had incurred ₹ 148.73 crore. The expenditure on dredgers below 19 years would have been much lesser had there not been compulsory dry docking expenditure of ₹ 38.22 crore during 2009-10.

16.1.3.2 Increase in dry dock repair time and less availability of dredgers

Apart from increase in dry dock expenditure, there was abnormal increase in actual dry dock repair periods as compared to the planned dry dock period particularly in respect of dredgers aged more than 19 years as of April 2005. The increase in actual dry dock days over planned days impacted adversely the availability of dredgers for operations. The performance of dredgers aged above 19 years as of 1 April 2005 and otherwise is depicted below:



This had in turn led to decrease in utilization of capacity from 67.50 M cum in 2005-06 to 43.39 M cum in 2008-09* as against an available capacity of 73.60 M cum throughout 2005-10.

16.1.3.3 Loss of business opportunities

Ports like New Mangalore and Mumbai stipulated prequalification criteria by specifying the age of dredgers that is, not exceeding 15 years. The Company did not fulfil the pre qualification criteria as regards to the age of the dredgers. This apart, there was shortage

* ***The base for calculation of capacity has been changed during 2009–10 making it not comparable with the previous four years.***

of dredgers. Consequently, the Company was not able to participate in maintenance dredging works of ₹ 345.61 crore♥ during the last six years ended 31 March 2010.

The Management in its reply (October 2010) accepted the audit view.

16.1.4 Monitoring by the Board

16.1.4.1 The Board is responsible for providing stewardship and direction for the effective functioning of the Company. It was, therefore, imperative that it monitored the customer requirement vis-à-vis the capability of the Company and took timely action to maximise revenue generation potential.

16.1.4.2 A review of the functioning of the Board of Directors revealed that the Company was in immense need to increase its fleet so as to increase its operations. 70 Board Meetings were held during the period 2002-2010 and the issue of procurement of dredgers was discussed 32 times. A review of the Board Meetings held during this period shows that:

- Though the Board initiated action for procurement of dredgers in April 2002, the investment appraisal prepared by reputed professional organizations (as per criteria stipulated by DPE) for incurring capital expenditure was completed only in January 2005. The delay in preparation of appraisal was not monitored by the Board.
- The tender for procurement of dredgers was floated in March 2004 and the price bids for tender were opened on 7 September 2004 after delay of 4 months from the date of receipt of price bids. Though, the Board met three times during this period, the issue was not discussed.
- Similarly, the price bid in response to GNIT floated in February 2006 was opened on 17 December 2006 after a delay of seven months from the date of receipt of bid. A revised note in this regard was forwarded to PIB on 14 June 2007. During the period from 10 May 2006 to 14 June 2007, the progress was discussed by the Board in only five meetings out of ten meetings held.

16.1.4.3 Board did not ensure effective monitoring, resulting in planned replacement of dredgers not taking place fully.

Recommendation

The Board should effectively monitor planning for and actual acquisition of dredgers.

The matter was reported to Ministry in December 2010; reply was awaited (February 2011).

♥ ***Mumbai Port for the years 2004 – 08 (₹87.73 crore); Cochin Port Trust for 2005 – 06 (₹27.50 crore) and 2007 – 10 (₹204.95 crore); Murmugoa Port for the year 2007 (₹14.00 crore); Southern Naval Command, Kochi (₹5.29 crore) and Western Naval Command, Mumbai for the years 2008 – 11 (₹ 6.14 crore).***

16.2 Loss due to failure in specifying measurement method in agreement

Failure to ensure method of measurement of dredged quantity in agreement resulted in a loss of ₹ 16.06 crore.

Cochin Port Trust (CoPT) offered (April 2006) annual maintenance dredging work for the year 2006–07 on nomination basis to Dredging Corporation of India Limited (Company) for ₹ 30.90 crore for an indicative quantity of 11.10 M cum of material. The Company accepted the offer and undertook (May 2006) the dredging work without finalizing the terms and conditions.

The said dredging work involved a crucial issue of methodology for measurement of the quantity dredged. Neither CoPT clarified, at the time of making a request to the Company about the methodology of measurement of quantity nor the Company specified at the time of communicating its acceptance of the offer, the methodology to be used in measuring the dredged quantity. As a result, the methodology for measurement of dredged quantity remained a grey area.

There are two commonly used methods for the measurement of quantity dredged: (i) in-situ method, and (ii) hopper volume method. Volume of material dredged on in-situ basis is determined by calculating the volume between the pre-dredging depth and the post-dredging depth. So far as hopper volume method is concerned, the volume of material dredged is determined on the basis of volume gathered in the hopper (the front end of the dredger where the dredged material is stored before dumping elsewhere). The hopper volume tends to be higher than the in-situ volume due to lower density of dredged material in the hopper. As the measurement methods have financial implications, the industry has adopted a practice of specifying the measurement method in the agreement so that no ambiguity remains on this front.

In the instant case, the Company did not ensure that the methodology of measurement was agreed to between it and CoPT before actually taking up the dredging work in May 2006. The Agreement for the work entered into between CoPT and the Company in October 2006, six months after start of actual operations, was silent about the measurement method.

The Company dredged a total quantity of 18.20 M cum on hopper volume basis and lodged total claim of ₹ 52.21 crore[1]with CoPT. CoPT converted the hopper volume quantity to in-situ volume of 12.13 M cum and made a payment of ₹ 34.46 crore[2]. Thus, due to failure of the Company to safeguard its financial interests by ensuring agreement on the methodology of measurement of quantity dredged, the Company lost the revenue of ₹ 17.75 crore[3]. The actual cost incurred by the Company on this job was ₹ 50.52 crore, thus, resulting in a loss of ₹ 16.06 crore to the Company.

The Management in its reply (October 2010) mainly contended that the Company signed the agreement as per the tender conditions and the Company was expecting that the additional quantity dredged could be proportionately settled by CoPT since the contract value of ₹ 30.90 crore was for the indicative quantity of 11.10 M cum. As the agreement

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[1] ***₹30.90 crore lumpsum price + ₹21.31 crore for the additional quantity of 7.10 M cum dredged.***

[2] ***₹30.90 crore – lumpsum price + ₹ 2.88 crore for additional quantity + ₹ 0.68 crore for fuel escalation cost.***

[3] ***Difference between claim lodged for 18.20 M.cum (₹52.21 crore) and realization of ₹34.46 crore***

was silent about methodology of measurement for quantity dredged, the Company should have negotiated the terms and conditions of the agreement and safeguarded its interest before the commencement of work.

Recommendation

The Company should finalize terms and conditions before commencement of work.

The matter was reported to Ministry in August 2010; reply was awaited (February 2011).

CHAPTER XVII: MINISTRY OF STEEL

Hindustan Steelworks Construction Limited

17.1 Loss due to providing inadequate resources and lack of control on the activities of Joint Venture

Company incurred a loss of ₹ 16.64 crore due to failure in providing adequate resources for the work and inadequate control over the functioning of JV and construction work.

Hindustan Steelworks Construction Limited (Company) entered (September 2004) into an agreement with Sricon Infrastructure Private Limited (SIPL) to form a Joint Venture (JV), sharing financial responsibility in the ratio of 51:49 respectively. As per JV agreement all the partners of JV were liable jointly and severally for execution of the contract in accordance with the contract terms. JV submitted (March 2005) a bid for 4 laning of Nagpur-Hyderabad Section of National Highway-7 from KM 94 to KM 123. National Highway Authority of India (NHAI) awarded (April 2005) the work to JV at a contract price of ₹ 105.27 crore. The work was to be completed by April 2008.

The Company for its share of responsibility deposited Bank Guarantee of ₹ 8.00 crore as performance guarantee to NHAI. The physical progress of the work was very slow as the JV achieved only 13.87 *per cent* of work till April 2008 being the scheduled date of completion of the work. The reasons for the delay was attributable to (a) shortage of fund (b) improper planning and progress of work not matching with the equipment deployed (c) frequent change of Project Manager (d) lack of proper technical personnel to man the project and (e) lack of proper material engineer. In spite of the repeated request from the consultant of NHAI, the work could not progress and subsequently JV abandoned the work and left the site.

As the JV could not complete the work and left the work site, NHAI terminated (February 2009) the contract and forfeited the bank guarantee of ₹ 8.00 crore. HSCL further incurred a loss of ₹ 8.64 crore being the fund provided to JV from time to time.

Audit observed that:

- The Chairman–Cum-Managing Director, HSCL approved (September 2004) formation of a JV with SIPL for the purpose of executing a job of the value of ₹ 105 crore which was beyond his power. The specific approval of the Board of Directors of the Company was not obtained for forming the JV.
- There was no record available with the Company on method and criteria for selection of JV partner; further the Company did not evaluate the credentials of the JV partner.
- There was delay in start of work though a stretch of 20 KMs clearance was given by the NHAI. Even after start of work it did not progress to the satisfaction of NHAI. The equipments available were not utilised to their capacity.

- The Company being the lead partner as per JV agreement did not keep the required control on the construction activities on its part leading to termination of contract and forfeiture of ₹ 8.00 crore.
- SIPL did not deploy required numbers of competent officials viz. project manager, materials manager, surveyors, engineers for bridge section to man the project and billing engineer for preparing bills.

The Management in its reply stated (October 2010) that:

- The work could not be completed due to the reasons attributable to NHAI i.e. non delivery of site in one stretch, delay in issue of drawings, indecision about use of fly ash in construction, cutting of trees, non compensation towards increased royalties and hike in input prices etc., and non performance of the JV partner who was actual executor of the work.
- It further stated that the Company would get the disputes resolved with NHAI through arbitration and had initiated civil suit proceedings (September 2010) against SIPL to recover an amount of ₹127.43crore.

The contention of the Management was not convincing in view of the following:

- Reasons attributable to NHAI were not correct since 20 KMs working site at a stretch out of 29 KMs was provided to the JV by NHAI, drawings were issued timely, use of fly ash was only for 4 KMs of road against total 29 KMs and also cutting of trees on left side for 28 KMs was done in time.
- As regards increased royalties and input cost the same were liable to be governed by the terms of the contract.
- So far as non-performance of JV partner was concerned it was the duty of HSCL who was the lead partner of the JV to ensure that the JV partner performed.

Thus, due to failure of the Company in providing adequate resources for the work and inadequate control over the functioning of JV and construction work it incurred a loss of ₹ 16.64 crore (₹ 8.00 + ₹ 8.64 crore).

The Matter was reported to Ministry in October 2010; reply was awaited (February 2011).

MSTC Limited

17.2 Export of Gold Jewellery

Introduction

MSTC Limited (Company) is a Mini Ratna Category-I PSU under the administrative control of the Ministry of Steel, Government of India. The Company was set up in 9 September 1964 to act as a regulating authority for export of ferrous scrap. MSTC became a subsidiary of SAIL in 1974. In 1982, it got delinked from SAIL and became an independent Company under Ministry of Steel. It was a canalizing agency for import of ferrous scrap till 1992.

As on date, MSTC has two major portfolios of business i.e. procurement of industrial raw materials in bulk, mainly consumed by the steel industry in the country, for its Principals and second which provides a virtual marketplace for domestic sellers and buyers to do business in metal scrap (ferrous/non-ferrous), surplus stores, machineries, obsolete spares, vehicles, Plants etc.

The Company on being approached (April 2007) by three merchant exporters/traders (associates) decided in July 2007 to enter into a new business of export of gems and gold jewellery on post-shipment basis[1] without opening letter of credit (L/C). As per arrangement agreed for the new business, the associates were required to export the articles and the Company was required to pay up to 80 *per cent* of the export bill value to the associates as advance by discounting the bills[2] from the bank and the balance 20 *per cent* was to be released to the associates on collecting full value of the bill from the foreign buyer on due date. During 2007-08, gold jewellery worth ₹ 260.63 crore was exported to 29 foreign buyers in Dubai under the above arrangement with the three associates and the entire export proceeds were fully recovered. The Company received ₹ 3.91 crore as service charges in the above business. In 2008-09, six associates (including three of 2007-08) exported gold jewellery worth ₹ 638.20 crore to 47 foreign buyers[3] with the insurance coverage from ECGC[4] and ICICI Lombard (ICICIL). 46 foreign buyers did not pay their dues amounting to ₹ 598.63 crore (August 2010). An amount of ₹ 611.79 crore remained unrecovered (August 2010) from the associates towards the advances paid to them and related financial charges incurred by the Company. The Company lodged claims with the insurers for non-payment of dues by the foreign buyers. However, the claims were rejected by both the insurers.

Scope of Audit

The theme audit was conducted to review the activities of the Company for export of gold jewellery during 2007-08 and 2008-09.

Audit Objective

Theme Audit of export of gold jewellery was taken up to ascertain whether:

- the decision of the Company to enter into the business of export financing of gold jewellery was prudent and economically justified;
- the Company carried out due diligence in selecting and identifying the associates and foreign buyers; and
- the Company took all prudent measures to safeguard its financial interest from the associated risks involved in the above business.

Audit Methodology

After a preliminary study and collection of background information, field audit was conducted during June 2010 to August 2010. Audit covered examination of the records of

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[1] ***Materials to be delivered to foreign buyers on acceptance of liability.***

[2] ***Bill discounting is a type of lending where bank takes the bill drawn by customer and pays immediately deducting some amount as discount/commission.***

[3] ***45 in Dubai, one each in Kuwait and Singapore***

[4] ***Export Credit Guarantee Corporation of India Limited, a Central PSU, was set up to provide export credit insurance support to Indian exporters.***

the Company relating to export of gold jewellery during the year 2007-08 and 2008-09 and the records maintained at the Head Office (Mumbai) of ECGC relating to the insurance policy of the Company.

Audit findings

17.2.1 Role of the Company and associates in the export of gold jewellery

As per the agreement entered into by the Company with the associates for export of gold jewellery, the latter was required to identify the foreign buyers, obtain export orders from them in the name of the Company, export gold jewellery and prepare relevant documents showing the Company as an exporter. The foreign buyers were required to pay the export proceeds after 170 days (due date) from the date of despatch. The associates were required to monitor and ensure realisation of export proceeds from foreign buyers on due date. The Company was required to release advance up to 80 *per cent* of the invoice value to the associates immediately after export and the balance amount was required to be paid only after realisation of full value of export proceeds. The associates ultimately had to bear all the expenses to be incurred by the Company for such export business. It was also stipulated that the associates would bear all the risks and costs in the event of non-payment of export proceeds by the foreign buyers.

Thus, instead of playing the role of an exporter, the Company was to provide only post shipment finance* to its associates, who were the actual exporters. In view of the above, Management's contention (October 2010) that the Company acted as an exporter and the associates acted as shippers is not acceptable as the export orders were actually executed by the associates.

17.2.2 Economic justification and risk involved

17.2.2.1 High risk exposure

Although the Company decided to finance the associates for the export of gold jewellery, it did not ascertain the volume of its risk exposure before entering into such business. It was observed that during 2007-08 and 2008-09, the credit exposure of the Company, by way of advancing finance to the associates, was high and the same was 80 *per cent* and 185 *per cent* respectively of its net worth of the respective previous years. The Company also did not obtain any security from the associates before releasing such advances to mitigate the risk of non-recovery of advances.

Management contended (October 2010) that the Company's risk exposure was hedged through credit insurance policy. This is not acceptable as the risk involved was payment of advances to the associates without any financial security and non-recovery of the same in the event of non-realisation of export proceeds.

17.2.2.2 Return not commensurate with the risk

The financial risk involved in the above business was 80 *per cent* of the export proceeds along with the cost of financing in the event of non-payment of dues by the foreign buyers and consequential non-realisation of the same from the associates. The return of

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* ***Post shipment finance is a kind of loan provided to an exporter against a shipment that has already been made.***

the Company was, however, only 1.25 to 1.5 *per cent* of the entire export proceeds. Thus, the quantum of return was not commensurate with the size of the risk involved. It was observed that the Company earned a service charge of ₹ 3.91 crore only from financing the export of gold jewellery worth of ₹ 260.63 crore in 2007-08 which was only three *per cent* of the profit for that year. Further, due to non-realisation of export proceeds, the Company did not earn any service charge during 2008-09. Thus, the decision of the Company to venture into the above business with a meagre return was not economically justified.

Management in their reply (October 2010) could not bring out any economic justification for the above. However, it was stated that the Company earned an average trading margin of one *percent* approximately, even in its import trade with huge credit exposure. The contention was, however, not acceptable as in the import business the risk of non-payment by the vendor was substantially reduced since the imported materials remain under the control of the Company till the receipt of final payment.

Recommendation

The Company should venture into such business where the return is commensurate with the risk involved.

17.2.3 Assessment of demand of gold jewellery in foreign markets

The Company did not analyse the demand of gold jewellery in foreign markets before venturing into the export business. The global market for gold jewellery was favourable in 2007-08. However, the demand for the same started declining globally (including UAE[♥] & Middle East) from the first quarter of 2008-09. The export of gold jewellery to the above countries was, however, increased by 143 *per cent* during 2008-09 compared to 2007-08.

Management stated (October 2010) that gold jewellery was exported against purchase orders placed by the foreign buyers and no material was returned back. This contention was not acceptable as the Company was providing advances on post shipment basis to the associates and the realisation of such advances primarily dependent on the overseas market conditions. Thus, the Company should have assessed the demand of god jewellery in the overseas market.

Recommendation

Assessment of demand of a particular commodity in the foreign markets may be made before entering into export business of that commodity.

17.2.4 Selection of the associates

The Company decided (July 2007) to venture into the business of financing the export of gold jewellery on the basis of proposals received (April 2007) from three associates viz. Space Mercantile Co. Pvt. Ltd. (Space), Ushma Jewellery & Packaging Exports Pvt. Ltd.(Ushma) and Bonito Impex Pvt. Ltd. (Bonito) and the business was carried out during 2007-08 with them only. Subsequently, the Company received (July/August 2008) proposals from three more associates viz. K.A. Malle Pharmaceuticals Ltd. (KA Malle), Joshi Bullion Gems & Jewellery Pvt. Ltd.(Joshi) and Bond Gems Pvt. Ltd. (Bond) and

[♥] ***United Arab Emirates***

the business was carried out with the above six associates during 2008-09. The acceptance of the proposals from these associates was done without properly verifying their credentials. No physical inspection of the offices/ manufacturing premises of the associates were carried out by the Company before entering into agreements with them. Two of the above associates (Bonito and KA Malle) were engaged, respectively, in the business of building materials and pharmaceutical intermediaries for animals and had never been in the business of gold jewellery. Four associates were having related party relationship (Space with KA Malle and Bond with Joshi). Therefore, the above export business was in fact carried out through four parties only. Audit scrutiny also revealed that one of the two related associates (Space with KA Malle) enjoyed a high credit exposure during 2008-09 by carrying out 53 *per cent* of the total export of gold jewellery.

Audit observed that three of the associates viz. M/s Ushma, M/s Space and M/s Bonito were already doing the business with State Trading Corporation Limited (STC) on similar lines but were in default during the period 2007-08. As the Company was aware of the dealings of the three associates with STC, it should have checked their performance vis-a-vis STC when it renewed their Memorandum of Agreements with three associates in August 2008.The Company, thus, did not take due care in selecting the associates. Rather, it extended undue favour to them by allowing to carry out the export transactions with each other (refer to para 17.2.5) and thus they enjoyed higher credit exposure (refer to para (17.2.6).

Management's contention (October 2010), that the Company did not extend undue favour to any of the associates, was not acceptable in view of the manner in which the Company selected its associates.

17.2.5 Identification of foreign buyers

The foreign buyers were identified by the associates and the Company did not verify their credentials. The associates also arranged to obtain export orders in the name of the Company. There was no agreement between the Company and the foreign buyers for the export and even the Company did not make any official communication with them before such export. It was observed that out of 47 foreign buyers related to export of gold jewellery during 2008-09, 18 were dealing either in wholesale business of stainless steel, food stuff, building materials or garments but 39 *per cent* of the total export of gold jewellery during 2008-09 was made to them. It was observed that in respect of 20 foreign buyers, ownership was concentrated in the hands of a few persons. Further, Director of one associate (Joshi) was also owner/ Director of 4 foreign buyers[♣] and three of them received gold jewellery from Space and another from Ushma during 2008-09. The existing related party relationship of Bond and KA Malle (other two associates) with Joshi and Space, respectively, indicated that the above five associates were having transactions between themselves. It was also observed that eight foreign buyers to whom gold jewellery worth of ₹ 99.78 core was exported were found not traceable. It was, further, observed that the principals of 13 foreign buyers refused to accept any liability of export dues of ₹ 187.13 crore on the ground that gold jewellery was actually not received by them.

[♣] ***(i) Himalaya Diamonds (₹ 17.54 crore by Ushma), (ii) Superior General Trading (₹ 9.69 crore by Space), (iii) Golden Stock Electronics (₹ 19.89 crore by Space), (iv) Leo Diamonds (₹ 13.80 crore by Space)***

Thus, the Company did not carry out due diligence in identifying the foreign buyers and left it completely on the associates who were the ultimate beneficiaries in the export business by receiving 80 *per cent* of the export proceeds as advance from the Company.

Management stated (October 2010) that it had relied on the due diligence made by the insurers regarding the foreign buyers. This contention was, however, not acceptable since as per the insurance policies, the Company was required to carry out due diligence in granting credit to the foreign buyers and the insurers did not make any independent investigation in this respect.

Recommendation

The Company should exercise due diligence in selecting the associates/ foreign buyers before entering into business transaction with them.

17.2.6 Safeguarding of financial interest

As per agreement, the associates were required to bear all the risks and costs in case of non-payment of export proceeds by the foreign buyers. Since advance up to 80 *per cent* of the export proceeds was payable to the associates immediately after export, the Company should have taken adequate measures to safeguard its financial interests before releasing such advance. Contrary to this, the Company modified (August 2007/ September 2008) original clause of the agreement enabling the Company to encash Post-Dated Cheques (PDC), covering equivalent amount of advance payable to associates in the event of non-receipt of export proceeds from the foreign buyers. As per modified clause, the PDCs could have been encashed only in the event of non-payment by the foreign buyers due to disputes with the associates relating to quantity, quality and price.

Thus, the financial interest of the Company was not safeguarded against protracted default by the foreign buyers. It was also observed that there was no provision in the agreement to obtain collateral security from the associates to cover the amount of advance payable to them. The financial position of the associates was also not considered while fixing their credit exposure as the advances given by the Company during 2008-09 ranged between 7 and 111 times of their networth. The Company, therefore, depended on the insurance coverage only, for safeguarding its financial interests towards recovery of advances from the associates in the event of non-realisation of export proceeds (refer to para 17.2.7).

Management stated (October 2010) that the associates did not agree to give PDCs for non-payment as envisaged in the agreement originally and the relevant clause of the agreement was therefore amended. It was also stated that the insurance coverage would not have been available had the Company accepted the PDCs from the associates for non-payment of export proceeds by the foreign buyer.

The above contention of the Management was not acceptable as the insurance coverage was taken towards non-realisation of dues from foreign buyer only. Further, the advances paid to associates were as per the agreement entered into with them and therefore there was no relationship between the non-recovery of such advances and the insurance coverage. Management's contention was also contradictory in view of the fact that the Company took insurance coverage irrespective of the clause of the agreement with the associates that all the risks and costs of the export business would ultimately be borne by them.

Recommendation

The Company should take adequate measures to safeguard its financial interest before making any advance payment.

17.2.7 Insurance coverage of export of gold jewellery

As per agreement, the Company would arrange to insure the risk of non-realisation of the export proceeds from the foreign buyers. The insurance premium was to be recovered from the associates. The Company accordingly insured the risk of non-payment of export proceeds of 2007-08 with ECGC. This insurance policy was renewed (September 2008) for the exports of 2008-09 to cover the risk of non-payment of dues by the foreign buyers whose bills (₹ 453.54 crore) were to be discounted through four banks. In addition, the Company took (August 2008) another insurance policy from ICICI Lombard General Insurance Co. Ltd. (ICICIL) to cover the risk of non-payment of export dues (₹ 184.66 crore) for which loan from Standard Chartered Bank (SCB) was obtained. The Company paid insurance premium of ₹ 4.37 crore during 2008-09 for the above policies. As per the terms and conditions of the policy with ECGC, the whole export proceeds of the Company were to be insured. It was also specified in the policy of ICICIL that the Company should not enter into any other export trade insurance policy without the consent of insurer.

It was observed that export business with five foreign buyers (during 2008-09) was covered under these two insurance policies. This was, however, not disclosed to the insurers. It was also stipulated in the above policies that the Company should exercise reasonable care and prudence in granting credit to the foreign buyers. It was, however, observed that the Company did not carry out due diligence in identifying the foreign buyers. It was, further, observed that the Company also did not disclose the insurers about the contractual obligations of the associates to bear the entire risks and costs in the event of non-realisation of export proceeds from the foreign buyers.

Management stated (October 2010) that there was no condition in the policies, debarring the Company to carry out export under any other policy and also not to enter into any other insurance policy without the consent of insurer. Management further contended that the agreement of the Company with the associates was an internal arrangement between them and the insurers were not party to the same and thus there was no need to disclose such information to the insurers.

The above contentions of the Management were not based on the facts as it was clearly mentioned in the first para of the insurance policy of ECGC that the policy was meant to cover whole of the export trade of the Company with buyers in the specified countries during the policy period. Condition 5 (b)(i) of the insurance policy of ICICIL also clearly mentioned that the "Insured must not, without written consent of ICICI Lombard enter into any trade credit insurance policy that indemnifies the insured in relation to the insured's own Account". The contention of the Management with regard to arrangement between the Company and the associates, specifying that the associate and not the Company would ultimately bear the loss, being an important fact, hence should have been disclosed to the insurers prior to taking up such insurance policies.

Recommendation

The Company should disclose all material facts to the insurer before taking up insurance coverage and also strictly adhere to the terms and conditions of the insurance policy.

17.2.8 Non-payment of dues by the foreign buyers

During 2008-09, gold jewellery worth ₹ 638.20 crore was exported by six associates to 47 foreign buyers and the last batch of export was made in November 2008. The Company discounted export bills worth ₹ 453.54 crore from four banks[1] and also obtained loan from one of the above banks i.e. Standard Chartered Bank, against the balance bills worth ₹ 184.66 crore. Six associates were paid ₹ 501.55 crore as advance. 46 foreign buyers did not pay their dues of ₹ 598.63 crore to the banks on the due dates. The Company paid ₹ 68.78 crore as interest, bank charges and discounting charges to the banks. Further, Fixed Deposit Receipt (FDR) of the Company amounting to ₹ 25 crore as security against the bank loan was encashed (April 2009) by the Standard Chartered Bank. In addition, the Company had to incur crystallisation loss[2] of ₹ 53.06 crore as deducted by banks. The Company could realize only an amount of ₹ 10.48 crore from the associates thus an advance amounting to ₹ 528.49 crore (including crystallisation loss) remained unrealised. Even the post dated cheques deposited by them could not be encashed as the non-payment by the foreign buyers was not due to disputes relating to quantity, quality and price.

The Company subsequently received (November 2008) two Bank Guarantees (BGs) amounting to ₹ 62 crore from two associates (Ushma – ₹ 32 crore and Space ₹ 30 crore) as security towards the exports to be made in future i.e. after December 2008. Since there was no export after November 2008, the above BGs could not be encashed. Further, 14 FDRs amounting to ₹ 100 crore issued by Pen Co-operative Bank (PCB), a non-scheduled urban co-operative bank, were received (April 2009) from Ushma (₹ 52 crore) and Space (₹ 48 crore) with the condition to encash the same on maturity (between October 2010 and June 2011) only. The Company placed (03 September, 2010) six FDRs maturing on 28 October 2010 amounting to ₹ 30 crore (₹ 15 crore pertaining to Space and Ushma each), to PCB for encashment. In the meantime, the Reserve Bank of India precluded the PCB, with effect from 22 September 2010, from incurring any liability or granting/renewing any loans/advances or making any payments or discharging any liability or obligation, vide its directives dated 21 September 2010. The Company, as such, could not encash these FDRs. It was worth mentioning that the above bank was having a meagre deposit of ₹ 400 crore only and one[3] of its Directors was an ex-Director of an associate (Space).

Thus, an amount of ₹ 611.79 crore remained unrecovered (August 2010) from the associates. The Company, however, referred (December 2009) the matter to arbitration.

[1] Corporation Bank, United Bank of India, Indian Overseas Bank and Standard Chartered Bank

[2] Foreign currency loss due to difference in foreign currency rates prevailing on the date of discounting of bills and due dates of payment of such bills.

[3] Shri Shishir P. Dharkar, was Director of Space from August 2000 to June 2007

17.2.9 Rejection of claim by insurers

Insurance claims were lodged (November 2009/ January 2010) with ECGC and ICICIL for non-realisation of export proceeds from the foreign buyers. Both the insurers, however, rejected such claims on the ground that as per the agreement with the associates, all the risks and costs in this business was to be borne by them in the event of non-payment by the foreign buyers and as such the Company did not have any insurable interest. Further, the insurance policies would cover only the risk of non-payment by the foreign buyers and in this case the risk of the Company arose due to non-realisation of advances from the associates who were the actual exporters.

Management stated (October 2010) that the Company was considering to initiate legal action against the insurers and the foreign buyers.

Conclusion

The business of post shipment finance of export of gold jewellery was conceived by the Company on being approached by the associates only. The Company ventured into this business inspite of the fact that there was high risk involved in the business with a meagre return. Moreover, the demand for the gold jewellery in the foreign market was not assessed. The associates in fact controlled the entire export business by selecting the foreign buyers, obtaining the export orders and also exporting the gold jewellery in the name of the Company. The Company financed to the extent of 80 *per cent* of the export proceeds to the associates immediately after export without any financial safeguard for recovery of the same in the event of non-receipt of export proceeds from the foreign buyers on due dates. The Company did not also verify the credentials of the associates and the foreign buyers. There was related party relationship amongst the associates themselves and also between one associate and four foreign buyers but the Company ignored their related party relationship. The Company ventured into this risky business without safeguarding its own financial interests. Thus, there were serious lapses on the part of the Management.

Finally, the Company had to face a financial burden of ₹ 611.79 crore due to non-recovery of advance and related financial expenses, from the associates for gold jewellery exports during the year 2008-09, as the foreign buyers defaulted to pay their dues. The insurers also refused to make good the loss on the grounds that the Company did not have any insurable interest in the business as all the risks and costs in this business were to be borne by the associates only and also due to violation of terms and conditions of the insurance policies by the Company.

The matter was reported to Ministry in November 2010; reply was awaited (February 2011).

17.3 Idle investment

Imprudent decision of the Company to set up an economically unviable stockyard resulted in an idle investment of ₹ 12.51 crore.

MSTC Limited (Company) dealing with import and export of materials on behalf of customers, decided (April 2005) to set up its own stockyard adjacent to Haldia port with a view to enhance business opportunity, reduce cost and ensure better control on the pledged materials. The Company, accordingly, acquired (April 2007) 15 acres of leasehold land from Haldia Dock Complex (HDC). The construction work of the stockyard commenced in August 2007 and the same was completed (June 2009) at a cost of ₹ 9.44 crore. The stockyard, however, remained unutilized (September 2010). Besides the above expenditure the Company had so far (31 March 2010) incurred ₹ 3.07 crore on the stockyard towards cost of acquisition of land, lease rent and other miscellaneous expenditure. Finding no scope of economic utilisation of the stockyard, the Company explored (May 2010) the possibility of returning the land to HDC or subleasing the stockyard to interested parties which was also found to be economically unviable.

It was observed that before setting up the above stockyard the Management was aware that maintaining its own stockyard for export of materials would not be remunerative due to higher expenses, low turn-over and thin margin on account of poor navigability of Haldia port. The decision to set up its own stockyard to ensure better control of materials was also not justified since the imported/exported materials were always kept under the custody of a third party selected by the Company. Further audit noticed that other PSUs like MMTC and State Trading Corporation of India Ltd. (STC) engaged in similar trading business did not have their own stockyards and such services, whenever required, were taken from the companies operating such stockyards.

The Management stated (September 2010) that more time is required to explore and make the stockyard operational and to recover the capital cost. The reply is not tenable as despite the fact that the feasibility study did flag the concerns for a viable proposal, the Management went ahead with the construction of the stockyard on the plea that business opportunities would flow in future. Moreover, the fact also remains that till an alternative arrangement for making the stockyard economically viable is worked out, the entire expenditure of ₹ 12.51 crore will remain idle.

Thus, due to injudicious decision of the Company to set up a stockyard, the entire investment of ₹ 12.51 crore became idle.

The matter was reported to Ministry in October 2010; reply was awaited (February 2011).

Rashtriya Ispat Nigam Limited

17.4 Irregular payment to employees

Payment of cash and one additional increment to ineligible employees in contravention of DPE guidelines resulted in irregular payment of ₹ 18.61 crore

Department of Public Enterprises (DPE) issued instructions on 20 November 1997 to all Public Sector Undertakings (PSUs), interalia, directing that the employees of PSUs drawing wage/salary exceeding ₹ 3500 per mensem (increased to ₹ 10,000 per mensem w.e.f. April 2006) would not be paid ex-gratia, honorarium, reward etc., unless the amount was authorized under a duly approved incentive scheme in accordance with the prescribed procedure.

The payment of ex-gratia by a large number of PSUs to their ineligible employees was pointed out in the previous Audit Reports (Commercial)[♣]. The matter was referred (February 2005) to DPE seeking clarification on payment of ex-gratia to ineligible employees. The DPE clarified (December 2005) that the payment of ex-gratia to ineligible employees was not allowed as per its Office Memorandum dated 20 November 1997 and that there was no provision for DPE/ Administrative Ministry to approve the payment of ex-gratia/ bonus to the ineligible employees in PSUs. However, the PSUs continued to make payments of ex-gratia/reward to their employees irregularly ignoring the instructions issued by DPE.

Audit observed that, in violation of the DPE guidelines, Rashtriya Ispat Nigam Limited (RINL), Visakhapatnam paid in cash (June 2006) ex-gratia of ₹ 8.25 crore at the rate of ₹ 5000 per employee on the occasion of Foundation Stone Laying Ceremony for the expansion/Prime Minister's Trophy for the Best Integrated Steel Plant in June 2006 and ₹ 10.36 crore on account of one additional increment/Special Personal Pay from 1 January 2007 on the occasion of Silver Jubilee celebrations in 2007 to ineligible employees without any approved incentive scheme.

The Management in its reply (September 2010) mainly contended the following:

- the payment of ₹ 5000 per employee and the grant of one additional increment was made to celebrate a very important event in the history of the Company to boost the morale and motivation levels of the employees; and
- since, both the payments made were one time measures and not in lieu of any bonus, the payments were not to be construed as ex-gratia payments within the purview of the DPE OM No. 2(22)/ 97 – DPE (WC) dated 20 November 1997.

The contention of the Management was not convincing in view of the following:

- the payments made in the form of cash and Special Personal Pay by RINL were not authorized under any duly approved incentive scheme in accordance with the prescribed procedure as per Para No. 5 of DPE OM No. 2(22)/ 97 – DPE (WC) dated 20 November 1997; and
- in addition to providing guidelines for payments towards bonus, the OM clarified on payments towards ex-gratia, honorarium, reward etc. .

Thus, payments in the form of cash and one additional increment to ineligible employees by the Company in contravention of DPE guidelines resulted in irregular payment of ₹ 18.61 crore.

The matter was reported to the Ministry in September 2010; reply was awaited (February 2011).

[♣] ***Report of the Comptroller and Auditor General of India (Commercial) No. 3 of 1994, 1995, 1999 to 2004, Report No. 13 of 2006 and Report No. 24 of 2009-10***

Steel Authority of India Limited

17.5 Blast Furnace Productivity and Production of Steel in Visvesvaraya Iron and Steel Plant, Bhadravathi

Introduction

Visvesvaraya Iron and Steel Plant (Plant) engaged in the manufacture of alloys and special steel of various grades catering to the needs of Defence, Railways and Automobile Sectors was acquired (August 1989) by Steel Authority of India Limited (SAIL) and became a subsidiary of SAIL. It was merged with SAIL in December 1998. The Plant is functioning as a unit of SAIL.

Scope of audit

Audit conducted between April and July 2010 covered the operations of Blast Furnace and Steel Making Shop (SMS) of the plant with reference to productivity, capacity utilisation, production performance, quality of hot metal produced, and production/handling losses during the three years ended 31 March 2010.

Audit objectives

The Audit was conducted with a view to assess the productivity of BF and performance of SMS.

Audit criteria

The audit criteria adopted for assessing the achievement of the audit objectives were:

- Productivity of Blast Furnace was reviewed with reference to the working volume of furnace and actual production achieved during the previous years, norms as per Annual Performance Plans, techno economic parameters, consumption and quality of raw materials and other inputs and handling losses;
- The performance of SMS was analysed with reference to available hours for operation and hours lost and production loss due to troubles faced in SMS.

Audit methodology

Audit examined records relating to budgets, targets, financial and production performance and interaction with the Management.

Financial position and Working Results

The table below summarises the Financial Position and Working Results of the plant for the last three years ended 31 March 2010:

PARTICULARS	Amount (₹ in crore)		
	2007-08	2008-09	2009-10
Inter Unit Current Account	1112.08	1198.10	1296.93
Cash Credit	0.00	12.11	0.00
TOTAL	**1112.08**	**1210.21**	**1296.93**
Net Block of Fixed Assets (including CWIP)	98.45	138.84	157.94
Working Capital	343.3	257.04	223.98
Miscellaneous Expenditure	5.29	0.00	0.00

Accumulated Loss	665.04	814.33	915.01
TOTAL	**1112.08**	**1210.21**	**1296.93**
Net Sales	639.59	525.61	466.43
Other income	66.58	67.59	67.58
Total Income	**706.17**	**593.2**	**534.01**
Total Expenditure	**764.96**	**742.49**	**634.69**
Loss before Tax	**58.79**	**149.29**	**100.68**

The Plant's income declined from ₹ 706.17 crore in 2007-08 to ₹ 534.01 crore in 2009-10. The accumulated loss stood at ₹ 915.01 crore as on 31 March 2010. The turnover of the Plant had declined considerably during 2008-09 and 2009-10 due to sluggish market conditions coupled with usage of inferior quality of raw material as discussed in the subsequent paragraphs.

Production Process

Blast Furnace Plant

Blast Furnace with a working volume* of 450 cubic metre (m^3) uses critical raw materials *viz.*, Iron ore and Coke. Iron ore is melted with coke as its heating agent. During the process flux materials like limestone, dolomite *etc.*, are used to remove impurities in iron ore, resulting in production of hot-metal.

During production of hot-metal by-products like slag and gas are generated. Slag is sold as such. BF gas is used as fuel in BF and SMS. The residual BF gas is flared.

Steel Making Shop and Mills

At SMS, on receipt of hot-Metal from Blast Furnace, Oxygen is blown to remove impurities and alloys are added as per the customer's specification to produce liquid steel. The liquid steel then being casted either through ingot mould boxes or passed through Continuous Casting Machines (CCM)/ Bloom Caster to produce crude steel. The crude steel produced (Ingots/ CCM Blooms) is then rolled at mills as per the requirement.

Audit findings

17.5.1 Production Performance of Blast Furnace

The production of hot metal during 2007-10 compared to installed capacity vis-a-vis the budgeted target is indicated below:

Year	(Lakh MT)			Achievement (*per cent*) as to		Shortfall in production with reference (Lakh MT)	
	Installed capacity *	**Budgeted Production**	**Actual Production**	**Installed capacity**	**Budgeted Production**	**Installed capacity**	**Budgeted Production**
2007-08	2.16	2.80	2.18	101	78	0.00	0.62
2008-09	2.16	2.80	1.25	58	45	0.91	1.55
2009-10	2.16	1.52	1.26	58	83	0.90	0.26

**** Capacity with Double Blower operation as per detailed project report.***

* ***Out of total volume of 530 m^3***

The above table shows that during 2007-10 hot-metal production ranged between 58 and 101 *per cent* of the installed capacity and 45 and 83 *per cent* of budgeted capacity. Reasons for budgeting the production more than the installed capacity during 2007-08 and 2008-09 were not on record. The Plant could not achieve budgeted production in any of the three years ended March 2010 and operated only on Single Blower during 2009-10 to curtail the production due to uncompetitive market conditions. It is observed in Audit that the planned production being much higher than the capacity declared, adoption of such capacity figure did not form a realistic basis for assessing the capacity utilisation of Blast Furnace.

On a comparison, the Blast Furnace of KIOCL Limited (another Central Government Company), Mangalore with working volume of 350 m^3 had an installed capacity of 2.16 lakh MTs of hot-metal as against the VISP's Blast Furnace capacity of 2.16 lakh MT from 450 m^3 working volume.

The Plant Management stated (October 2010) that by reorienting the sourcing of raw material from the Raw Material Division (RMD) (Ore) of SAIL, ISSCO and M/s Gujarat Nre for coke, cost reduction was anticipated during second half of 2010-11 thereby offering competitive prices which would help improved loading in the Plant.

Reply of the Management did not address the observation about the correctness of the installed capacity being adopted by the Plant.

Recommendation

The Company should re-assess the installed capacity of the Plant based on the working volume and re-fix the installed capacity on scientific and realistic basis in order to measure its performance.

17.5.2 Declining productivity of Blast Furnace:

The productivity of the blast furnace is measured in terms of tonnes of hot metal produced, per cubic meter of blast furnace working volume, per day (Tonnes/m^3/day). Iron ore was procured mainly from National Minerals Development Corporation Limited (NMDC)- a Central Government Company, and partly from Raw material Division (RMD) of SAIL (through Inter-plant transfer). Coke was sourced mainly from SAIL's sister Plants and partly from other sources. The table below summarises the productivity of Blast Furnace:

Particulars	2007-08	2008-09	2009-10
Hot Metal produced (in Metric Tonne)	2,17,892	1,25,343	1,25,969
Working volume of furnace (in m3)	450	450	450
Number of days worked	359	297	359
Productivity (Tonne per m^3 per day)	**1.37**	**0.90**	**0.80**

It would be seen from the above that the productivity of Blast Furnace had declined from 1.37 tonnes/ m^3/day in 2007-08 to 0.80 tonnes/ m^3/day in 2009-10. Apart from curtailment in production levels due to market constraints during 2008-09 and 2009-10, the reasons for declining trend in productivity were due to (i) increase of Silica (SiO_2) content and decrease in iron (Fe) content in iron ore as against the Annual Performance

Plan (APP)[*] norm (ii) increase of ash content and decrease in fixed carbon in coke as against the APP norm as seen from the table below:

	APP Norms	2007-08	2008-09	2009-10
IRON ORE				
Percentage of Fe content	65 minimum	65.06	64.36	63.95
Percentage of SiO2 content	2.5 maximum	2.65	2.38	3.21
COKE				
Percentage of fixed carbon	86 minimum	84.73	84.9	81.54
Percentage of ash content	12 maximum	13.99	14.03	17.24

It would be seen from the above that the quality of raw materials used by the Plant was not as per APP norms except Fe content during 2007-08 and silica content during 2008-09.

The Plant Management admitted (October 2010) that productivity of the Blast Furnace was affected by the quality of raw materials charged to Blast Furnace and that efforts were being made to expedite the allotment of iron mines for the Plant so as to get good quality of iron ore with less fines.

The Reply was not convincing due to the fact that even after a lapse of six years, when the Kemmangundi (KGD) iron ore mines from where the ore was sourced for the plant was closed (June 2004) as per the Orders of Ministry of Environment and Forests based on environmental issues, the Plant was not successful in getting its own iron ore mines in Karnataka so far (December-2010).

Recommendation

Plant should make concerted efforts to get its own iron ore mines early and ensure procurement of good quality raw material with a view to increase productivity of Blast Furnace.

17.5.3 Quality of Raw Materials:

Poor quality of raw materials as above resulted in (i) excess consumption of iron ore and coke, (ii) deteriorating quality of hot metal (iii) excess ladle loss in transportation of hot-metal to user departments and (iv) low lining life of hot-metal ladles, as discussed below:

17.5.3.1 Excess consumption of Iron Ore & Coke

The Fe content in the iron ore used in Blast Furnace which was 65.06 *per cent* in 2007-08 decreased to 63.95 *per cent* in 2009-10 as against APP norms of 65 *per cent* minimum which resulted in excess consumption of iron ore by 207 and 378 kilogram (Kg.)/Tonne Hot Metal (THM) over APP norms during 2007-08 and 2008-09 respectively. The percentage of excess consumption of iron ore over APP norms which was at 11 *per cent* in 2007-08 increased to 21 *per cent* during 2008-09 resulting in extra expenditure on account of excess consumption of iron ore to the extent of ₹ 25.73 crore. Further, it could be seen from the table below that the quality of hot metal deteriorated due to decline in Fe content and increase of SiO_2 content in the iron ore:

[*] ***The Plant in order to assess its performance prepares APP wherein norms are fixed for consumption of raw materials, power, and transportation and handling losses considering the quality of raw materials, production process involved and operational conditions.***

Particulars	2007-08	2008-09	2009-10
Percentage of Silicon content in hot metal	0.91	1.21	1.26
Percentage of Fe content in hot metal	94.71	94.47	94.31

As regards coke, the Plant could not contain the consumption against APP norms in any of the years under review. This was mainly due to decrease in fixed carbon content in coke from 84.73 *per cent* in 2007-08 to 81.54 *per cent* in 2009-10 as against the APP norm of 86 *per cent* minimum and increase in ash content in coke from 13.99 *per cent* in 2007-08 to 17.24 *per cent* during 2009-10 as against APP norm of 12 *per cent* maximum which resulted in extra expenditure of ₹ 149.35 crore on account of excess consumption of coke by 137, 189 and 304 Kg./THM during 2007-10.

It was observed that the percentage of coke sourced from SAIL units as compared to procurement from other sources had increased from 29 *per cent* in 2007-08 to 53 *per cent* in 2008-09 and to 96 *per cent* in 2009-10. Concurrently, there was a drastic increase in generation of coke breeze from 10 *per cent* in 2007-08 to 13 *per cent* in 2008-09 and 18 *per cent* in 2009-10. Taking coke breeze generation of 10 *per cent* of 2007-08 as a base, the Plant had incurred an avoidable payment of freight of ₹ 2.57 crore for the two years 2008-09 and 2009-10 merely for its disposal. The Plant also ended up with accumulation of Coke breeze stock of 44284 MT valued ₹ 38 crore as on March 2010.

The Project Report (1990) for the Blast Furnace envisaged installation of Sinter Plant at later stage, after setting up of the Blast Furnace. Unlike in most of the SAIL Plants where Sintering facility is available to make use of iron ore fines/coke breeze, no such facility existed in VISP till date (December 2010). Use of sinters in Blast Furnace reduced the consumption of raw materials to a greater extent in production of hot-metal as could be seen from the comparison with Durgapur Steel Plant (DSP), Durgapur as given below:

(Kgs. per tonne of hot-metal)

Consumption rate	VISP			DSP		
	2007-08	2008-09	2009-10	2007-08	2008-09	2009-10
Iron ore	2,018	2,178	1,760	515	501	495
Coke	837	939	1,054	522	500	506

The Plant Management (October 2010) admitted that (i) the major effect of decreasing Fe content in Iron Ore was on the consumption of coke, ore and fluxes; (ii) the gross iron ore consumption was high in 2007-08 and 2008-09 due to higher percentage of fines in iron ore; (iii) the Management was in the process of reworking the agreement with NMDC for supply of good quality iron ore with less fines; (iv) as far as Inter Plant Transfer (IPT) is concerned, there were no fixed guaranteed specifications and the material available at the respective plants was issued to VISP and coke breeze generation was more due to many handlings and (v) efforts were being made to transfer coke breeze to sister plants.

The Plant Management could have reduced the consumption of raw materials had they initiated action to put up its own Sinter Plant to avoid accumulation of coke breeze. Further, the option of transporting coke-breeze to sister plants might not be viable in view of the sufficient stock of breeze available with these plants.

17.5.3.2 Excess ladle loss in transportation of hot metal

It was observed that while transporting hot-metal from blast furnace to down stream production units through hot-metal ladles, the unit suffered loss of hot-metal called ladle loss because of skulling due to drop in temperature of hot-metal.

The percentage of ladle loss during 2007-08 was 1.96 as against the APP norm of 0.75. The Plant Management revised its own APP norm from 0.75 *per cent* to 1.5 *per cent* from 2008-09 onwards. Despite increasing the APP norm, the actual percentage of ladle loss was higher than the APP norm which reached alarming levels of 4.05 *per cent* and 6.30 *per cent* in 2008-09 and 2009-10 respectively. Considering the increased norm of 1.5 *per cent* of the year 2008-09 as a base, the Plant incurred a loss of ₹ 8.45 crore during the three years ended 2009-10.

17.5.3.3 Low lining life of hot-metal ladles

Average tonnage of hot metal handled by a hot metal ladle before it was taken out of circulation for re-lining had declined sharply from 1171 MT in 2007-08 to 548 MT in 2009-10 due to non-operation of mixer♦ unit and inferior quality of coke.

The Plant had no norms for the lining life of hot metal ladles. Keeping the performance of average tonnage handled per each lining in 2007-08 as base, the extra expenditure incurred by the Plant was to the extent of ₹ 2.72 crore.

Plant Management (October 2010) admitted that increase in ladle loss and decrease in the lining life of hot metal ladle was on account of use of inferior quality of coke and subsequent temperature drop of tapped hot metal due to increase in time of holding hot metal ladles necessitated by non-operation of Mixer Unit at SMS since November 2008. The Management also stated that the mixer operation was discontinued to save on furnace oil cost.

Audit also observed that no cost benefit analysis was done by the Plant taking into consideration the value of precious raw material wasted due to skulling/process cost incurred in BF operation, excess power consumption at Ladle Refining Furnace (LRF) due to reheating, relining cost of hot-metal ladles and reduced availability of hot-metal for production of steel.

Recommendation

The Management should (i) incorporate suitable clauses in agreement with NMDC to ensure supply of quality iron ore to safe-guard the economic interest; (ii) ensure supply of quality coke so as to reduce consumption of raw materials and to improve the quality of hot-metal; and (iii) reconsider its decision of discontinuation of operation of mixer unit by making a comprehensive cost benefit analysis to reduce ladle loss and increase lining life of hot-metal ladles.

♦ ***Mixer was being operated as intermediary storage till November 2008 so as to maintain the Hot Metal temperature at SMS before drawing the metal for further processing.***

17.5.4 Utilisation of Blast Furnace Gas

Blast Furnace gas is generated as a by-product in Blast Furnace during its operation. Part of BF gas generated is used internally for stove heating in Blast Furnace, SMS Department and heating furnaces of Heat Treatment Shop (HTS). The remaining Blast Furnace gas is flared to the atmosphere resulting in loss of energy which otherwise could have been utilized for power generation. It was observed that the short-term plan which envisaged usage of Blast Furnace gas in New Reheating Furnace at primary mill was yet to be implemented and the plant had no long-term measures for using the excess Blast Furnace gas. The Board envisaged (1997) installation of 7.5 MW of power plant to effectively utilize the surplus gas to conserve energy, reduce procurement of power as well as pollution. The report also projected a gross margin of ₹ 1.86 per Kwh of power being generated.

KIOCL, Mangalore which operated a BF with 350 m^3 capacity had installed 3.5MW Captive Power Plant (CPP) and been gainfully utilizing the BF gas to produce captive power.

By establishing a CPP, the dependence of Plant on Karnataka Power Transmission Corporation Limited (KPTCL) towards procurement of power would have been reduced by 25.67 million units during the three years ended 2009-10 and a saving of ₹ 4.78 crore[1] could have been effected.

The Plant Management stated (October 2010) that the excess BF gas generated over the actual usage in down stream facilities was being flared to atmosphere. It was further stated that as a short term measure, the proposal of utilization of BF gas in the new Re-heating Furnace in Primary Mill was being considered.

Management's reply was not acceptable as the short term plan envisaged in 1997 was yet to be implemented and the Management had not formulated (December 2010) any long term plans for installation of CPP to utilize the excess BF gas to prevent loss of energy.

Recommendation

Plant should take effective steps to beneficially use the BF Gas being flared by implementing short term and long term plans.

17.5.5 Performance of Steel Making Shop (SMS):

The production of crude steel during 2007-10 compared to installed capacity vis-a-vis the budgeted target is indicated below:

Year	(lakh MT)			Achievement (*per cent*) as to		Shortfall in production with reference (lakh MT)	
	Installed capacity	Budgeted Production	Actual Production	Installed capacity	Budgeted Production	Installed capacity	Budgeted Production
2007-08	0.80	1.81	1.59	198	87	0	0.22
2008-09	0.80	1.87	0.96	120	51	0	0.91
2009-10	2.05[2]	1.41	1.03	129	73	0	0.38

[1] ***Rs.1.86 per unit X 25.67 million units***

[2] ***Plant commissioned (2009-10) a new Bloom Caster, which further increased the Crude steel production capacity by 1.25 lakh MTs***

It would be seen from the table that during 2007-10 production of crude steel ranged between 120 and 198 *per cent* of the installed capacity and 51 and 87 percent of budgeted capacity. Reasons for budgeting the production more than the installed capacity during 2007-09 were not on record. The basis of determining the installed capacity was not made available to Audit. The Plant could not achieve budgeted production in any of the three years ended March 2010 due to uncompetitive market conditions.

The Management did not specifically reply about the correctness of the installed capacity being adopted by the plant.

Recommendation

The Plant in order to realistically assess its performance should revisit the installed capacity of SMS

17.5.6 SMS Furnace Availability

On a review of availability of Basic Oxygen Furnace (BOF-A & B) at SMS, it was observed that during 2007-08 to 2009-10, the BOFs were operated for less number of hours than the hours available ***(Annexure-IX).***

Audit observed that the Plant could work for only around 50 *per cent* of the available hours during the years under review and lost 50 *per cent* of hours *viz.* 13 *per cent* due to planned shut down, 16 *per cent* due to unscheduled shut down (on account of production curtailment in BF) and 21 *per cent* due to other reasons like electrical and mechanical troubles. Despite providing 13 *per cent* of the total hours available for planned shut down for maintenance purposes, the Plant could not prevent stoppages due to other reasons like electrical, mechanical and operational troubles *etc.*

Further analysis in audit revealed that the Plant lost around 14 *per cent* of the available hours on account of operational troubles towards maintenance and refractory repairs of converters which resulted in loss of crude steel production of 1,44,311 MT.

The Plant Management stated (October 2010) that (i) there was market recession during 2008-09 and 2009-10 and consequent shortage of orders; (ii) waiting of equipment mainly for input like hot metal; (iii) trouble hours were inevitable as the equipment were old and overloaded; and (iv) as the equipments are old, preventive maintenance was necessitated to enhance the life of the equipment.

The Reply was not convincing as the audit observation related only to trouble hours which could have been minimized with better preventive maintenance for utilization of BOF.

17.5.7 Excess Slag and handling loss at SMS

Hot-metal received at SMS from Blast Furnace is consumed at SMS for production of liquid steel. Audit observed that there was wide difference between the quantity of hot-metal received and quantity of hot-metal consumed at SMS. The Plant accounts for the above difference as 'slag and handling loss'. During 2008-09 and 2009-10, the Plant could not contain the slag and handling loss within APP norms. The norm was reduced from 8 *per cent* in 2007-08 to 6.5 *per cent* in 2008-09 and to 4 *per cent* in 2009-10. However, the actual slag and handling loss increased from 5.95 *per cent* in 2007-08 to 7.75 *per cent* in 2009-10 by which Plant suffered a loss of ₹ 3.73 crore.

The Plant Management stated (October 2010) that (i) APP norm was based on targets fixed for bigger steel plant and that the slag and handling loss included spillage during charging to mixer, pouring to transportation ladles from mixer, pouring to converter for blowing (ii) due to intermittent operation of SMS and controlled operation of BF. As a result, the slag and handling loss was higher than the norms fixed.

The reduction of norms was a conscious Management decision. The actual loss increased during the period under review. Further, such losses could have been minimized had the Plant taken action for careful emptying of hot-metal ladle into the converter without spillage of hot-metal and proper training of the operators.

Recommendation

The Plant needs to initiate action for more effective skimming and careful handling of hot-metal to reduce slag and handling loss of hot-metal.

17.5.8 Excess consumption of Power in production of steel

The Plant was purchasing power from KPTCL for consumption in production units. On a review of consumption of power, it was observed that in respect of BF and SMS units, the actual power consumption was not within the norms in any of the three years ended 2009-10. As a result, excess consumption of power for the years 2007-08 to 2009-10 amounted to ₹ 7.15 crore.

The Plant Management stated (October 2010) that (i) in respect of BF with increased production, the consumption of power would come down (ii) higher power was consumed in SMS due to process requirement for specified grades as per the requirement of customers (iii) due to lower volume of production, the gap between each heat widened resulting in increased delay in circulation of ladle as it become cold and the drop in temperature in steel ladles necessitated higher power consumption.

The reply was not convincing as despite and production of hot-metal being almost at the same level of 1.25 lakh MTs in 2008-09 & 2009-10, there was huge variation in power consumption of 50 kwh/MT (*i.e.* 231 Kwh –181 Kwh).

The matter was reported to the Ministry in November 2010; reply was awaited (February 2011).

17.6 Installation of Steel Processing Units

The proposal for setting up of Steel Processing Units (SPUs) in 10 sites to meet specific requirements of customers could not proceed beyond in-principle approval stage in eight units due to in-sufficient surveys, non-availability of infrastructural facilities and non ensuring of concessions from the state Governments concerned resulting in failure to achieve the stated objectives and idle investment of ₹ 101.75 crore.

Introduction

The Steel Authority of India Limited (Company) decided (May 2007) to set up Steel Processing Units[♣] (SPUs) at different parts of the country especially in states where there

[♣] ***SPUs are manufacturing units set up at a location beyond the plant to process the semis into marketable product or size the finished product according to the demand of customers.***

was no steel plant to meet customer demand for supplying sized and finished steel near the point of consumption, to increase the consumption of steel in rural areas and to expand market base. It was also envisaged that SPUs would help in increasing the per capita rural consumption of steel from 2 kg per annum to 4 kg per annum as per National Steel Policy by 2019-20 and generate employment opportunities. The pre-requisites for setting up SPUs were tax concessions/exemption, subsidized land etc., from the concerned State Government.

The Board of Directors of the Company accorded 'in principle' approval for installation of 10 SPUs in six states where no integrated steel plant was located at an investment of ₹ 1259.67 crore during October 2007 to February 2009 with installed capacity to produce 9,45,000 tonne per annum of sized /finished steel for consumption in the rural areas. The Company worked out a gross margin of ₹ 201.14 crore per annum from these SPUs. Centre for Engineering and Technology (CET) of the Company prepared the feasibility reports for setting up the SPUs. Each SPU was linked with a Steel Plant and the plant was termed as nodal plant/ controlling plant. The details of the project were as below:

Sl. No.	Site/state	Controlling plant	Date of 'in-principle' approval	Date of final approval	Anticipated cost (₹ in crore)	Expenditure upto 30-06-10 (₹ in crore)
1.	Bettiah, Bihar	BSL, Bokaro	30-10-2007	July 2008	236.02	**79.13**
2.	Kangra, HP	DSP, Durgapur	20-02-2009	July 2010	78.93	**0.52**
3.	Mahnar, Bihar	BSL, Bokaro	30-10-2007	-	265.70	**4.02**
4.	Gaya, Bihar	-do-	27-06-2008	-	81.74	**2.91**
5.	Hoshangabad, MP	BSP, Bhilai	30-10-2007	-	154.23	**0.76**
6.	Ujjain, MP	-do-	14-03-2008	-	88.37	**0.41**
7.	Gwalior, MP	-do-	25-07-2008	-	82.57	**0.24**
8.	Guwahati, Assam	RSP, Rourkela	28-04-2008	-	96.87	**8.63**
9.	Lakhimpur, UP	-do-	18-06-2008	-	84.28	**1.50**
10.	Srinagar, J&K	DSP, Durgapur	28-04-2008	-	90.96	**3.63**
Total					**1259.67**	**101.75**

Scope of Audit

The study covers approval of SPUs, selection of sites, availability of infrastructure viz. road, water and power, implementation of the project and their viability.

Audit Objectives

The study was conducted with a view to examine whether:

- Selection of location for setting up of SPUs was based on proper survey keeping in view the availability of suitable land, power, water and extent of local demand of products
- The Company was able to get exemption/relief of taxes and duties from the Governments as per assumption made in the feasibility reports and
- Project implementation conformed to implementation schedule.

Audit Criteria

The main audit criteria used in the study were:

- Decision of the Board of Directors and related agenda papers regarding installation of SPUs
- Deliberation in the Project Appraisal Group (PAG) and Board's Sub-committees
- Capital Cost estimates, Feasibility Reports, Financial analysis
- Assumption of exemptions, relief and incentives to be received from the state Governments.

Audit Findings

17.6.1 Selection of sites for setting up of SPUs

The Company selected the sites for setting up of SPUs by considering the following:

- Availability of water and power supply
- Road connectivity
- Rail link with loading /unloading facility and
- Preference for Government land.

However, it was observed in six sites necessary facilities like loading/unloading arrangement, power, water, approach road were not available or the land was not suitable as detailed below:

- The nearest railway station to the site selected at Ujjain was Vikram Nagar at a distance of 20 kilometers (kms). Loading and unloading facility was not available at the railway station. The Company was required to develop loading/unloading facility at the railway station at an estimated cost of ₹ one crore. Water and high tension power line were not available at the site. The Company approached the Government of Madhya Pradesh (MP) for providing water which had not been agreed to so far. Power line was 22 kms. away from the site and to provide the same, the electricity authority had demanded ₹ 2.22 crore from the Company. This expenditure would adversely impact the feasibility of the project.

The Management stated (August 2010) that they had written (March 2009) to Madhya Pradesh Paschim Kshetra Vidyut Vitaran Company Limited to provide HT power near the site and that the response from State Government was awaited.

- As loading/unloading facility was not available in the railway station near the site in respect of SPU at Gwalior, the Company was exploring the possibility of shifting SPU to a site near Rairu railway station, about 45 kms. from the present site.

The Management stated (August 2010) that the Company had requested Government of MP in December 2009 to change the location from the existing allotted site and location of new site was being explored.

- In SPU at Hoshangabad, 33 KV power line and water were to be supplied by the State Government. The clearance from the State Government was awaited.
- The site for SPU at Mahnar was at a distance of 10 kms. from national highway and to connect the site from highway, 10 kms. long metal road was to be constructed. The Company approached the State Government (November 2008)

for construction of the road which had not been agreed to so far. Further, 50 acres of agricultural land purchased from private parties could not be used for industrial purpose unless permitted by the Government. Further, the land which was low lying and prone to floods and required massive land filling which would adversely impact viability of the project. Keeping in view the huge expenditure on land filling the Company decided to review the viability of the project.

The Management stated (August 2010) that on detailed survey as well as topographical study the land at Mahnar was found low lying and prone to floods due to which the investment and installation of SPU at Mahnar was under review.

- In the land measuring 25 acres purchased from the State Government for construction of SPU at Srinagar, there was a level difference of about 17 meter between the two ends of the plot which was not suitable for setting up of SPU. The Company approached the State Government for alternative piece of land adjacent to the present plot. Decision of the State Government was awaited.

The Management stated (August 2010) that the Government had offered land adjacent to the existing plot for survey which was found satisfactory and that soil investigation would be carried out for modifying technical specifications.

- In Gaya 27.30 acres of private agricultural land was purchased at a cost of ₹ 2.86 crore. The land could not be used for industrial purpose as agricultural land could not be used for industrial purpose unless permitted by the Government.

The Management stated (August 2010) that the Government had empowered local SDO for conversion of agricultural land for industrial use and that the Company had taken up the matter with the state.

- The Company approved (June 2008) proposal for installation of an SPU at Sitapur (Uttar Pradesh) on 30 acres of land. Due to non availability of land the site was changed to Lakhimpur without carrying out any market survey or preparing revised feasibility report. In Lakhimpur the Company purchased only 12 acres of land from a private party against the requirement of 30 acres.

The Management stated (August 2010) that 12 acres of land was purchased after ascertaining the minimum requirement of land from the consultant (CET) for installation of SPU.

From the above it was clear that the criteria set for selection of site for setting up of SPUs were not followed and the site was selected without proper market survey.

Recommendations

- ***Site should be selected after detailed market survey of demand for steel.***
- ***Selection of site for setting up SPU should be made after ensuring availability of infrastructure like road, water, power and loading/unloading facilities.***

17.6.2 Concession/relief by the State Governments

As per feasibility reports viability of the project was dependent on availability of certain concessions/relief from State Governments. However, it was observed that in seven cases the Company's request for the concessions was either refused, conditionally agreed to or had not been granted so far. Non availability of the concessions/reliefs rendered the projects unviable. SPU wise position was as below:

- The SPU at Guwahati was financially viable on availability of excise duty and income tax exemption for 10 years and interest subsidy at the rate of three *per cent* on the working capital. The Government of Assam informed (August 2008) the Company that it was not entitled to the fiscal incentives and concessions turning project unviable and the entire expenditure of ₹ 8.63 crore rendered infructuous.

The Management stated (August 2010) that issue of grant of concession had been taken up with the State Government and that their response was awaited.

- As per feasibility report for SPU at Gaya concession from the Government of Bihar in the form of entry tax at the rate of four *per cent* on input materials for entire life of the project and 80 *per cent* reimbursement against the admitted Value added Tax (VAT) amount for 10 years were to be extended. The state Government had not agreed to the concessions so far.

The Management stated (August 2010) that the relief was applicable if the production started by March 2011 and that the Company had taken up the matter with the State Government for extension of the start of production till 2013.

- Viability of SPU at Srinagar was based on excise duty exemption on value addition for 10 years, 100 *per cent* refund of excise duty on input material, capital investment subsidy of ₹ 30 lakh, 100 *per cent* sales tax exemption for the initial period of five years and 30 *per cent* for balance period, interest subsidy on working capital for 10 years and transport subsidy from the nearest railway head to the industrial unit at the rate of 90 *per cent.* However, the Government of J& K had not agreed for the same till date.

The Management stated (August 2010) that they were pursuing with the state Government for concessions.

- Viability of SPUs at Ujjain, Gwalior and Hoshangabad in MP were based on expected exemption/relief from State Government in the form of exemption of entry tax for five years, exemption of 75 *per cent* VAT on finished goods for five years, interest subsidy on term loan etc. The state Government agreed for the concessions subject to the condition that production in the units commenced on or before 31 March 2010. However, as construction activities were yet to start (July 2010) the grant of the concessions lapsed.

The Management stated (August 2010) that they had requested the state Government to extend the date of production to March 2013 and that the reply of the Government was awaited.

Recommendation

The Company should confirm availability of concessions and exemptions from state Governments.

17.6.3 Project Implementation

As per decision of the Board of Directors of the Company, all the SPUs were to be commissioned within 18-19 months from the date of stage-II (Final) approval of individual project. However, the Company did not fix any time limit for obtaining final approval of the Board of Directors since in – principle approval. Audit observed that though a period ranging from 8 to 33 months had lapsed (till July 2010) since in – principle approval, final approval was accorded in respect of only two SPUs, at Bettiah (Bihar) and at Kangra(HP) in July 2008 and July 2010 respectively. The SPU at Bettiah could not be completed within the stipulated time of 18 months i.e. January 2010.

The Management stated (August 2010) that the project could not be commissioned due to heavy rains in 2008 and 2009 and due to delay in 33 KV power supply from Bihar State Electricity Board which would result in further delay in trial and commissioning.

Conclusion and Impact Assessment

The Company could not get the intended benefits of setting up of SPUs as final approval of only two units was accorded after lapse of 8-33 months of in-principle approval and actual work of construction/erection had started at one site only.

Due to purchase of inappropriate land, non availability of required infrastructural facilities, non grant of the concession/relief by the State Governments concerned which were essential for financial viability of the projects, investment of ₹ 101.75 crore made so far was idle. As the Company had not prepared the revised cost estimates due to delay Audit could not ascertain the impact on viability of the units.

As per Company's own estimate, 2007 numbers of employees were directly required for the SPUs. Due to non-installation of SPUs, additional employment could not be generated.

The matter was reported to the Ministry in September 2010; reply was awaited (February 2011).

17.7 IT audit of Material Management Module of SAP-ERP system of Bhilai Steel Plant

Steel Authority of India Limited decided (December 2006) to implement Enterprise Resource Planning at Bhilai Steel Plant, Bhilai at a cost of ₹ 51.47 Crores. The Company implemented SAP (ECC 6.0) ERP in April 2009 and incurred ₹ 23.73 crores upto May 2010. A review of implementation with special attention to Material Management Module revealed delay in implementation, non implementation of certain ERP features like Audit Information System, Material Requirement Planning, Warehousing sub module etc. The vendor database was not complete. The other issues noticed in audit related to physical and logical access controls, Disaster recovery plan etc.

Introduction

Bhilai Steel Plant is the largest integrated steel plants of Steel Authority of India Limited (Company) with capacity of 4 MT per annum of saleable steel. The Board of Directors of the Company decided (December 2006) to implement Enterprise Resource Planning at

Bhilai Steel Plant, Bhilai at a cost of ₹ 51.47 Crores. The Company opted for SAP (ECC 6.0) ERP solution which consists following six modules through which various transactions have been mapped in an integrated manner;

- Material Management (MM);
- Production Planning & Control (PPC);
- Financial Accounting & Controlling (FICO);
- Quality Management;
- Plant Maintenance (PM); and
- Sales & Distribution (S&D)

SAP was implemented in a centralised and three layer architecture namely Database, Application and Presentation layers. The SAP system is having separate servers for Development, Quality Assurance, Production and one for Training.

The operating system is UNIX with Oracle as RDBMS (Relational Database Management System) for managing its database. The Company has kept its Database and Application servers at the corporate data centre. The Company incurred ₹ 23.73 Crores upto May 2010, on implementation of ERP.

Scope of audit

Audit reviewed MM module and its sub modules to evaluate the implementation and customisation vis-à-vis Company's requirements.

Audit objectives

The main objective of the audit was to ascertain whether the implementation of MM module in the Company was carried out in most effective manner. To achieve this, Audit focused on the following:

- Whether all related transactions of the Company were mapped in the MM module;
- Whether the Company was making optimum use of features available in MM module;
- Whether the system was customized to suit the requirements of the Company and its users;
- Whether effective input controls and validation checks existed in the system to check and prevent recording errors and
- Whether the Disaster Recovery System was adequate.

Audit criteria

The Audit adopted following criteria to achieve the audit objectives:

- Documented User Requirements;
- Module manuals and available standard functionalities; and
- Procurement manual and procedures of the Company.

Audit methodology

The IT Audit of MM module of ERP system was conducted by adopting following methodology:

- Entry conference was held in February 2010 with the Management of the Company;
- Correspondence and questionnaire issued to the Management; and
- Analysis of data obtained through available Transaction Codes as Audit Information system (AIS) module was not activated.
- Exit conference was held in November 2010 with Management for discussion of the audit findings.

Audit findings

Test checks revealed significant weaknesses in the customization and utilization of MM module, incorrect/incomplete master records, and lack of input controls and validation checks as detailed below:

17.7.1 Implementation of ERP project

The implementation of Enterprise Resource Planning (ERP) system was delayed as against the scheduled Go-Live in February 2008; the actual Go-live was 1 April 2009 which further delayed the achievement of the anticipated benefits.

The Management accepted the facts and stated (Nov 2010) that the customisation process was very complicated and mapping them in SAP involved lot of challenges and BSP was having the onus of designing the system across SAIL.

17.7.2 Non Achievement of intended benefits of Material Management Module

Need for a well defined Inventory Control/ Management System was felt considering the volume of transaction and the ₹ 519.55 crores being the value of closing stock of around 2.5 lakhs of items at the end of year 2008-09. Such inventory management system was not available in the legacy system. The required inventory management could be exercised through the Material Requirements Planning (MRP), a feature available in ERP (SAP) through which Minimum/Safety Stock Level and Re-order Stock level for critical materials could be defined and whenever the stock level of any of such material goes below its respective re-order level, the procurement of that material could be initiated through the MRP feature.

The feasibility report of ERP anticipated an annual financial savings of ₹ 7.70 Crores by achieving Inventory Level Reduction and ₹ 5.8 Crores on account of Reduction in MRO[♣], Spare Inventory Carrying Cost by the implementation of ERP project. However, it was noticed that MRP feature available was not activated in the ERP, thus the intended benefits could not be derived from ERP system.

Management accepted (November 2010) and stated that the MRP feature would be activated by the end of financial year 2010-11 after gathering reliable data in SAP.

[♣] ***Maintenance Repair Operation***

17.7.3 Disaster Recovery Plan - Location of Data Centres and back up

It was observed that the Production Data Centre and Fail over Server were situated within 500 meters thus increasing the risk of simultaneous data loss in the event of any disaster. As the entrance to both the data centres was common, the risk of non-access during strikes or lockouts persisted. It was also noticed that both data centres were on the ground floor only and the back-up tapes were kept at the same location of the original data centre which defeated the purpose of taking backups and increased the risk of non-accessibility of data in hours of need and increased the vulnerability and probable hazards due to water seepage or flood etc.

Management stated (November 2010) that data mirroring has been implemented for important data in production server and during exit conference (November 2010) promised to take action regarding storage backups.

17.7.4 Access controls

17.7.4.1Physical access controls

It was noticed that though the location of the steel plant was secured by CISF personnel, no security guards were posted at the rear entrance to the Production Data Centre and it was easily accessible.

Management during exit conference (November 2010) agreed to review the present security arrangement.

17.7.4.2 Logical access controls

Presence of an adequate logical access control is a prerequisite of the healthy, safe and secured Information Technology enabled system so that the data in the system and system itself can be protected from unauthorised access and use. However it was observed that though the features for exercising proper logical access controls were available in the SAP system, the same were not enabled as detailed below:

- Password Expiry Period was not set in the system and the users continued to access the system with the initially set passwords.
- The system instead of locking user ids to prevent confirmed invalid login attempts permitted further login attempts with the same user identity.
- The system did not log off automatically in case of sudden shutdown of PCs due to power cut.
- The alphanumeric combination of passwords was not insisted by the system and the user ids were allowed as the part of passwords, thus increasing the risk of cracking of passwords.
- The minimum required password length was also set as '*six*' only instead of minimum required length of '*eight*'.

Management in their reply (November 2010) stated that the issues regarding invalid login attempts and auto log off were taken care of and other rectification action would be taken by April 2011.

17.7.4.3 Authorization to users and Availability of stock

The required materials are obtained through the indents from the stores and the indenter needed to raise Purchase Requisitions (PR), if the intended items were not available in stores. As a prudent practice for raising Purchase Requisitions, if the details of the ongoing procurement details about the materials including status of material in transit, if made available to the intender through the system the average time being spent in processing of Purchase Requisitions can be brought down to the minimum.

It was noticed that ERP System did not have any facility for automatic prompting of availability of indented material in the stores and pending deliveries of the same, to indenters. It was also observed that the though permission had been given to users for creation of indent, posting of receipt of material, view material document, view stock of material etc, access to some more useful transaction codes had not been given to indenters which were designed to view PR and PO dues of any material so as to know the availability status of indented items (especially in the absence of the automated prompting facility about the availability).

Management replied (November 2010) that the access to all useful transaction codes are being given to the intenders as suggested by audit.

However, the reply did not address the issue of automatic prompting facility in the system.

17.7.5 Customisation of ERP features

17.7.5.1 Audit Information System (AIS)

The AIS module which would be useful for conducting audit and forming audit opinion about the Confidentiality, Integrity and Availability of the system has not been implemented by the Management. The Audit faced difficulties in getting access to the system in the absence of AIS module during the earlier phase of audit.

In this regard, Management stated that the implementation of the AIS module would be explored.

17.7.5.2 Online Complaint Monitoring System

A system based complaint monitoring would facilitate timely redressal of complaints against the defective supplies and rapid disposal of the same. However, it was noticed that the complaints were continued to be monitored manually instead of through the system.

Management stated (November 2010) that such system would be explored in consultation with the SAP consultants.

17.7.5.3 Storage locations of stock

In order to physically access the location* of any specific material, the sub store-wise or rake wise information should be made available in the system which would facilitate easy access and reduce delay in logistic procedure and improvement in inventory control. However it was noticed that due to not implementing "warehousing sub-module" of ERP, the sub store-wise location of material was not made available through the system.

***** *Store/Sub-Store / rake-wise location*

Management accepted that facts and stated the "warehousing sub module" was not in the current scope of implementation and stabilization.

17.7.5.4 Liquidated Damages

It was noticed that Liquidated Damages (LD) recoverable from the suppliers for any default were not calculated and levied through the system. However, such LD were calculated manually and entered in the system for effecting recoveries. In order to ensure optimum utilisation of available system and to ensure transparency in procurement procedure it is desirable that the same be automated through the system.

Management reply (November 2010) did not address the issue pointed out and stated that recoveries were made as per the provisions of PO.

17.7.5.5 Preparation of Comparative Statements

During audit, it was observed that the system of generating Comparative Statements was not fully stabilised and required manual intervention with regard to calculation of Excise Duty, Education Cess etc.

Management reply (November 2010) did not address the issue of manual intervention with regard to excise duty.

17.7.5.6 Customisation of SAP reports

Reporting is the key instrument for exercising effective managerial control over various significant organisational activities. The SAP system has its own predesigned reporting feature, which can be customised according to the specific industry, culture or organisation. One of the prerequisite of a perfect customisation is unambiguous User Requirement Specifications (URS).

In this regard it was observed that the reports were not customized as per requirement. However, as a temporary solution some Management reports were being developed manually on need basis which were neither generated on regular basis nor were available in the system for any future reference.

Management stated (November 2010) that alternative efforts (viz. training to users and development of required reports) were being undertaken to fulfill the stipulated needs.

17.7.6 Mapping of business rules

17.7.6.1 Adherence to CVC guidelines incorporated in Purchase/ Contract Procedure

It was noticed that certain CVC guidelines as provided in the Purchase/Contract Procedure-2009 were not being adhered to as detailed below:

- MM department/Contract Cell should process the indent, within 3 days in case of Purchase Contracts and within 7 days in case of Job Contracts, on receipt from the screening committee. But such provisions were not mapped in the system. Absence of these controls resulted in delay in processing of approved purchase requests and it was observed that out of 1311 purchase requisitions for the period January 2010 to March 2010, in 833 cases, action was taken with a delay ranging between one month ten months.
- The post tender contract details for all tenders above ₹ 50 Lakhs like nature of work, mode of tender, type of bidding, details of technical evaluation, award of

contract to L-1 bidder etc., required to be posted on the Company's website were not updated in complete shape in the website and not being processed in the system.

- The approvals from the competent authority in case of extension of delivery period in any contract were being taken manually and not through the system and information of such approval was not available in the system which might result in incorrect information to users of the system.

Management accepted (November 2010) that approvals regarding extension of delivery period were obtained manually and replied that comprehensive MIS had been developed to monitor the progress of procurement of materials and the uploading of post tender details were being done outside SAP module.

However, it was reiterated that instead of monitoring through MIS, such controls should have been built in the system and the uploaded post tender details need to be complete in all respects as required by the guidelines.

17.7.6.2 Non-mapping of rate contracts finalisation process

Procurements of regular materials are being done through rate contracts. It was noticed that the finalisation process of rate contracts was done manually and not through the ERP system. The finalized contracts were then entered in the system and subsequent orders were placed on such rates. Manual intervention would lead to non transparent procurement process.

The Management accepted (November 2010) the audit observation.

17.7.7 Input controls

17.7.7.1 Purchase Requisitions

Purchase Requisition (PR) is generated by the respective indenter shops and during the preparation of PRs some basic data such as Quantity Required, Date of Delivery etc. needed to be entered in the system. Further, the annual requirement, normal delivery period and lead time should be captured in the system so as to have control over procurement and reduction in inventory carrying cost.

In this regard it is observed that the same were not captured in the system. In the absence of such controls regarding inventory management, the system accepted any figure/amount as 'quantity required' and the current date as 'delivery date' which lacked justification.

Management replied (November 2010) that PRs were screened for indented quantities and other aspects by online screening committees through the system and system was customised to accept current date to take care of emergency purchases.

However, it is suggested that controls inbuilt at the point of requisition creation would avoid discrepancies and loss of time during online screening.

17.7.7.2 Date of Purchase Orders

During the creation of Purchase Orders, the system automatically assigns current date as PO issue date. Wherever, when the PO was kept pending for finalisation, it was desirable that the date of finalisation of the PO be taken as the PO issue date.

However, it was observed that the date of creation of PO had been taken as PO issue date finalised even in case of delayed finalisation of the respective POs. This might result in incorrect information to the users, disputes regarding validity of offers submitted by vendors and could affect the delivery schedule.

Management stated (November 2010) that the standard SAP check to disallow PO creation with back date was later deactivated due to business requirements and separate development was being taken up to address this issue.

17.7.7.3 Data migration form legacy system

The data from legacy system (i.e. MMIS) was migrated to MM module of ERP according to the UCS (Uniform Codification System) code corresponding to the each item code of MMIS. Data analysis revealed that 850 stock items valuing ₹ 78.54 lakh were not migrated into ERP system. On further analysis with MMIS data, it was noticed that 564 such items were among the non moving items which have not been issued for the past one year to 50 years.

Management accepted (November 2010) the facts.

17.7.7.4 Data Analysis

The data available for the year 2009-10 in Materials Management Module of ERP was analysed and following observations were noticed during the analysis;

- System allowed creation of 14 numbers of Purchase orders without bearing any Delivery Date in the ERP system.
- Material code has not been captured in respect of 174 numbers of POs issued during 2009-10.
- Material Codes have been designed as 14 digits as per the UCS and at the time of preparation of Purchase Requisition/ Order the 14 digit Material Code is automatically taken by the system. However, contrary to the above, the presence of material codes with 10 digits and 13 digits were noticed.
- The quantity ordered was not captured in 133 Purchase Orders and captured in negative in two POs during 2009-10.
- The requisition date was not captured in 8252 Purchase requisitions in the ERP system for the year 2009-10.

Management stated (November 2010) that the status of the Purchase Orders was 'under hold' and not finally released and further stated that these POs were planned for deletion in April 2011.

The reply could not be accepted since Purchase Orders having status as 'Hold' were not considered for this analysis.

- Fractional values of less than one representing the balance quantity to be delivered by the suppliers were found against ordered quantity in total 1020 items. These entries were supposed to be entered in "Still to be delivered" field of ERP database.

Management accepted (November 2010) the facts and stated that the problem was due to data migration.

- As per the normal procedure, the Purchase Requisition is prepared and Purchase Orders are placed within a period of 90 days therefore PO dates are usually a later date than the Requisition date except the cases of emergency purchases. However, analysis of database revealed that in 52 no. of cases Purchase Order Date (Document Date) was prior to the Requisition Date and the no. of days ranged between 1 day and 251 days.

Management accepted (November 2010) the facts and stated that the document date prior to the requisition were allowed only in rate contract cases like HSCL/township contracts. The Management reply, however, did not indicate the reasons thereon.

17.7.8 Vendor database

Materials Management Module of ERP has the provision of Suppliers Relationship Module (SRM), which deals with the communication between vendors and the Company, the efficiency and effectiveness of this part of ERP was highly dependent on vital vendor information/ database.

During audit it was found that no dedicated vendor database had been developed for ERP or SRM and the database developed previously for the legacy system was in use without any material modification or update, which resulted in ineffective and inefficient utilisation of system. The following issues were noticed in this regard:

- The vendor data of legacy system migrated to ERP system contained only some basic information. It was desirable that it should contain some financial and past details also.
- The system did not check on the registration status of the vendor as vendors with expired registrations were still appearing in the system which gave misleading information to the users of system. Further analysis revealed that 686 purchase orders valuing ₹ 176.96 crore were issued on such vendors during 2009-10 through SAP ERP.
- The status♠ of the vendors was not made available to the users through the SRM module and needed separate login into SAP. This might lead to inconvenience to users while floating inquiry proposals to vendors.
- The vendors had not been given the privileges to amend or update their own basic information available in the system through the web interface.
- System displayed an error message "Vendor under Hold" wherever no information regarding vendor was available which gave misleading information about the status of vendor.
- The Company continued to depend on manual registration process for new vendors in the absence of any provision for online registration of vendors in the SRM module. The manual intervention in this regard resulted in duplicate registrations of 14 vendors and the 28 numbers of duplicate profiles of such vendors were maintained in the ERP system.

♠ ***Valid, Hold or Inactive etc***

- The Material Management System has more than 2.5 lakhs item codes and BSP had developed Uniform Codification System (UCS) along with the implementation of ERP. Each item has been allotted a specific UCS code and there were more than 7000 suppliers connected with BSP. The system should have a linkage between vender profile and item code (UCS) in order to find out registered suppliers with BSP for that particular item to assist the procurement process. However, no such linkage was found in the system, which was confirmed by the Management.
- It was observed that the in case of limited tender inquiries, selection of vendors was done manually and the procedure was not mapped in the ERP.

Management in its reply (November 2010) stated that the issues regarding inadequate viewing privilege in SRM and wrong error massaging were taken care of and assured that rectification action would be taken by April 2011.

17.7.9 Amendments to Purchase conditions

In SAP system, during the preparation of PR, the purchase terms and conditions were entered in text format. As a prudent practice, amendments to the conditions required a modified PR.

However, it was noticed that system allowed changes to the conditions of approved PR without insisting for modified PR and the changes were also not reflected in log related to such PR. This increased the risk to reliability and integrity of the data.

Management replied (November 2010) that the deficiency in this regard had since been corrected. However, it was noticed that the history of such changes made were not separately logged so as to serve as an audit trail.

17.7.10 Integration of Finance Module with Materials Management Module

In SAP ERP, the accounting and processing of payments to suppliers relating to purchases done through Materials Management Module (MM) were dealt by the Finance and Accounting Module (FI). The final payment to be made was ascertained based on the payables and recoveries and then a payment advice containing particulars regarding amount claimed by the supplier, recoveries to be made and amount to be paid etc., was prepared and cheques were generated with the help of SBI net banking.

It was observed that, the details as per Payment Advices differed with the "Recovery Details" which was misleading and represented lacuna on the part of integration of these modules as illustrated below.

- In one of the payment advice though the payment due as per the details of claim and recoveries was ₹ 11,24,326.48, the payment was indicated as ₹ 34,45,341.00. However, further analysis with reference to the recovery details annexed and those indicated in advice, showed that the recovery details were shown wrongly in the advice. This indicated lacuna on the part of generation of advices through the system.
- In another case the total recoveries to be made from the payment due as per Payment Advice was not matching with the details as per annexure as details of recoveries relating to *'Tax Deducted at Source'* were not available in the annexure.

The Management replied (November 2010) that the system was in stabilization stage and the lacuna in this regard had since been corrected.

On verification it was noticed that no changes to the design of the particular MIS report had been carried out and the new format did not indicate the recoveries separately and amounts relating to the *'Refund of Security Deposit'* were also not indicated.

Conclusion

The implementation of Enterprise Resource Planning (ERP) system was delayed by 14 months. Various features available in the SAP ERP like Audit Information System, Material Requirement Planning, Online complaint Monitoring system, warehousing sub module, Levy of Liquidated Damages and Preparation of Comparative statement etc need to be activated to minimise the manual interventions and to achieve the intended benefits. The logical access controls need to be strengthened. The disaster recovery plan and business continuity plan needed to be revisited. Non mapping of CVC guidelines in the system resulted in delayed processing of approved purchase requests. Deficiencies in input controls resulted in non migration of stock data from legacy system, incomplete data entry and deficient vendor data base etc. Such deficiencies may make the system unreliable and vulnerable.

The matter was reported to the Ministry in January 2011; reply was awaited (February 2011).

Recommendations

The Management may consider the following measures to optimise benefits of ERP system:

- ***Audit Information System may be implemented without further delay in order to facilitate audit through the system***
- ***Ensure customisation and usage of various features of ERP Solution like material requirement planning, warehousing sub module, levy of liquidated damages and preparation of comparative statement etc as per business and statutory requirements.***
- ***Vender Database may be updated with all required information.***
- ***Strengthen input control and internal control procedures to ensure accurate, reliable, pertinent and complete data.***

The matter was reported to the Ministry in September 2010; reply was awaited (February 2011).

17.8 Avoidable payment due to defects in plan implementation

Due to non- synchronisation of creation of oxygen supply facility with expansion plans and delay in installation of CDI facility, the Company had to incur avoidable expenditure of ₹ 81.96 crore towards fixed facility charge and minimum off take charge during July 2008 to March 2010 and pending further corrective actions to minimise the gap between supply and demand there would be recurring expenditure to the tune of ₹ 45.72 crore per annum.

In steel making process oxygen is required to enrich air and increase combustion temperatures in blast furnaces and open hearth furnaces as well as to replace expensive coking coal with other combustible materials. Durgapur Steel Plant (DSP) of Steel Authority of India Limited (Company) was having a 700 tonne per day (TPD) oxygen plant to cater to the need of its existing 1.8 million metric tonne (MMT) crude steel production capacity.

A task force constituted (May 2004) by the Company prepared (June 2004) a comprehensive report about future oxygen requirement based on production plan (expansion plan) as well as technological improvements specially in blast furnaces (BF) envisaged in the Company's corporate plan (CP) 2012.

Based on the recommendations of the task force, the Board of Directors of the Company approved (March 2006) the proposal for installation of additional 700 TPD Oxygen Plant on Built, Own and Operate (BOO) basis and accordingly entered (May 2006) into a 15 year agreement with Praxair India Private Limited (contractor) for setting up the same. The terms of agreement inter-alia provided that:

- The contractor would supply oxygen and other gases on sale basis. The Company in addition to sale price would pay a fixed facility charge at the rate of ₹ 3.81 crore per month from the date of successful commissioning of the production facilities.
- In case of lower demand the Company would continue to pay monthly fixed facility charges and price for gases supplied on actual consumption basis subject to minimum off take.

In June 2008 the contractor informed the Company that the oxygen plant became ready to supply gases to DSP. The Company and the contractor mutually agreed that fixed facility charge would be paid from July 2008.

Audit observed that:

- The task force reported (June 2004) that the oxygen requirement in DSP in 2006-07 would be 1361 TPD due to commissioning of Coal Dust Injection (CDI) facility in Blast Furnace (BF) No. 3 and 4 in June 2006, whereas the approval for installation of CDIs in BF No. 3 and 4 was given in January 2006. The facility was to be implemented within 19 months of approval i.e. by August 2007, however the facility was finally commissioned in July/October 2009 after a delay of 24/26 months.
- The average oxygen enrichment levels were 1.5 *per cent* and 2 *per cent* for BF 3 and BF 4 respectively during 2009-10 against the target of 4 *per cent* upto 2006-07 and 6 *per cent* in 2011-12. During the year 2010-11 (upto December 2010) it was 1.97 *per cent* and 3.17 *per cent* in BF 3 and 4 respectively.
- The task force also mentioned (June 2004) that the oxygen requirement would increase to 2309 TPD during 2011-12 based on the envisaged production plan of crude steel of 3 MMT. The Board of Directors of the Company approved (July 2007) expansion & modernization plan of DSP for increasing the capacity of crude steel production from 1.8 MMT to 3 MMT at an indicative cost of ₹ 5549 crore. However, in June 2009 the Company reviewed its decision of expansion

and drastically reduced the number of facilities to be installed. The revised approved cost estimate was ₹ 2875 crore. But the Company did not work out any revised oxygen requirement.

- The average oxygen consumption during 2009-10 and 2010-11 (up to December 2010) was 757 TPD and 864 TPD respectively against the available production capacity of 1400 TPD.

Thus, non- synchronization of creation of oxygen supply facility with expansion plans/ technological improvements and delay in installation of CDI facility, resulted in avoidable payment of ₹ 81. 96 crore towards fixed facility charge and minimum off take charge during July 2008 to March 2010. Further pending corrective actions to minimise the gap between supply and demand there would be recurring expenditure to the tune of ₹ 45.72 crore per annum.

The Management in its reply stated (September 2010) that:

- In order to meet increased oxygen requirement for enhanced production level of hot metal and crude steel decision for setting up new oxygen plant was taken.
- Due to global meltdown which was unforeseen and unexpected, the implementation of modernisation and expansion plan of DSP had to be reviewed, which delayed its implementation. With the BOO Oxygen plant, DSP was able to meet requirement of Oxygen beyond the production potential of Captive Oxygen plant without any constraint.

The reply of the Management is not convincing in view of the fact that:

- In the committee report the CDI facility in BF 3 and 4 was expected to be completed in June 2006 whereas the approval for the same was accorded in January 2006 and the facility was actually commissioned in July/October 2009 after a delay of 24 and 26 months.
- The situation could have been avoided if the Company would have entered into contract for less capacity with the option to extend the contract with additional facility/ capacity as per change in requirements as the Company has done in case of its IISCO steel plant (ISP). In ISP, the Company entered into contract with BOO contractor for a capacity of 70 TPD only and based on future projected requirements it increased the requirement gradually through subsequent contracts.
- Further, as per termination clause the agreement could be terminated by either party on completion of 15 years whereas in case of ISP the initial agreement was for 10 years and the same could be terminated by either party after completion of 5 years.

Thus, failure of the Company in implementing its roadmap for expansion/ development in an integrated manner resulted in mismatch in supply and demand of oxygen which led to avoidable payment of ₹ 81.96 crore towards fixed facility charge and minimum charge to the contractor. Since expansion plan was deferred, the chances of utilisation of additional capacity in near future was also not clear and hence the Company would continue to incur ₹ 45.72 crore per annum.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

17.9 Irregular excess payment of house rent to employees

The Company irregularly paid house rent allowance (HRA) to its employees at higher rates in violation of DPE guidelines. The Company made irregular excess payment of HRA amounting to ₹ 16.71 crore during the years 2005-06 to 2009-10.

As per the instructions (June 1999) of Department of Public Enterprises' (DPE), House Rent Allowance (HRA) was payable to the employees of Central Public Sector Enterprises (CPSEs) at the rates applicable to Central Government employees based on the reclassified list of cities notified by the Government of India (GOI). In January 2001, DPE clarified that the CPSEs employees would be allowed to draw the earlier rates of HRA on the revised pay wherever HRA rates are lower than the earlier rates as per new classification of cities. Reclassification of cities was done by the GOI in November 2004 with retrospective effect from 1 April 2004.

Audit scrutiny of the records revealed the following:

- Steel Authority of India Limited (Company) paid HRA to its employees of Rourkela Steel Plant (RSP) at the rate of 10 *per cent* up to 31March 2005. On reclassification (November 2004) of Rourkela as class 'C' city, the Company started payment of HRA to its employees of RSP at the rate of 15 *per cent* with effect from 1 April 2005 violating the DPE guideline as admissible rate of HRA was 10 *per cent*.
- Bhilai was classified (November 2004) as B-2 city and employees of Bhilai Steel Plant of the Company were eligible for HRA at the rate of 15 *per cent*. But the Company started (September 2005) payment of HRA at the rate of 17.5 *per cent* with effect from 1 April 2005 violating the DPE guideline as admissible rate of HRA was 15 *per cent*.
- On reclassification of the mines (Rajhara, Jharandalli, Dalli Mechnical & Manual) as class 'C' city the Company started payment of HRA to its employees these mines at the rate of 15 *per cent* with effect from 1 April 2005 violating the DPE guideline as admissible rate of HRA was 10 *per cent*.

Thus, payment of HRA at higher rates in violation of DPE guidelines resulted in irregular excess payment of ₹ 16.71 crore to its employees of BSP, RSP and Mines during the years 2005-06 to 2009-10.

The Management in its reply contended (September 2010) that as per reclassification of cities Rourkela, Bhilai and Mines (Rajhara, Jharandalli, Dalli Mechnical & Manual) were shown under 'C', 'B-2' and 'C' class city respectively. The HRA as *per cent* of basic for 'C' and 'B-2' class cities in SAIL was 15 per *cent and* 17.5 *per cent* respectively, which continued as per the clarification issued (January 2001) by DPE. Therefore, no irregular payment had been made.

The contention of the Management is not convincing in view of the fact that on reclassification of cities, Bhilai was classified as B-2 city and admissible HRA was 15 *per cent* which was higher than the existing rate of 10 *per cent* of HRA drawn by the employees of BSP and therefore, protection clause was not applicable to them. RSP and Mines on reclassification were classified as 'C' class city for which the rate of HRA was 7.5 *per cent* and since employees of RSP and Mines were getting HRA at the rate of 10 *per cent* prior to 2005; hence protection clause was applicable to them and they should have been paid at the rate of 10 *per cent.* However, the Company paid HRA at higher rates of 15 *per cent.*

Thus, the Company made irregular excess payment towards HRA amounting to ₹ 16.71 crore to its employees of BSP, RSP and Mines violating the DPE guidelines.

The matter was reported to Ministry in September 2010; reply was awaited (February 2011).

CHAPTER XVIII

Follow-up on Audit Reports (Commercial)

Audit Reports of the Comptroller and Auditor General of India (CAG) represent the culmination of the process of scrutiny starting with initial inspection of accounts and records maintained in various offices and departments of PSUs. It is, therefore, necessary that appropriate and timely response is elicited from the Executive on the Audit findings included in the Audit Reports.

The Lok Sabha Secretariat requested (July 1985) all the Ministries to furnish notes (duly vetted by Audit) indicating remedial/corrective action taken by them on various paragraphs/appraisals contained in the Audit Reports (Commercial) of the CAG as laid on the table of both the Houses of Parliament. Such notes were required to be submitted even in respect of paragraphs/appraisals which were not selected by the Committee on Public Sector Undertakings (COPU) for detailed examination. The COPU in its Second Report (1998-99-Twelfth Lok Sabha), while reiterating the above instructions, recommended:

- setting up of a monitoring cell in each Ministry for monitoring the submission of Action Taken Notes (ATNs) in respect of Audit Reports (Commercial) on individual Public Sector Undertakings (PSUs);
- setting up of a monitoring cell in Department of Public Enterprises (DPE) for monitoring the submission of ATNs in respect of Reports containing paras relating to a number of PSUs under different Ministries; and
- submission to the Committee, within six months from the date of presentation of the relevant Audit Reports, the follow up ATNs duly vetted by Audit in respect of all Reports of the CAG presented to Parliament.

While reviewing the follow up action taken by the Government on the above recommendations, the COPU in its First Report (1999-2000-Thirteenth Lok Sabha) reiterated its earlier recommendations that the DPE should set up a separate monitoring cell in the DPE itself to monitor the follow-up action taken by various Ministries/Departments on the observations contained in the Audit Reports (Commercial) on individual undertakings. Accordingly, a monitoring cell is functioning in the DPE since August 2000 to monitor the follow up on submission of ATNs by the concerned administrative Ministries/Departments. Monitoring cells have also been set up within the concerned Ministries for submission of ATNs on various Reports (Commercial) of the CAG.

Further in a recent meeting of the Committee of Secretaries of Government of India (June 2010) it was decided to make special efforts to clear the pending ATNs/ATRs on CAG Audit Paras and PAC recommendations within the next three months. While conveying this decision (July, 2010), the Ministry of Finance recommended institutional mechanism to expedite action in the future.

A review in Audit revealed that despite reminders, the remedial/corrective ATNs on the transaction audit/compliance audit paragraphs/reviews contained in the last five years' Audit Reports (Commercial) relating to the PSUs under the administrative control of various Ministries, as detailed in ***Appendix-III,*** were not received by Audit for vetting. No ATN has been received in respect of 24, 17, 31, and 27 transaction audit/compliance audit paragraphs/reviews contained in Audit Reports (Commercial) of 2006, 2007, 2008 and 2009 respectively.

For Audit Reports (Commercial) of 2009-10 which were presented to Parliament in August, 2010, ATNs on 53 out of 100 transaction audit/compliance audit paragraphs/reviews were awaited from various Ministries as of 7 March 2011.

Out of 152 paras/reviews on which ATNs were awaited, 62 paragraphs related to PSUs under the Department of Telecommunications, 18 paragraphs related to PSUs under the Ministry of Finance (Banking and Insurance Division) and 9 paragraphs related to PSUs under the Department of Defence production and supply.

(SUNIL VERMA)
Deputy Comptroller and Auditor General
and Chairman, Audit Board

New Delhi
Dated: 27 April 2011

Countersigned

(VINOD RAI)
Comptroller and Auditor General of India

New Delhi
Dated: 27 April 2011

APPENDICES
&
ANNEXURES

APPENDIX-I

(Referred to in para 14.4)

Recoveries at the instance of audit during the year 2009-10

Amount (₹ in lakh)

Name of PSU	Name of the Ministry/ Department	Audit observation in brief	Amount of recovery pointed out by Audit	Amount recovered by the Management
Food Corporation of India	Consumer Affairs, Food and Public Distribution	Non-recovery of cost of food grains from the district administration towards supply of mid-day meals to ineligible students	6.12	6.12
BEML Limited (Hydraulies and powerline division–KGF)	Defence Production and Supplies	Non recovery of excess amount paid to the supplier for supply of 13 items of casting without considering the downward revision of the rates	8.75	8.75
New India Assurance Company Limited	Finance-Insurance Division	Short charging of fire premium due to incorrect application of premium rate for storage risk under floater policy in violation of AIFT	34.81	37.75
United India Insurance Company Limited	Finance-Insurance Division	(i) Short loading of premium	2.04 (Amount pointed out by audit was ₹ 6.04 lakh, however, ₹ 4 lakh were recovered in 2007 itself, amount pointed out by audit is therefore shown as ₹ 2.04 lakh)	2.04
		(ii) On account payment to an insured despite serious	Audit has pointed out discrepancy in the	8.85

Name of PSU	Name of the Ministry/ Department	Audit observation in brief	Amount of recovery pointed out by Audit	Amount recovered by the Management
		irregularities	submission of the insured. Amount to be deducted for same was not worked out by audit	
Bharat Heavy Electricals Limited	Heavy Industries and Public Enterprises	(i) Non-realisation of service tax on freight from customer	106.90	102.42
		(ii) Non-recovery of disallowance by a customer in cost plus contract from the contractor to whom the work was assigned	205.91	205.91
		(iii)Non-claiming of differential turn over discount from vendor despite eligibility	22.51	23.69
		(iv)Payment of works contract tax at a higher rate	6.65	3.05
		(v) Failure to recover sea freight charges from suppliers	2.89	2.08
Hindustan Paper Corporation Limited	Heavy Industries and Public Enterprises	Undue benefit extended to the stockist by supplying paper at lower rate than that finalized during the tendering process	113.92	118.17
BSNL	Telecommunications	(i) Non billing of rentals of Leased Circuits provided to M/s Hughes Telecom Limited, (now Tata Teleservices Limited, Maharashtra)	136.69	78.58
		(ii) Excess payment of entry tax to the Government of Assam (Kolkata circle)	80.22 (amount reworked by the Company	66.58

Name of PSU	Name of the Ministry/ Department	Audit observation in brief	Amount of recovery pointed out by Audit	Amount recovered by the Management
			as ₹ 66.58 lakh)	
		(iii)Non-reduction of proportionate amount of leave periods resulting in excess payment of pension and leave salary contribution to DoT	57.25	57.25
			784.66	**721.24**

APPENDIX-II

(Referred to in para 14.5)

Corrections/rectifications at the instance of audit

Name of PSU	Name of the Ministry	Audit observation/suggestion in brief	Action taken by the management
Food Corporation of India	Consumer Affairs, Food and Public Distribution	Section 34 (1) of Food Corporation (Amendment) Act, 2000 provides that Corporation is required to maintain proper Accounts and other relevant record and prepare an annual statement of accounts including Profit and Loss Account and Balance Sheet in such form as may be prescribed by the Central Government in consultation with the CAG. The Management of the PSU was stressed upon in a series of meetings to adopt the format of Balance Sheet and Profit and Loss Account as given in the Schedule VI of the Companies Act, 1956.	Revised format of Balance Sheet and Profit and Loss Account based on Schedule VI of the Companies Act has been approved by the Corporation in the 312th meeting of Board of Directors held in July, 2008. Proposal was agreed to by the Ministry in November, 2009.
Rashtriya Chemicals and Fertilizers Limited	Ministry of Fertilisers	(i) Accounting Policy of Company Para 7.3.2 provided for inclusion of cost of catalysts replaced during the year in cost of manufactured goods which was contrary to the Accounting Standard 2. This was confirmed by the Institute of	Company has changed its Accounting policy during the year 2009-10 to bring the same in tune with opinion of ICAI. The catalysts are treated as inventories and are charged off over the estimated useful life as technically assessed.

Name of PSU	**Name of the Ministry**	**Audit observation/suggestion in brief**	**Action taken by the management**
		Chartered Accountants of India (ICAI) in June, 2009. As per opinion of ICAI, at the end of the year, where the catalysts are still in use, cost thereof to be charged under cost of conversion as per para 8 of AS 2 should be only to the extent of catalyst consumed during the period.	
		(ii) There should be a transparent accounting policy for making provision for old doubtful debts and loans and advances after taking into account the age of the debt.	The Company has framed an accounting policy for making provision for old doubtful debts and loans and advances. The same has been approved by the Board of Directors in their meeting held on 6 May 2010.
Bharat Heavy Electricals Limited	Ministry of Heavy Industries and Public Enterprises	Trichy unit of the Company made payment of Excise Duty and Central Sales Tax to the vendor without restricting to the actual payments made by the vendor as was stipulated in the terms of contract. This resulted in excess payment of ₹ 32.67 lakh.	The Company has inserted the clause for payment of taxes and duties against documentary evidence in the Terms and conditions of the tender so that this aspect is taken care of in future transactions to have a fool proof mechanism to ward off such discrepancies.
MECON Limited	Ministry of Steel	As per DPE Guidelines, the Company has to evolve a suitable procedure/methodology to cover investment of funds to be followed by	The Company has prepared an investment policy and this was approved by the Board of Directors in the Board meeting held on 29 March 2010.

Name of PSU	**Name of the Ministry**	**Audit observation/suggestion in brief**	**Action taken by the management**
		the Company. No such procedure/methodology was evolved by the Company except formation of a Committee.	
Steel Authority of India Limited	Ministry of Steel	Bhilai Steel Plant (BSP) of SAIL was paying royalty for the iron ore extracted from its captive Mines at Rajhara-Dalli on dispatch basis i.e. for the quantity finally dispatched after processing of the raw iron ore. Rates for royalty vary on the basis of Fe content present in the iron ore i.e. rates are higher for iron ore containing higher Fe content and vice versa. Processing of raw iron ore (including crushing, screening and washing) leads to increase in the Fe content of the iron ore. Hon'ble Supreme Court of India in a decision dated 10th August 1998 held that the Royalty was payable at the rate applicable for Fe content present on the whole quantity produced i.e. on production basis rather than on dispatch basis. Hence, from the year, 1999-2000, BSP started to pay Royalty at the rate applicable for iron	Policy was changed by the Management and liability of ₹ 32.48 crore as appearing in the books of Accounts as on 31 March 2009 was withdrawn.

Name of PSU	Name of the Ministry	Audit observation/suggestion in brief	Action taken by the management
		ore at the rates applicable for Fe content on pre-processed quantity. However, BSP was still charging (May, 2009) expenditure in the aforesaid account the amount of Royalty calculated on the dispatch basis (i.e. after processing the iron ore) which attracts more royalty because of its enrichment in Fe content. This resulted in creation of excess liability amounting to ₹ 32.48 crore accumulated on year to year basis since 1999-2000. Creation of such excess provision without any reasonable justification distorted the fairness of the Accounts of the Company.	

APPENDIX-III

(Referred to in Chapter XVIII)

Statement showing the details of Audit Reports prior to 2010 (Commercial) for which Action Taken Notes are pending (As on 7 March 2011)

No. and Year of Report	Name of the Report	Para No.
Ministry of Agriculture		
1. No. 24 of 2009	Transaction Audit Observations	Para 1.1.1 (agriculture insurance)
Department of Bio-Technology		
1. No. 11 of 2007	Compliance Audit Observations	Para 3.1.1
Department of Fertilizers		
1. PA 9 of 2008	Performance Audit on working of Udyogmandal Division of FACT Limited.	Paras 1.7.1.1, 1.7.1.2, 1.7.2, 1.7.3.1, 1.7.4.1, 1.7.5.1, 1.7.5.2, 1.7.5.3, 1.7.5.4, 1.7.5.5, 1.7.5.6, 1.7.5.7, 1.7.6, 1.7.7, 1.7.8.1 and 1.7.8.2
2. No. 11 of 2008	Compliance Audit Observations	Para 9.2.1(RCF)
3. No. 24 of 2009	Compliance Audit Observations	Paras 7.1.1 & 7.1.2 (NFL), 13.2.1 (RCF & NFL)
Ministry of Civil Aviation		
1. No. 12 of 2006	Transaction Audit Observation	Paras 4.1.1 and 16.2.1
2. No. 23 of 2009	Frequent Flyer Program of NACIL	CH-I
Ministry of Commerce and Industry		
1. No. 24 of 2009	Compliance Audit Observations	Paras 4.1.1, 4.2.1
Ministry of Communications and Information Technology Department of Telecommunications		
1. No 9 of 2006	Chapter-II (Performance Audit of Human Resource Mgt. in BSNL)	Paras 2.12.3.3, 2.13.1.1, 2.1.5.4, 2.1.6.2
2. No. 13 of 2006	Transaction audit observations Chapter-II	Paras 2.11(VIII) 1, 2.13 case I to case II, 2.15(XI)3
	Chapter III	Paras 3.6.1 to 3.6.8, 3.7 (3.7.1 & 3.7.2), 3.8 (3.8.1 to 3.8.6), 3.9 (3.9.1 to 3.9.7)
3.	Chapter-IV	Para 4.19
	Chapter-VI	Para 6.2
4. No. 10 of 2007	Billing and Customer care in MTNL	Paras 3.10, 3.11.1, 3.13.1, 3.13.2, 3.13.3, 3.14.2, 3.15.1, 3.15.2 and 3.15.3
5. No. 12 of 2007	Telecommunications Sector Transaction Audit Observations	Paras 2.2(II)12, 2.2(II)20, 2.3(III)(6, 7, 10,11, 13 & 14), 2.7 (V) (50), 2.8 (VII)(8 to 11), 2.18(XIII) (1 to 11), 2.21(XV) (2 to 22), 3.3(XVII)(4), 4.1, 4.7

No. and Year of Report	Name of the Report	Para No.
6. PA 9 of 2008	Performance Audit of Revenue earnings from leased line services	Paras 3.7.1(VI)(9, 10, 12), 3.7.3 (V)(1 to 10, 12, 13, 20 to 22, 24 to 37), 3.7.3(VI)(1), 3.7.4(VII) (11 to 13, 20 to 24, 27 to 29,31, 32), 3.7.5.1(VIII)(1,2,3,7,8,9,16,17, 22 & 23), 3.7.5.4(IX) (4, 5 to 9)
7. CA 10 of 2008	IT review of BSNL	Paras 1.6.1.1 & 1.6.2.2
8. CA 12 of 2008	Compliance Audit Observations Chapter-II	Paras 2.1.1(I)(10, 12), 2.1.2(II)(11), 2.1.4(V)(1,3), 2.1.5(VI) (3&7), 2.2(X)(3, 8 to 16), 2.3, 2.3(XI)(8 to 11), 2.5(XII)(2 to 6, 9, 10), 2.7(XIV)(1), 2.8(XV)(1 to 6)
	Chapter-III	Paras 3.1.1, 3.1.4, 3.14
	Chapter-V	Paras 5.2, 5.6
9. No. 25 of 2009	Chapter-II	Paras 2.3(III)(11 to 18), 2.4(IV)(1 to 9), 2.(V) (3 to 6), 2.7(VII)(2 to 4), 2.8(VIII) (1 to 3)
	Chapter-V	Paras 5.1, 5.2, 5.3, 5.5
10. No. 27 of 2009	Chapter-III	Para 3.8.2.7
Ministry of Consumer Affairs Food & Public Distribution		
1. No. 11 of 2008	Compliance Audit Observations	Para 7.1.3
2. No. 24 of 2009	Compliance Audit Observations	Para 5.2.3(FCI)
Department of Defence Production and Supplies		
1. CA 10 of 2008	IT review of Garden Reach Shipbuilders and Engineers Limited (ERP system in material management)	Paras 2.8.1, 2.8.2.1, 2.8.2.2, 2.8.3.1, 2.8.3.2, 2.8.3.3, 2.8.3.4, 2.8.4.1, 2.8.4.2, 2.8.4.3, 2.8.4.4, 2.8.4.5, 2.8.4.6, 2.8.4.7, 2.8.4.8, 2.8.4.9 and 2.8.5
2. CA 10 of 2008	IT review of HAL (Financial module under ERP package)	Paras 3.7.1.1, 3.7.1.2, 3.7.2.1, 3.7.2.2, 3.7.2.3, 3.7.2.4, 3.7.3.1, 3.7.4, 3.7.5, 3.7.6, 3.7.7, 3.7.8 and 3.7.9
3. No 24 of 2009	Compliance Audit Observations	Paras 13.2.1(MIDHANI), 6.1.3(BEML)
Ministry of Finance (Banking Division)		
1. No. 12 of 2006	Transaction Audit Observations	Para 2.1.1
2. No. 11 of 2007	Transaction Audit Observations	Para 2.1.1
3. CA 10 of 2008	IT review of BRBNML (Distribution and Manufacturing Modules under ERP)	Paras 4.7.1.1, 4.7.1.2, 4.7.1.3, 4.7.1.4, 4.7.1.5, 4.7.1.6, 4.7.2.1, 4.7.3, 4.7.4, 4.7.5.1 and 4.7.5.2
4. No. 11 of 2008	Compliance Audit Observations	Paras 2.1.1, 2.2.1

No. and Year of Report	Name of the Report	Para No.
Ministry of Finance (Insurance Division)		
1. No. 12 of 2006	Transaction Audit Observations	Paras 11.2.2(NIC),
2. No. 11 of 2007	Transaction Audit Observations	Paras 10.1.1, 10.2.1, 10.3.4, 10.4.3,
3. PA 15 of 2008	General Insurance Companies	Paras 2.3, 2.4, 2.5, 2.6, 2.7, 2.8, 2.9, 2.10, 2.11, 2.12, 3.6, 3.7, 3.8, 3.9, 3.10, 3.11, 3.12, 3.13, 3.14, 3.15, 3.16(a),(b),(c),(d),(e), 3.17, 3.18, 3.19, 4.3, 4.5.1, 4.6, 4.7, 4.8, 4.9, 4.10, 4.12, 4.13, 1.14, 5.4, 5.5, 5.7, 5.8, 5.9, 5.10, 5.11, 5.12, 5.13, 5.14, 5.15 and 5.16
4. No. 24 of 2009	Compliance Audit Observations	Paras 8.2.1(NIACL) and 8.3.1(ORIINS)
Ministry of Heavy Industry & Public Enterprises		
1. No. 11 of 2008	Compliance Audit Observations	Para 11.2.1
2. No. 24 of 2009	Compliance Audit Observations	Para 9.3.1
Ministry of Petroleum and Natural Gas		
1. No.12 of 2006	Transaction Audit Observation Chapter-XIV	Paras 14.7.8 (ONGC) and 14.8.1(OIL)
Ministry of Power		
1. No. 11 of 2008	Compliance Audit Observations	Paras 20.1.1(bspl)
2. No. 27 of 2009	Implementation of 10th Plan hydel projects in North Eastern and Eastern Region-NEEPCO & NHPC	Ch-VIII
Department of Road Transport & Highways		
1. No. 11 of 2008	Compliance Audit Observations	Paras 18.1.1 and 18.1.2
Ministry of Science and Technology		
1. No.12 of 2006	Transaction Audit Observation Chapter-XIX	Para 19.1.1
Department of Shipping		
1. PA 9 of 2008	Performance Audit of IWAI	Paras 8.2.1, 8.2.2, 8.2.3, 8.3.1.1,8.3.1.1 (i), 8.3.1.1 (ii), 8.3.1.2, 8.3.1.3, 8.3.1.4, 8.3.1.5(i), 8.3.1.5 (ii), 8.3.2, 8.4.1, 8.4.1.1, 8.4.1.2, 8.4.2, 8.4.3.1, 8.4.3.2, 8.4.4.1, 8.4.4.2, 8.4.4.3, 8.4.5.1, 8.5.1, 8.5.2.1, 8.5.2.2, 8.5.2.3, 8.6.1, 8.6.2, 8.7, 8.8.1, 8.8.2, 8.8.3, 8.8.4 and 8.8.5
Ministry of Steel		
1. No. 24 of 2009	Compliance Audit Observations	Paras 13.1.1(Neelachal Ispat

No. and Year of Report	**Name of the Report**	**Para No.**
		and 16.4.1 (Mecon)
Ministry of Union Territory Administration		
1. No. 24 of 2009	Compliance Audit Observations	Para 13.1.1(ANIIDCO)

Annexure–I
(Referred to in para 5.3.1)

Statement showing loss of revenue due to delayed provisioning of circuits

Sl. No.	Name of the Circle/SSA	No of leased circuits/ Points of interconnections	Period for due date of provision of circuits	Period of delay (in days)	Loss of Revenue (₹ in lakh)
Andhra Pradesh telecom circle					
1.	Hyderabad	304	2007-2010	15-538	319.39
2.	Eluru	8	2008-2010		1.98
3.	Visakhapatnam	45	2007-2010		4.91
4.	Khammam	2	2009-2010		3.18
	Sub Total	**359**			**329.46**
N.E.-I telecom circle					
1.	GMTD, Bongaigaon	8	2006-07 -2009-10	38 - 911	27.44
2.	GMTD, Jorhat	23	2006-07 to 2009-10	17-405	24.74
	Sub Total	**31**			**52.18**
Kerala telecom circle					
1.	GMTD Ernakulam	26	2008-2009	10 - 235	6.05
2.	GMTD Mallapuram	15	2008-2009	20 - 128	1.56
3.	GMTD Kollam	33	2007-08 to 2008-09	6 - 423	1.52
4.	GMTD Pallakad	17	2007-08 to 2009-10	8 - 224	1.21
5.	GMTD Kannur	33	2007-08 to 2009-10	7 - 302	1.32
6.	GMTD Kottayam	6	2008-09 to 2009-10	16 - 184	1.49
7.	GMTD Trivandrum	407	2007-08 to 2009-10	3 - 973	30.09
	Sub Total	**537**			**43.24**
Gujarat telecom circle					
1.	CGMT Ahmedabad	108 VPN	July 2006 to December 2009	30 - 566	42.44
		59	June 2007 to October 2009	31 - 362	19.70
2.	PGMTD Vadodara	146	January 2007 to October 2007	68 - 255	51.37
		49 VPN	June 2007 to February 2010	30 - 201	16.95
3.	PGMTD Surat	76	April 2007 to March 2009	32 - 244	13.32
4.	GMTD Rajkot	21	February 2007 to December 2009	30 - 175	2.59
	Sub Total	**459**			**146.37**
Bihar telecom circle					
1.	Principal General Manager Telecom District Patna	119	August 2007 to June 2008	30 - 517	275.07

2.	Principal General Manager Telecom District Patna	31	June 2009 to September 2009	60 - 160	38.30
3.	General Manager Telecom District, Katihar	10 Data	November 2007	496	8.26
4.	General Manager Telecom District, Bhagalpur	19 Data	June 2006 to March 2009	90 - 1040	5.75
5.	Telecom District Manager Arrah	25 Data	March 2007 to October 2008	12 - 283	3.05
6.	Telecom District Manager Madhubani	2	May 2007 to July 2008	397 & 866	1.10
7.	Telecom District Manager Sasaram	10 Data	February 2008 to September 2008	8 - 534	1.86
Sub total		**216**			**333.39**
Calcutta telecom district					
1.	General Manager, OP & CR Calcutta	47 lines	Nov 2008 to July 2009	33 - 417	9.08
2.	General Manager, OP & CR Calcutta	4 Internet lines	September 2008 to July 2009	62 - 376	23.48
Sub Total		**51**			**32.56**
West Bengal telecom circle					
1.	Chief General Manager, West Bengal circle	45 related to bulk user (Eastern Railway)	February 2007 to April 2007	137 - 1038	10.65
Sub Total		**45**			**10.65**
Jammu and Kashmir telecom circle					
1.	Telecom District Manager, Udhampur	17 Data	January 2007 to February 2009	12 - 448	5.65
Sub-total		**17**			**5.65**
Jharkhand telecom circle					
1.	General Manager Telecom District Dhanbad	30	January 2005 to May 2009	43 - 853	243.49
2.	General Manager Telecom District Ranchi	198	2006-07 to 2008-09	6 - 773	32.41
Sub-total		**228**			**275.90**
Haryana telecom circle					
1.	General Manager Telecom Gurgaon	79	December 2004 to December 2009	1 - 363	16.01
2.	General Manager Telecom Rewari	17	July 2009 to August 2009	29 - 140	14.04
3.	General Manager Telecom Faridabad	15	May 2008 to May 2009	4 - 156	1.22

4.	General Manager Telecom Jind	19	September 2007 to March 2008	4 - 226	1.82
	Sub-total	**130**			**33.09**
Himachal Pradesh telecom circle					
1.	General Manager Telecom Mandi	7	August 2006 to August 2008	353 - 925	4.82
2.	Telecom District Manager, Kullu	1	October 2008	63	0.46
3.	General Manager Telecom Shimla	32	September 2007 to January 2010	8 - 212	2.43
	Sub-total	**40**			**7.71**
Maharashtra telecom circle					
1.	Chief General Manager Telecom , Mumbai	868	January 2007 to March 2009	24 - 625	298.46
3.	General Manager Telecom, Aurungabad	1	September 2004 to September 2009	over 5 years	4.10
4.	General Manager Telecom, Jalgaon	6	August 2007 to March 2010	15 months - 32 months	8.26
5.	Principal General Manager Telecom, Nagpur	20	June 2007 to March 2010	12 - 276	3.24
6.	General Manager Telecom, Sangli	37	September 2006 to March 2007	17 - 559	1.95
	Sub-total	**932**			**316.01**
Orissa telecom circle					
1.	GMTD Cuttack	13	September 2007 to March 2009	9-37	0.99
2	GMTD, Berhampur	4	October 2007 to October 2008	11-49	0.12
3.	GMTD, Rourkela	21	July 2007 to October 2008	66 - 517	11.89
4.	GMTD, Balasore	5	Jun-09	68 - 287	13.30
5.	GMTD, Sambalpur	7	February 2008 to September 2008	26 - 363	7.32
6.	GMTD, Bhubaneswar	12	July 2008 to May 2009	41 - 301	26.15
7.	TDM, Bolangir	4	February 2008 to May 2009	108 - 316	10.18
8.	DGM, ETR, Bhubaneswar	1	January 2008 to July 2009	542	11.30
	Sub-Total	**67**			**81.25**
Punjab telecom circle					
1.	General Manager Telecom Patiala	25	July 2006 to September 2009	16 - 262	3.25
2.	General Manager Telecom Jalandhar	173	May 2003 to November 2009	26 - 276	15.29

3.	General Manager Telecom Ludhiana	53	May 2006 to July 2009	1 - 365	6.06
4.	General Manager Telecom Pathankot	16	March 2004 to January 2008	63 - 322	1.93
5.	General Manager Telecom Hoshiarpur	71	January 2006 to September 2009	3 - 287	9.59
	Sub-total	**338**			**36.12**
Rajasthan telecom circle					
1.	General Manager Telecom District Alwar	31	October 2007 to November 2009	4 - 614	1.06
2.	General Manager Telecom District, Bhilwara	12	December 2007 to October 2009	9-98	3.84
3.	General Manager Telecom District, Bikaner	23	March 2007 to August 2009	9 - 236	9.48
4.	Principal General Manager Telecom District Jaipur	185	2007-08 to 2009-10	2 years and 6 months	99.85
5.	Telecom District Manager Jaisalmer	8	December 2007 to December 2009	33 - 345	5.45
6.	General Manager Telecom District Jhunjhunu	22	May 2007 to September 2009	2 - 124	2.20
7.	General Manager Telecom District, Sirohi	4	September 2006 to April 2008	8-64	1.64
8.	General Manager Telecom District, Sriganganagar	8	April 2007 to July 2009	68 - 1120	3.45
9.	General Manager Telecom District, Ajmer	18	March 2006 to October 2009	13 - 315	1.16
10.	General Manager Telecom District, Sawaimadhopur	4	July 2008 to July 2009	10 - 250	1.02
	Sub Total	**315**			**129.15**
Karnataka telecom circle					
1.	Bangalore Telecom District	266	August 2007 to April 2009	30 - 327	64.60
	Sub Total	**266**			**64.60**
UP (West) telecom circle					
1.	Noida	221	2006-2009	2-829	66.25
2.	Ghaziabad	28	2008-2010	35-793	12.76
	Sub Total	**249**			**79.01**
UP (East) telecom circle					
1.	GMTD Kanpur	12	2007-2010	91-393	24.03
2.	GMTD Jhansi	39		13-374	11.23
3.	TDM Jaunpur	22	2006-2010	53-1202	36.61

Sub Total		**73**			**71.87**
Uttarakhand telecom circle					
1.	GMTD Dehradun	48	April 2005 to March 2010	32 - 1799	28.09
Sub-total		**48**			**28.09**
73 SSAs	**Grand Total**	**4401**			**2076.30**

Annexure –II
(Referred to in para 5.3.2)

Statement showing loss of revenue due to non provisioning/commissioning of circuits

Sl. No.	Name of the Circle/SSA	Non provisioning of circuits ranging in days	No. of cases/circuits	Loss of potential revenue (₹ in lakh)
Gujarat telecom circle				
1.	PGMTD Ahmedabad	29 to 327 days as on March 2010	29	7.17
2.	PGMTD Surat	239 to 612 days as on February 2010	2	1.52
Subtotal			**31**	**8.69**
Rajasthan telecom circle				
1.	GMTD Alwar	60 to 133 days as on January 2010	18	1.92
2.	GMTD Jhunjhunu	39 to 71 days as on December 2009	37	1.47
3.	GMTD Sri Ganganagar	up to 89 days as on November 2009	16	7.14
4.	GMTD Jaipur	Up to 355 days as on February 2010	22	37.49
Subtotal			**93**	**48.02**
West Bengal telecom circle				
1.	1 (CGM West Bengal)	More than 2 years as on November 2009	**126**	**60.46**
Kolkata telecom district				
1.	1 (GM OP & CR BD) Kolkata	27 days to 417 days as on September 2009	26	18.17
2.	2 (GM OP & CR BD) Kolkata	Up to 378 days as on September 2009	4	7.53
Subtotal			**30**	**25.70**
N.E.-I (Assam) telecom circle				
1.	GMTD Bongaigaon	160 days as on November 2009	1	0.55
2.	GMTD Jorhat	Up to 329 days as on March 2010	3	5.99
Subtotal			**4**	**6.54**

Karnataka telecom circle				
1.	AGM (Comml.) Bangalore telecom district	More than 3 years as on November 2009	**283**	**382.65**
Maharashtra telecom circle				
1.	Chief General Manager Telecom, Mumbai	Up to 951 days as on January 2010	**731**	**1124.02**
Orissa telecom circle				
1.	General Manager Telecom District, Cuttack	Up to 164 days as on September 2009	**22**	**10.80**
U.P. (East) telecom circle				
1.	GMTD Jhansi	Up to 759 days as on November 2009	**36**	**46.06**
Grand Total			**1356**	**1712.94**

Annexure-III

(Referred to in para 5.3.4)

Statement showing delay in issue of bills

Sl. No.	Name of SSA	Billing period	Amount outstanding (in ₹)	No. of bills	Period of delay
Gujarat telecom circle					
1.	PGMTD Vadodara	2007-08	7594148	1	Up to 08 months
Sub Total			**7594148**		
Rajasthan telecom circle					
1.	CGMT Jaipur	2007-10	52805689	60	Up to 484 days
2.	PGMTD Jaipur	2007-10	46064607	505	Up to 1227 days
3.	TDM Jaisalmer	2007-10	4016041	52	Up to 284 days
Sub Total			**102886337**		
Kerala telecom circle					
1.	Kollam	2004-05 to 2009-10	2092975	66	69 to 1626 days
2.	Pathanamthitta	2008-09 to 2009-10	173000	20	94 to 111 days
3.	Kannur	2008-09 to 2009-10	1304841	7	16 to 253 days
4.	Kottayam	2008-09	467941	8	74 to 166 days
Sub Total			**4038757**		
Karnataka telecom circle					
1.	Bangalore Telecom District	2008-09	16338233	25	121 to 1606 days
		2009-10	302012705	71	30 days
Sub Total			**318350938**		
GRAND TOTAL			**43,28,70,180**		

Annexure –IV

(Referred to para 9.5)

I. Details of policies issued, premium collected, number of claims settled and amount paid for the period from 2007-08 to 2009-10

A. OICL

Year	2007-08	2008-09	2009-10
Number of policies issued	96,76,466	96,55,839	102,63,262
Premium collected (₹crore)	3900.21	4077.89	4854.68
No. of claims settled	5,77,825	5,39,526	7,42,429
Claims paid (₹ crore)	2792.13	3365.14	3708.67

B. Northern Zone

Year	2007-08	2008-09	2009-10
Number of policies issued	2678102	2779317	3114079
Premium collected (₹ crore)	990.24	994.79	1194.70
No. of claims settled	167548	158955	222216
Claims paid (₹ crore)	770.02	968.08	909.81

II. Details of claims reported, paid and outstanding for three year period ending 2009-10

A. OICL

Year	No. of claims reported *	Claims Settled *		Claims outstanding*		
		No.	Value ₹ in crore	At year end	More than six months	Value ₹ in crore
2007-08	576038	577825	2792.13	307366	225845	3776.78
2008-09	530721	539526	3365.14	298561	230906	4158.28
2009-10	739623	742429	3708.67	295755	217882	4462.30

***The information was extracted from the Annual Report of the Company.**

A. Northern Zone

Year	No. of claims reported *	Claims Settled *		Claims outstanding*		
		No.	Value ₹ in crore	At year end	More than six months	Value ₹ in crore
2007-08	167768	167548	770.02	57017	31989	958.77
2008-09	156435	158955	968.08	54497	35922	1044.13
2009-10	227924	222216	909.81	60205	31175	1003.23

Source: Data relating to number of claims extracted from Performance appraisals of the Company and relevant values obtained from annual accounts of the Company.

B. Divisional Offices selected

Year	No. of claims reported	Claims Settled		Claims outstanding		
		No.	Value ₹ in crore	At year end	More than six months	Value ₹ in crore
2007-08	11594	11280	85.15	3441	1925	138.14
2008-09	7174	7543	150.54	3072	2086	200.11
2009-10	6087	5965	73.65	3194	1730	158.78

Annexure-V

(Referred to in Para 10.1)

Working Results of the Division for the last three years ended 31 March 2010

(₹ in lakh)

DESCRIPTION	2007-08	2008-09	2009-10
INCOME			
Gross Sale	103717.48	122647.91	141138.42
Excise Duty	9107.13	8366.54	4786.57
Net Sale	94610.35	114281.37	136351.85
Other Income (including accretion/decretion to WIP & FG)	7497.55	16869.27	13437.37
NET INCOME	**102107.90**	**131150.64**	**149789.22**
EXPENDITURE			
Consumption of raw materials	39672.89	48755.95	58497.50
Stores & Spares	372.42	525.06	595.81
Wages, Salaries & Bonus	11044.90	13247.96	29242.40
Staff Welfare Expenses	1467.88	1914.96	2103.12
Repairs & Maintenance	580.79	911.39	729.29
Water, Power& Fuel	373.80	412.50	473.76
Other expenditure including provisions	6081.08	14535.82	-584.62
TOTAL EXPENDITURE	**59593.76**	**80303.64**	**91057.26**
NET INCOME ANALYSIS			
GROSS MARGIN	**42514.14**	**50847.00**	**58731.96**
Depreciation	1011.20	1248.32	1539.04
GROSS PROFIT	**41502.94**	**49598.68**	**57192.92**
Interest Charged	69.36	67.41	98.61
Tax and Dividend	21379.00	24726.10	28158.31
PROFIT AFTER TAX	**20054.58**	**24805.17**	**28936.00**

Annexure-VI
(Referred to in para 11.1.2.1)
Operational Performance

(₹ in crore)

Financial Indicators	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Loans disbursed during the year					
(i). Government	1548.42	1614.63	1948.05	2017.19	1347.36
(ii). Non-Government	1142.73	1007.53	916.28	1114.22	948.34
Total	**2691.15**	**2622.16**	**2864.33**	**3131.41**	**2295.70**
Growth Rate of Disbursement over the previous year (%)					
(i). Government	(58.50)	4.28	20.64	3.55	(33.20)
(ii). Non-Government	99.65	(11.83)	(9.06)	21.60	(14.89)
Loans outstanding at the end of the year					
(i). Government	12064.04	11637.22	11520.35	11364.96	9725.46
(ii). Non-Government	1831.00	2624.55	3237.51	4187.77	4215.49
Total	**13895.04**	**14261.77**	**14757.86**	**15552.73**	**13940.95**
Defaults at the end of the year					
(i). Government	635.77	679.46	819.28	894.34	801.72
(ii). Non-Government	517.94	617.23	649.66	821.53	1047.10
Total	**1153.71**	**1296.69**	**1468.94**	**1715.87**	**1848.82**
Defaults to total loan outstanding (%)	5.27	5.84	7.11	7.87	8.24
(i). Government	28.29	23.52	20.07	19.62	24.84
(ii). Non-Government					
Income from loans	1248.66	1301.14	1491.30	1647.53	1554.48

Annexure-VII
(Referred to in para 11.1.2.2)
Sector wise performance

(₹ in crore)

Particulars	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Drainage	0	15.75	0	0	0	**15.75**
Sewerage	11.12	4.00	11.38	14.99	6.85	**48.34**
Solid Waste Management	1.69	32.10	30.33	2.54	5.75	**72.41**
Water Supply	335.47	516.18	167.03	301.63	26.00	**1346.31**
Social Infrastructure	147.06	346.23	357.56	215.89	234.54	**1301.28**
Road and Bridges	607.56	382.96	459.23	286.82	122.00	**1858.57**
UII (Industrial Infrastructure	301.13	400.00	1.70	66.77	243.06	**1012.66**
Transport	565.51	87.66	90.28	165.05	190.91	**1099.41**
Power	470.13	304.92	1170.60	1665.01	1093.70	**4704.36**
Others (Commercial)	251.48	532.36	576.22	412.71	372.89	**2145.66**
Total	**2691.15**	**2622.16**	**2864.33**	**3131.41**	**2295.70**	**13604.75**

Annexure-VIII
(Referred to in Para 14.3.1)

Statement showing excess payment on account of Perquisites & Allowances to Executives and non unionized Supervisors in BHEL

(₹ in crore)

Particulars of Perquisites & Allowances	**2008-09**	**2007-08**	**2006-07**	**2005-06**	**2004-05**	**2003-04**	**2002-03**	**2001-02**	**Total**
Transport subsidy	0.85	0.5	0.46	0.59	0.42	0.64	0.58	0.53	4.57
Education allowance	1.6	2.51	0	0	0	6.1	5.86	4.94	21.01
Washing allowance	2.04	0.91	0	0	0	0	0	0	2.95
Other allowance	3.1	3.05	10.17	9.55	6.09	0	0	0	31.96
L T A	4.5	28.67	0	15.69	10.34	11.07	0.83	0.22	71.32
L T C	0.87	4	0	2.15	2.02	2.02	11.21	2.01	24.28
Leave encashment	139.65	97.06	59.33	58.31	59.22	57.9	32.49	60.05	564.01
Subsidized transport	7.27	8	5.84	5.97	5.45	5.11	5.17	5.42	48.23
Interest subsidy on housing loans	38.83	41.56	50.1	47.42	40.7	34.71	26.88	22.69	302.89
Interest subsidy on vehicle loans	10.04	7.73	0	0	0	0	0	0	17.77
Interest subsidy on other loans	0.18	0.48	0	0	0	0	0	0	0.66
Other benefits& staff welfare expenses	29.51	21.63	76.37	34.78	30.16	16.83	11.68	12.2	233.16
Medical expenses reimbursement	14.12	15.12	64.66	30.7	28.74	27.41	25.37	22.68	228.8
Payment to empanelled hospitals and doctors	35.42	30.64	0	0	0	0	0	0	66.06
Other expenses on medical facilities	2.24	1.86	0	0	0	4.57	4.02	3.95	16.64
Total	290.22	263.72	266.93	205.16	183.14	166.36	124.09	134.69	1634.31
Basic Pay	358.87	340.91	338.06	335.88	330.2	328.03	328.33	329.19	2689.47
50% of Basic Pay	179.44	170.46	169.03	167.94	165.1	164.01	164.17	164.59	1344.73
Excess payment of Perks & Allowances excluding Plant Performance Incentive	**110.78**	**93.26**	**97.9**	**37.22**	**18.04**	**2.35**	**0**	**0**	**359.55**

Annexure-IX

(Referred to in para 17.5.6)

Operation of BOF in terms of no. of hours for the three years ended 31.3.2010

Year		Total hrs. available	Total hrs worked	Total hrs. lost	Planned shutdown hours	Unscheduled shut down hours	Trouble hours
2007-08	BOF- A	8760	5451	3309	864	575	1870
2007-08	BOF -B	8760	5686	3074	752	537	1785
	TOTAL	17520	11137	6383	1616	1112	3655
2008-09	BOF- A	8760	3512	5248	1943	1189	2116
2008-09	BOF -B	8760	3804	4956	1754	1106	2096
	TOTAL	17520	7316	10204	3697	2295	4212
2009-10	BOF -A	8760	4004	4756	473	2855	1428
2009-10	BOF -B	8760	4130	4630	803	2300	1527
	TOTAL	17520	8134	9386	1276	5155	2955
	Gr. TOTAL	52560	26587	25973	6589	8562	10822
Per cent to total available hours			50	50	13	16	21

GLOSSARY

ADC	Access Deficit Charge
AFS	Aviation Fuel Station
ALCO	Asset Liability Management Committee
APM	Administered price mechanism
ASMGCS	Advanced Surface Movement Guidance and Control System
ATF	Aviation Turbine Fuel
ATM	Air Traffic Management
BA	Business Associates
BODs	Board of Directors
BRLM	Book Running Lead Managers
C&F	Cost and freight
CFFP	Central Foundry Forge Plant
CNS	Communication, Navigation, Surveillance
CPSEs	Central Public Sector Enterprises
DCS	Distributed Control Systems
DIAL	Delhi International Airports (P) Limited
DME-LP	Distance Measuring Equipment–Low Power
DPE	Department of Public Enterprises
DPR	Detailed Project Report
DPU	Digital Processing Units
DSCN	Dedicated Satellite Communication Network
DSLAM	Digital Subscriber Line Access Multiplexer
DVORs	Doppler Very High Frequency Omni Directional Radio Range
ECB	External Commercial Borrowings
EOI	Expression of Interest
ERP	Enterprise Resource Planning
ETV	Elevated Transfer Vehicle
F–F GTG	Flange to Flange Frame 9FA Gas Turbine Generator
FPQ	Fixed Price Quotation
GCC	General Conditions of Contract
GOI	Government of India
GoU	Government of Uttarakhand
GSM FWP	Global System for Mobile communication based Fixed Wireless Phone
H&T	Handling and Transportation
HRA	House Rent Allowance
IFS	Industrial Finance System
IISFM	Integrated Information System for Food grains Management
IPO	Initial Public Offering

IRDA	Insurance Regulatory and Development Authority
IRR	Internal rate of return
JSERC	Jharkhand State Electricity Regulatory Commission
JVC	Joint Venture Company
LLA	Leave and licence agreement
MAF	Metso Automation Inc.
MIS	Management Information System
MSP	Minimum Support Price
MT	Metric Tonne
NHB	National Housing Bank
NIT	Notice Inviting Tender
OFC	Optical Fibre Cables
OMC	Oil Marketing Companies
OMDA	Operation, Management and Development Agreement
OS	Operation Support
OTS	One Time Settlement
P&WC	Pratt & Whitney, Canada
PCO	Public Call Office
PD	Projects Department
PEL	Petroleum exploration license
PG	Phospho gypsum
PICs	Procurement Incidental Charges
PIL	Petronet India Limited
PQD	Project Quality Document
PSF	Passenger Service Fee
RIL	Reliance Industries Limited
RTL	Rupee Term Loan
SERC	State Electricity Regulatory Commissions
SMS	Steel Melting Shop
SPUs	Steel Processing Units
SSA	Secondary Switching Areas
T&D	Transmission and Distribution
TCA	Technical Collaboration Agreement
THDC	Tehri Hydro Development Corporation
TSHDs	Trailer Suction Hopper Dredgers
UI	Urban Infrastructure
USO	Universal Service Obligation
VAT	Value Added Tax
VCCS	Voice Communication and Control System