CHAPTER VII: MINISTRY OF DEFENCE

BEML Limited

7.1.1 Extra expenditure due to amending the currency of payment

The Company incurred an extra expenditure of Rs.26.62 crore by agreeing to the request of the supplier for amending the currency of payment which was in contravention of the terms of the purchase orders.

For meeting the supply order (March 2006) of the Ministry of Defence (MOD) for Tatra vehicles, BEML Limited (Company) placed (July 2006) a purchase order (PO) on Tatra Sipox (UK) Limited (supplier), for supply of semi knocked down (SKDs) and complete knocked down (CKDs) sets for different models of Tatra vehicles at a total order value of US$97.70 million. As per terms and conditions of the PO, prices were firm on FOB[1] European port basis in US Dollar and payable by irrevocable letter of credit (LC) on sight basis.

The supplier requested (December 2006) the Company to change the currency of payment from US Dollar to Euro for all shipments to be made from January 2007. This was stated to be based on the insistence of Czech National Bank as the Czech Republic being a member of European Union was expected to be in Euro Zone whereby all non-US business had to be converted to Euro.

The Company's request (December 2006) to adopt the cross currency rate prevailing on the date(s) of establishment of LC was not accepted by the supplier. Subsequently, a meeting was held on 6 February 2007 to settle the issue in which the proposal of the supplier for a fixed cross currency rate of US$1.2936=1 Euro[2], instead of cross currency rate as on the date(s) of payment was accepted by the Company. Accordingly, the value of supplies pending against the POs as of December 2006 for US$78.49 million was amended to Euro 60.68 million.

Audit observed that:

- Explicit reasons/compulsions on the Company to accept the fixed conversion rate of US Dollar to Euro on a fixed date i.e., 16 January 2007 were not on record.

- The Company had also not covered itself against exchange rate fluctuations by taking a forward cover. This had resulted in extra cash outflow of Rs.26.62 crore due to increase in rates of Euro in comparison to US Dollar in respect of pending supplies received between March 2007 and October 2008. In the absence of provision in the contract with the MOD for reimbursement of the rise in the

[1] ***Free on Board***
[2] ***Rate as on 16 January 2007***

landed cost due to exchange rate fluctuation, the Company had to bear the entire extra expenditure.

The Management stated (May 2009) that:

- Despite highlighting the fact that the Company would lose substantially if supplier's terms were accepted, the supplier was adamant and the Company had no other option but to accept the fixed cross currency conversion rate of US Dollar to Euro insisted by the supplier as the firm was the proprietary supplier of Tatra vehicles.
- Had there been a stalemate with the supplier, the Company would not have met the committed deliveries to MOD.

However, Audit observes that:

- The contention of the supplier about the insistence by the Czech National Bank do not corroborate with the fact as the supplier had accepted payment in US Dollar for orders placed after January 2007 and supplies made after February 2007. Further, there was no evidence in the files made available to audit to indicate that the veracity of the Czech National Bank's insistence for change in currency for pending supplies as at the end of December 2006 was ensured by the Management.
- Even if the Company was to accept the change in the currency of payment, it should have taken the safeguard to protect its financial interest by taking hedging/forward cover.

Thus, the Company had to incur an extra expenditure of Rs.26.62 crore by agreeing to the request of the supplier for changing the currency of payment in PO from US Dollar to Euro and manner of its conversion in contravention of the 'firm' terms of the PO.

The matter was reported to the Ministry in July 2009; their reply was awaited (November 2009).

Bharat Electronics Limited

7.2.1 Loss in supply of solar home lighting system

Failure to consider the in-house capacity constraints and current outsourcing cost of modules resulted in a loss of Rs.5.19 crore.

Bharat Electronics Limited (Company) quoted (August 2005) against a tender of Tripura Renewable Energy Development Authority (TREDA) for supply, installation, commissioning and comprehensive maintenance of 18000 Solar Home Lighting Systems (SHLS). Quotation was based on in-house cost valid for 120 days (November 2005). TREDA placed orders for 9000 SHLS in October 2005 and 9000 SHLS in February 2007.

The Company manufactures solar cells from silicon wafers and manufactures modules[♣]. As its in-house module manufacturing capacity was inadequate to meet the above order,

[♣] ***Module-a critical component in a solar lighting system*** the Company had to outsource this work by issuing cells to module manufacturers. The Company failed to consider actual cost of outsourcing of modules while quoting. The first 9000 SHLS were executed by outsourcing 8100 modules and the Company completed supplies by September 2007 with a meager margin (Rs.10 lakh only).

Audit noticed that:-

- The Company accepted the second order of 9000 SHLS (February 2007) beyond validity period (November 2005) without considering the increased cost of outsourcing.
- Considering its capacity constraint, the Company should not have accepted an un-remunerative order beyond its validity. The Company lost Rs.5.19 crore[1] in execution of the second order.

The Ministry replied that the project was viable based on inputs available at the time of quotation and the Company issued low cost cells from the available stock for module manufacture.

The Ministry's reply is not correct since Management confirmed (October 2009) that the low cost cells were diverted to other orders as the second order of TREDA was delayed.

Thus, failure to consider the in-house capacity constraints and outsourcing cost of modules for second order, while it was not bound to accept the lapsed commitment, resulted in a loss of Rs.5.19 crore.

Hindustan Aeronautics Limited

7.3.1 Locking up of funds due to acceptance of an unviable delivery schedule

Acceptance of an unviable delivery schedule coupled with delay in submission of change order resulted in locking up of Rs.95.26 crore and consequent loss of interest of Rs.16.62 crore.

Hindustan Aeronautics Limited (Company) received (August 2000) a letter of intent from Ministry of Defence (MOD) for manufacture and supply of 20 Single Seater Jaguar Aircraft to the Jaguar NavWASS[2] upgrade standard. The Company submitted (December 2002) a quotation of Rs.113.82 crore per aircraft based on the Standard of Preparation (SOP)[3]. During price negotiation[4] IAF[5] insisted for revised SOP covering additional items/modifications and price was finalised at Rs.109.50 crore per aircraft and the contract was signed in March 2006. As per contract, all 20 aircraft were to be supplied by 2007-08 (six aircraft were to be delivered in 2005-06). Delay in supply attracted levy of liquidated damages subject to a maximum of five per *cent*.

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[1] ***Outsourced at Rs.15,564 per module as against the quoted rate of Rs.9,425 per module arrived at based on in-house manufacturing cost of 2005-06, i.e. Rs.8,841 per module.***
[2] ***Navigation and Weapon Aiming Sub System***
[3] ***Standard of preparation represents various items/components fitted in the aircraft***
[4] ***October 2005 to March 2006***
[5] ***Indian Air Force***

Audit noticed that the Company accepted unviable delivery schedule despite being aware at the time of signing of the contract in March 2006 that the revised SOP was yet to be finalised as the delivery was dependent on final SOP terms.

The revised SOP was finalised in March 2007 and the first aircraft was supplied in May 2007 and the supply of all 20 aircraft was completed by October 2009 with delays ranging from 1 to 17 months. Accordingly, MOD recovered Rs.95.26 crore towards LD for delayed supplies.

The Ministry replied (October 2009) that:

- The delivery schedule for 20 strike jaguar contract was agreed to in view of the likely extra time that would have taken for fresh CCS♦ approval. However, a provision to rework through amendment in the delivery schedule was kept in the contract.
- Consequently, a consolidated change order was made by the Company and is currently under process. This was not moved earlier as insisting on amendment prior to delivery of completed aircraft was not considered a practical proposition.

The reply of the Ministry is not convincing due to the following reasons:

- The apprehension of the Ministry of likely extra time that would have taken for fresh CCS approval is not borne out by facts as the delivery schedule stipulated in the contract finalised in March 2006, was different from what was originally approved by the CCS (December 2002) and was not realistic as supply of aircraft could not be made without finalisation of SOP.
- Further, the decision to submit consolidated change order, based on actual delivery of the aircraft, after completion of the supplies is not in the interest of the Company as the Company had not received any advance against this contract and payments received were only against completion of mile stones which has resulted in locking up of Company's funds in the form of LD recovered by MOD for delay in supplies.

Thus, the acceptance of unviable delivery schedule despite being aware at the time of signing of the contract in March 2006 that the revised SOP was yet to be finalised led to blockage of Rs.95.26 crore as payment of LD with consequent loss of interest of Rs.16.62 crore (October 2009).

7.3.2 Avoidable loss due to non provision of full maintenance expenditure

Failure to include a provision towards full maintenance expenditure of prototype aircraft beyond scheduled FOC in the MOU resulted in avoidable loss of Rs.5.26 crore.

♦ *Cabinet Committee on Security*

A tripartite Memorandum of Understanding (MOU) was entered (March 2002) amongst Defence Avionics Research Establishment (DARE)[1], Indian Air Force (IAF) and the Hindustan Aeronautics Limited (Company) for series upgradation of 38 MIG-27M aircraft apart from two prototype aircraft with modern avionics system based on the core avionics computer developed by DARE at a total cost of Rs.204.25 crore to be funded by IAF.

The first phase of the programme was to upgrade two prototype aircraft for which the Company was responsible for aircraft modification and maintenance of two aircraft upto Final Operational Clearance (FOC) which was scheduled in October 2005. The total amount sanctioned (August 2003) for the first phase programme was Rs.20.41 crore (excluding contingency amount of Rs.2.04 crore) which included Rs.74 lakh towards maintenance of two prototype aircraft. FOC was achieved belatedly in December 2008. The Company incurred expenditure of Rs.6.30 crore over and above Rs.74 lakh provided in the MOU towards maintenance of two prototype aircraft till the extended date of FOC.

The Company requested (February 2008) Air Head Quarter's (AHQ) to reimburse the extra expenditure stating that the cost of Rs.74 lakh was only for maintenance support of new equipment integrated during up-gradation and not for full maintenance till FOC. The Company admitted that this aspect was not clearly brought out in the MOU due to drafting mistake. AHQ rejected the claim of the Company stating (April 2008) that the estimated cost for maintenance of aircraft for a period of 19 months was reflected in the worksheet of MOU and the extra expenditure projected beyond planned FOC in the absence of any other justification and provision in the MOU was not admissible.

The Company again requested (May 2008) for reconsideration of their claim, admitting that delay in FOC was not envisaged during price negotiations/MOU and hence the expenditure towards full maintenance support was not provided. The extra expenditure was towards deputation of more number of specialists, material/spares and deployment of manpower towards maintenance of aircraft, snag rectification, modifications etc.

In response, AHQ agreed (August 2008) to reimburse Rs.1.04 crore as the last payment towards extended product support due to delay in FOC on the condition that no further element of expenditure would be considered in future. The subsequent request (November 2008) of the Company was also not considered (April 2009) by the AHQ.

The Management stated (March 2009) that the total cost sanctioned was tentative. The AHQ's contention had neither been accepted nor had the payment of Rs.1.04 crore been accepted. Project is to be seen in totality and profitability cannot be viewed against each element of cost.

The reply is not convincing as the project cost sanctioned was on 'not-to-exceed basis' as per the tripartite MOU and was not tentative. The fact that even reimbursement of Rs.1.04 crore agreed by AHQ, is restricted to the available contingency amount[2] provided

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[1] ***a part of Defence Research Development Organisation/ Ministry of Defence***

[2] ***Out of Rs.2.04 crore contingency provisions in the contract, Rs.one crore was transferred to DARE in January 2009***

in the sanctioned project cost. Elemental cost assumes significance as savings on each element of cost contributes to the overall profitability of the project.

Thus, failure to include a provision towards full maintenance expenditure of prototype aircraft during design and development phase beyond scheduled FOC in the MOU resulted in avoidable loss of Rs.5.26 crore.

The matter was reported to the Ministry in June 2009; their reply was awaited (November 2009).

7.3.3 Failure to enter into a formal contract with AHQ for MiG upgrade

Company's failure to enter into a formal contract before accepting the upgrade work of MiG-BiS to MiG-BISON on annual overhaul task with explicit provision for rejections resulted in absorbing extra cost of Rs.3.81 crore.

Hindustan Aeronautics Limited (Company) undertook (2001-02) the series upgradation of 123 MiG BiS to MiG BISON aircraft under annual overhaul/upgrade task and no separate contract was concluded between the Company and Air Headquarters (AHQ). BiS upgrade was a customer project and the kits/material was to be supplied by AHQ for upgradation work.

During upgradation (2002-03 and 2003-04), some spares supplied by AHQ were found unserviceable and were rejected. The Company assessed the additional spare parts required for upgradation of 123 aircraft and requested (February 2005) AHQ for their procurement from M/s. Rosoboronexport, Russia, supplier of materials/spares for the upgradation. AHQ indicated that they would only place a Repair, Maintenance and Supply Order (RMSO) and the Company should purchase the items required. The Company decided to procure the spares considering the delivery schedule, the lead-time required for supply of the spare parts and to follow up with AHQ for issue of RMSO for regularising the procurement.

The Company procured (November 2005) spares valued at Rs.15.58 crore. However, AHQ placed RMSO for Rs.10.78 crore only as AHQ did not agree (June 2006) to place RMSO for spares valued at Rs.3.81 crore arising out of shop floor rejections and for spares valued at Rs.0.99 crore required to be stocked by the Company for future requirement. The Company upgraded 123 aircraft upto 2007-08 and absorbed the expenditure incurred on procurement of spares in 2006-07 and 2007-08.

Audit observed that the Company failed to safeguard its commercial interest as this particular task was being executed by the Company under a different pricing procedure for the first time. Hence, the Company should have taken care to cover the cost of normal shop floor rejections through a formal contract or to get reimbursement of the cost of rejected spares separately. This failure of the Company resulted in absorbing extra cost of Rs.3.81 crore.

The Management/Ministry admitted (November 2009) that pricing was separately done for the upgrade distinct from Overhaul and stated that the FPQ price excluded the material cost. Considering the delivery schedule and consequent penalties, the Company procured the material and absorbed the cost.

Audit, however, observes that:

- As there was no formal contract, the AHQ refused to reimburse the expenditure in the absence of a mandate.

- Ministry of Defence being the administrative ministry should have facilitated reimbursement of extra cost incurred by the Company .