

Chapter VII: Contract Management

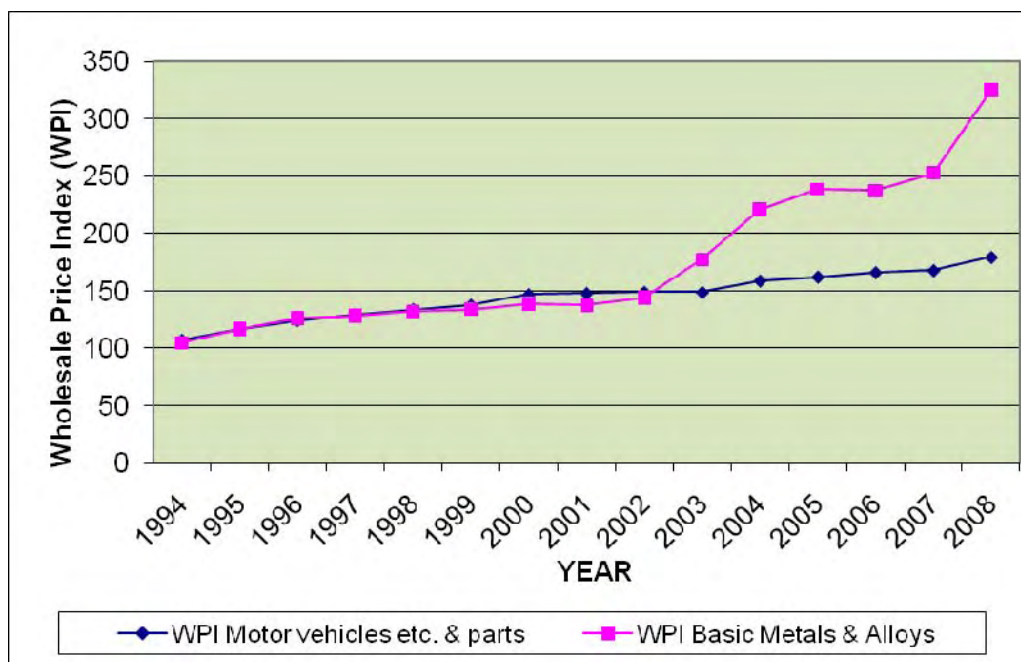
7.1 Linking of Price Variation Formula to WPI of wrong group led to huge loss

Ordnance Factory Board (OFB) and Tata Engineering and Locomotive Co. (TELCO) entered into an “**Agreement**” in September 1998 granting OFB rights for producing 2.5 Ton pay load model LPTA 713(4x4) vehicle ‘the product’ at Vehicle Factory, Jabalpur (VFJ) from the CKD/SKD vehicles to be supplied from the firm. The agreement included inter alia the following two conditions:

- (a) The prices of the Product, its aggregates, and items of itemised price list of components/sub-assembly/other materials would be subject to the “**price variation formula**”.
- (b) In case of reduction in price of any vehicle model identical to the one under that agreement, the benefits in reduction in prices would be passed on to OFB/VFJ.

OFB and TELCO entered into supplemental agreements on 07 August 2001 and 04 December 2006 to amend certain articles of the Principal Agreement/Supplemental agreements. It included that the obligation of TML (Tata Motors Limited formerly known as TELCO) would extend up to fourteen years from the effective date of the Principal Agreement i.e. 4 September 1998.

The price variation formula of the above agreements was linked to the WPI (wholesale price Index) of the sub-group ‘Basic Metals and Alloy’ instead of the WPI for the appropriate sub-group ‘Motor Vehicles, Motorcycles, Scooters, Bicycles & Parts’. The trend analysis of WPI for above two sub groups for September (designated month of price variation formula of the agreements) indicated that from September 2003 onwards, the WPI for the sub-group ‘Basic Metals and Alloys’ was rising steeply in comparison of the WPI for the sub-group ‘Motor Vehicles, Motorcycles, Scooters, Bicycles & Parts’ as depicted below: -



During the audit of supply orders valuing Rs 1 crore and above placed on the TML during the period 1 April 2006 to 31 March 2009 the total additional payment made to the TML in respect of the supply orders under the Principal Agreement and its supplemental worked out to Rs.105 crore plus taxes and excise duty thereon due to adoption of **WPI** for sub-group “Basic Metal and Alloys” rather than for “Motor Vehicles etc. and parts” for calculating the price variation.

Similarly, OFB and Ashok Leyland Ltd. entered into an agreement on 10 August 1998 granting OFB rights for producing STALLION Mk III Model 5/7.5 Ton payload 4x4 version at Vehicle Factory, Jabalpur and /or any other Ordnance Factory under the control of OFB. The prices of the Product, its aggregates, and items of itemized price list of components/sub-assembly/other materials were subject to a similar price variation formula with minor variations in the weightage of various factors. The agreement also had a similar fall clause.

OFB and Ashok Leyland entered into supplemental agreements on 09 April 2003, 16th December 2005, and 17th October, 2006 to amend certain Articles of the Principal Agreement/Supplemental agreements. It included that the Principal Agreement would be in vogue during a period of fourteen years from the date of the signing the (Principal) Agreement i.e. 10 August 1998.

The price variation formula of the above agreements also adopted WPI for the sub-group 'Basic Metals and Alloy' instead of the WPI of the appropriate sub-group 'Motor Vehicles, Motorcycles, Scooters, and Bicycles & Parts'. The trend analysis of WPI of above two sub groups for the for month of March (designated month of price variation formula of the agreements) indicated the same trend of steep rise in "Basic Metals and Alloys" compared to "Motor Vehicles etc. and parts".

From supply orders valuing Rupees One crore and above placed on the M/s Ashok Leyland during the period 1 April, 2006 to 31 March, 2009 the total additional payment that had to be made to the Ashok Leyland in these supply orders worked out to Rs.148 crore plus taxes and excise duty thereon due to adoption of WPI for wrong sub-group for the "price variation formula".

In reply to the observation made regarding the excess payment the factory mainly stressed that the sub-group (for WPI) suggested by audit was not covering vehicles of exclusive Military use which were technically quite different from the commercial ones. It also stated that the WPI which was perceived to be more suitable was decided at the time of agreement as it could not be anticipated in advance, that which index would move which direction in the future. Ministry's reply confirmed the above replies of the factory.

The factory's reply was not tenable as the vehicles under the agreements were actually truck and basic material of commercial truck and military truck are almost similar. Further the agreement itself had a fall clause that should there be a reduction in price of any vehicle model identical to the one covered by the agreement, the benefit in reduction in prices would be passed on to OFB/VFJ.

7.2 Non furnishing of Performance Security Deposit

Rule 158 of the General Financial Rules stipulates that "to ensure due performance of the contract, performance security is to be obtained from the successful bidder awarded the contract. Performance security is to be obtained from every successful bidder irrespective of its registration status. Performance Security should be for an amount of 5-10 *per cent* of the value of the contract." It further stipulates that "Performance security should remain valid for a period of sixty days beyond the date of completion of all contractual obligations of the supplier including warranty obligations."

Paragraph 5.2 of the MMPM also stipulates that Performance Security Deposit is payable to the purchaser by the supplier in the form of bank guarantee issued by a scheduled bank within 30 days of the contract. The BG is to be returned to the supplier on successful completion of all obligations under the contract. According to the manual, the performance security deposit is to be paid by all firms irrespective of the registration status with DGS&D and NSIC. MMPM also stipulated the performance security deposit at 10 *per cent*, but OFB later in October 2006 brought the amount down to 5 *per cent*, the lowest point of the range provided in the GFR.

The MMPM however, exempted the PSUs and firms supplying proprietary items from payment of performance security. Apart from the fact that such exemption is not authorised by the GFR, there is no rationale also for such exemption. Performance security is designed to protect the purchaser from the risks of non supply of stores at the right time and such risks are present even when the suppliers are PSUs or single source. Incidentally Railways have not exempted the PSUs from payment of security deposit.

It was noticed in audit that in many cases the Factories did not take security deposit. In Ammunition Factory Kirkee, in several cases the factory did not insist on the security deposit and finally orders were not successfully executed by the firm.

Following is an illustrative list of firms which did not deposit the security deposit and also did not supply the store so far is shown in the following table:-

Table 6: Cases of Performance Security Deposit waived or not insisted upon

Name of the firms	SO No & date		Name of the item	Oty. Ordered	Oty. Received	Total value	Remarks
RK Machine tools	800455 28-04-09	dt	Mine APM	10015 set	NIL	9894820	Waived
Hydrabad precision	800937 25-03-09	dt	Mine APM	550 set	NIL	5508250	Waived
Naveen Tools	900116 30-04-09	dt	Mine APM	988 set	NIL	5936892	Waived
Ashoka Industries	900111 28-04-09	dt	Mine APM	988 set	NIL	5936892	Waived
Shiva Plastic	800478 11-10-08	dt	Ammn. Container	37600 Nos	NIL	860288	Not deposited
Pandit Engg Pune	700344 6-07	dt 7-	Air bolt	1000	NIL	731250	Not deposited
Stuti Enterprises	800784 17-2-09	dt	Separators for cartoon 23 A	525000	NIL	645750	Not deposited
Unipack Industries	701386 15-3-08	dt	Box M 20 A/L	3000	NIL	582000	Not deposited
Alcast	800722 27-1-09	dt	Notched coil	25500	NIL	561000	Not deposited
Precision Engg	800721 27-1-09	dt	Notched coil	25500	NIL	561000	Not deposited

Ministry replied that in the revised Procurement manual, the provisions regarding waiver of Performance Security Deposit would be made more stringent.

7.3 Management of the option clause

Option clause for quantity enhancement is included in a contract to reap the benefit of the present price against future demand. The purchaser through this clause gains an option to procure part of the goods if required in future at a cheaper rate, if the market prices go up.

Paragraph 9.15 of the MMPM lays down detailed guidelines for operation of the option clause. Factories are required to indicate at the stage of tender enquiry itself the decision regarding inclusion of the option clause in the supply order. While the Manual provides that the tenderers should be directed to quote for quantities mentioned in the tender as well as give consent for up to 100 *per cent* enhanced quantities against option clause. Subsequent exercise of the option clause, according

to the Manual would be decided on the standard factors like existence of requirement, market trend, quality and quantity of supplies received etc. up to the point of time of exercising the option with due care to avoid over provisioning.

A large number of cases were seen in different Factories indicating extremely poor management of option clauses.

Ministry stated that though the audit observation is in line with the Procurement Manual, inclusion of option clause in the tender enquiry has its effect on the price as the firm has to supply items with longer delivery period. Accordingly, the firm may keep the price high so as to accommodate any market fluctuation.

Option clause is a standard contract condition widely prevalent. The reply of the Ministry does not conform to this.

Case 1

Undue favour to firms due to non exercise of option clause

In Ordnance Factory Dehu Road, it was noticed that for procurement of Fuze 213P MK (M-3) empty for 81 mm Illuminating, 10 supply orders were placed on different firms as detailed in the following table

Table 7: Procurement of Fuze 213P MK (M-3) empty for 81 mm Illuminating

Sl No	SO No & date	Name of the firms	Ord qty (nos)	Rate (Rs)	25 per cent option qty (nos)
1	2005SP0173 dt 2/8/05	IST N.delhi	20500	1223/-	5125
2	2005SP0759 dt 8/3/06	MI	16400	1285/-	4100
3	2005SP0760 dt 8/3/06	IST	16400	1285/-	4100
4	2005SP0761 dt 8/3/06	VXL	16400	1285/-	4100
5	2006SP0807 dt 30/3/07	MI	12300	1410/-	3075
6	2006SP0808 dt 30/3/07	IST	12300	1410/-	3075
7	2006SP0809 dt 30/3/07	VXL	12300	1410/-	3075
8	2007SP0636 dt 31/12/08	VXL	23210	1736.28/-	5802
9	2007SP0637 dt 31/12/08	IST	21100	1736.28/-	5275
10	2008SP0478 dt 22/12/08	IST	10550	1789/-	

It was observed that though the demands were available, there was no declining trend in the price and the supply orders had the option clause, the factory did not exercise the option clause even though factory purchased the stores from the same suppliers at higher rates. Due to non operation of QEC, the factory incurred an additional expenditure of Rs.54.52 lakh.

In reply the factory stated that as per the Manual, option clause is normally exercised after receipt of 50 *per cent* quantity and in these cases, 50 *per cent* quantity was not supplied within the original delivery period. Such a literal interpretation of the manual provisions belies the judgment expected of the senior management of the factory, as they did not hesitate to place fresh supply orders on the same firms at a higher rate.

Ministry stated in June 2010 that the firms supplied small quantities during the original delivery period and bulk supplies were made during the extended delivery period. As the manual provides that option clause could be exercised during original delivery period, such clause could not be exercised.

Case 2

Non-inclusion of option clause by HVF Avadi

Heavy Vehicles Factory placed a supply order in January 2006 on ASL Systems, Bangalore for procurement of 132 Navigational GPS Satellite Sets by October 2006 at a rate of Rs 133621. No option clause was provided for in the tender enquiry and in the supply order, Material Planning Sheet generated in July 2006, which was within the validity period of the supply order, indicated a total requirement of 167 Units after taking into account the dues in from the earlier supply order. In August 2006, however, the Factory decided to procure 134 sets.

The factory placed another supply order on the firm in March 2007 for the 134 sets to be supplied by Mar 2008 at a higher unit rate of Rs 1,50,696. Though option clause for 50 *per cent* was provided for in the tender enquiry for the fresh requirement of 134 sets and HVF and AV HQ recommended for inclusion of the option clause, OFB TPC while approving the proposal did not specifically mention the option clause. Hence the option clause was not included in the supply order.

Within currency of this second order (of March 2007), requirement arose in November 2007 for another 74 sets. As no option clause was available in the order of March 2007, the factory had to again place one more supply order on the same firm in July 2008 for procurement of 74 sets at a higher rate of Rs 1,52,170. But the factory included the option clause for 50 *per cent* this time in the supply order of July 2008 and availed of the same in May 2009.

The factory informed Audit that as there was no specific mention in the approval of OFB on inclusion of the option clause, the same was not included in the two supply orders of January 2006 and March 2007. The reply is not justified as inclusion of option clause is a manualized provision. Failure of the Factory to include the option clause (for 25 *per cent* in the first case and 50 *per cent* in the second case) resulted in an extra expenditure of Rs 6.62 lakh.

Case 3

Non-inclusion of option clause by OF Medak

Ordnance Factory, Medak placed a supply order in July 2006 on Bhaskara Dynamics, Bangalore for supply of 59 Units of Assembly Track Guard at a unit rate of Rs 194625. Even though the tender enquiry provided for option clause for 25 *per cent*, yet the same was not incorporated in the supply order. Even before placement of the supply order in July 2006, a further requirement of 10 Units of the item arose in June 2006. As the order did not contain the option clause, the additional requirement of 10 Units had to be procured at a higher rate of Rs 243000 through another supply order of August 2008 placed on the same firm, resulting in delay and an extra expenditure of Rs 483750. The factory informed Audit that the order was to be placed for 59 Units of the item and the balance requirement was to be developed in-house and therefore the option clause was not incorporated in the order of July 2006. The fact remains that no in house development took place and besides it would have been prudent to include the mandatory provision of option clause in the supply order particularly when the clause was included in the tender enquiry.

Case 4

Option clause not exercised by HVF Avadi

Heavy Vehicles Factory placed a supply order in February 2006 on Universal Radiators for supply of 68 Units of Rack with Radiators at a unit rate of Rs 2,49,812 by March/September 2007 with an option clause for supply of 17 Units (25 *per cent*). Material Planning Sheet generated in September 2006 indicated a net requirement of 92 Units. When the accounts authorities vetted a requirement of 50 Units, the factory did not avail the option clause available in the supply order of February 2006 to procure 17 Units at the rate of Rs 2,49,812. Instead it placed

another supply order in June 2007 on Halgona Radiators, Bangalore for procurement of 50 Units at a unit rate of Rs 3,28,753.

HVF replied to Audit that as action for procurement of 17 Units had already been initiated through OTE, option clause available in the order of Feb 2006 was not availed of. However, the reply overlooks the fact that the requirement was more than 17 and hence the benefit of the option clause could well have been derived. Failure to do so involved an additional expenditure of Rs 13.41 lakh.

Case 5

Delay in exercise of option clause

HVF placed a supply order in October 2006 on BEMCO Ltd for supply of 114 Units (LH) and 125 Units (RH) of Distributing Mechanism at a rate of Rs 67,500 with a delivery period up to November 2007 later extended up to December 2008. An option clause for 25 *per cent* was included in the supply order. The firm supplied all the items by August 2008. Material Planning Sheet of June 2008 indicated a requirement of 352 Units in Jun 2008. However HVF took two months to process the case for availing the option clause. By the time it decided to avail the same, the firm completed the supplies by Aug 2008. HVF, therefore, had to place another order on the same firm in Mar 2009 for the 352 Units at a higher rate of Rs 87,674.

HVF replied to Audit that option clause could not be exercised since the firm had completed the supplies. Delay on the part of the factory to avail of the option clause resulted in an extra expenditure incurred was Rs 24.21 lakh.

Case 6 Refusal to accept discount by OLF Dehradun resulted in loss

Opto Electronics Factory Dehradun placed a supply order in June 2008 on Belop Pune for 4248 Units of High Performance Super Gen Image Intensifier tube at the rate of Euro 1935. It floated another tender enquiry in January 2009 for a further quantity of 2400 Units. AV Headquarters advised the factory in April 2009 to take up with the firm for acceptance of 25 *per cent* option clause. The firm while refusing to accept the option clause agreed to supply 25 *per cent* of the earlier quantity provided a discount of Euro 10 per unit is withdrawn from the second offer. Despite the recommendations of AV Headquarters, OFB refused. The refusal of OFB resulted in an extra expenditure of Rs 18.43 lakh taking into account the discounted rate of Euro 2025 per Unit with an exchange rate of Rs 64.26 for each Euro.

7.4 Arbitrary management of option clause to favour RK Machine Tools

Case 1

Heavy Vehicles Factory placed a supply order in March 2006 for supply of 300 Units of Track Assembly at a rate of Rs 3.55 lakh by Dec 2006 extended up to June 2007. The supply order incorporated an option clause for a further quantity of 76 Units. When action was initiated by HVF to avail of the option quantity of 76 sets at the rate of Rs 3.52 lakh, a reduction in price agreed to by the firm earlier, OFB decided in April 2007 to avail of the option clause for nine sets only (25 per cent of the **balance quantity**) since as per MMPM manual, during the extended period of validity of the contract, option clause could be utilized for 25 per cent of the balance quantity only. OFB took the decision despite the fact that the factory was holding **nil** balance of the item in its stock. The nine sets were procured in May 2009.

Case 2

OFB however took an exactly opposite position in June 2007 in case of another supply order which was placed by the Factory on the same firm in August 2006 for 122 sets of Track Assembly by March 2007 extended up to June 2007 at a unit rate of Rs 352000. The order included option clause for 30 sets. When HVF initiated action in Jun 2007 (during the extended period) to procure all the 30 sets under the option clause, OFB approved the same . As per rules applicable in the earlier case, OFB should have approved 25 per cent of the balance quantity. This was despite the fact that the factory was holding in the month of June Units ranging from 29 to 78 as against average monthly consumption of 17 Units.

The option clause was used to favour the firm.

Case 3

As on 31 July 2008, the holding of Track Assembly by Heavy Vehicles Factory was 106 Units. Between 01 August 2008 to 05 December 2008, 23 Units were issued. Despite this the factory placed one more supply order on the firm on 14 Oct 2008 for 144 sets of Track Assembly to be supplied by 28 Feb 2009. Option clause for 50 per cent (72 Nos) was included in the order.

The firm supplied 90 sets on **the next day**, i.e. on 15 October 2008 and 35 sets **on the second day** i.e. on 16 October 2008 for inspection. The firm requested the

factory **on the sixth day** i.e. on 20 October 2008, to exercise the option clause. The factory, however, exercised the option clause in December 2008 with a stipulation that the firm should supply the option quantity after 31 March 2009 citing its budgetary constraints in 2008-09. By that time the factory was holding **173 sets** of the item in its stock catering to for nearly 10 months' average requirement when it exercised the option clause. But the firm supplied the option quantity in January 2009 itself informing the factory that additional funds were already allotted to the factory by the OFB. When Audit sought clarifications, HVF clarified that the firm, being the sole supplier of the item, was having more than one supply order at any day and therefore it supplied the items immediately. However, the fact remains that instead of the option clause proposal to be initiated by the factory based on its actual requirement, the firm requested the factory to exercise the option clause in the instant case, that too within six days from placing the order. HVF exercised the option clause when it was holding 173 sets of the item (catering to nearly 10 months' requirement). The above facts indicated that the option clause in the instant case (having financial implication of Rs 3.57 crore) was exercised to enable the firm to supply the item even though those were not immediately required by the factory.

Case 4

HVF placed a supply order on the firm in September 2006 for supply of 41,367 sets of Track Shoe Assembly (a part of Track assembly) at a unit rate of Rs 3442. The delivery period was initially up to September 2007, which was extended to December 2007. Though HVF at the time of initiating the procurement proposal, recommended for inclusion of the option clause for 100 *per cent*, sanction of the CFA i.e. Ministry was silent on the issue. Nevertheless, the factory included the option clause for 25 *per cent* in the supply order placed in Sep 2006. The firm completed the supply by December 2007.

In the meantime requirement of further quantities of 330 and 9170 sets arose in January 2007 and July 2007 respectively. HVF initiated action in December 2007 to procure the total additional requirement of 9500 sets under option clause. However, OFB refused to avail the option clause on the grounds that the MOD's sanction did not contain the option clause and the firm had already supplied all the ordered quantity of 41,367 Units by that time. This was despite the fact that all concerned were aware of the fact that prices against a fresh tender would go up due to upward

trend of the cost of the item. When HVF subsequently floated fresh tender enquiry for 9500 Units, a unit rate of Rs 3771 with price variation clause was received from the same firm. However, no order could be placed on the firm due to Ministry's orders to put on hold any further order on the firm.

Ministry stated in reply that option clause could be used any time after 50 *per cent* have been supplied against a supply order.

Ministry should investigate the brazen favouritism shown to the firm in exercising the option clause.

7.5 Liquidated damages and penalty

Case 1

Ordnance Factory Board approved in April 2007 a supplementary agreement between Gun Carriage Factory Jabalpur and RosoboronExports Russia for supply of 50 sets of Article 2A46M with SPTA on 1:1 basis required for T-90 guns at the unit rate of US\$ 1,26,000. The delivery was to be completed in two batches within 11 months from the date of transfer of advance payment, which was done on 7 August 2007. The delivery therefore was to be completed by the supplier by 6 July 2008. The original contract signed in April 2001 envisaged payment of liquidated damages at the rate of 0.07 *per cent* of the value of stores per day supplied later than one month of the stipulated last date of delivery up to maximum 5 *per cent*.

The second consignment of 25 Units arrived at the designated port, Chennai, in January 2009. However in stead of recovering liquidated damages as per the contract conditions, GCF actually extended the delivery period to December 2008.

Ministry stated in June 2010 that ROE is a government company of Russia and is an exclusive supplier of defence equipments. General Manager of the factory had exercised his delegated authority in waiving the LD and had taken a composite view to ensure deliveries.