

Executive Summary

Introduction

In June 2009 Ministry of Defence informed the Comptroller & Auditor General of India that consequent to a case having been registered by Central Bureau of Investigation (CBI) against Shri Sudipta Ghosh, former Director General Ordnance Factories involving serious charges of corrupt practices, CBI had requested the Ministry to examine whether there were irregularities in the procurement cases finalized during the tenure of the former Director General. Since a proper analysis of the procurement cases would require in-depth examination and considerable professional skills, Ministry requested CAG to undertake a special audit of all the procurement contracts during the period by a suitable team of officers from the Indian Audit & Accounts Department.

Averring that the matter of involvement of the former DGOF in corrupt practices needs to be examined by the investigative agencies through criminal investigation and the institution of the office of the CAG is neither empowered nor equipped to carry out investigations of a forensic nature, CAG nevertheless authorised review of the procurements of stores and machineries by the OFB and Ordnance Factories as a follow up audit of the previous Report No 19 of 2007 on OFB procurements.

A team of 19 officers conducted the audit between September 2009 and February 2010. It was conducted in Department of Defence Production, Ordnance Factory Board, Ordnance Equipment Group Headquarters, Kanpur, Armoured Vehicles Group Headquarters, Avadi and 18 Ordnance Factories. The audit broadly covered procurement during the period from 2006-07 to 2008-09, but in several cases in order to analyze current procurement decisions, decisions taken in earlier years were examined. Apart from examining files and documents in Ministry and OFB, 1291 supply orders valuing Rs 4434 crore were examined by the team during the audit of the Board and Factories. This Report contains the findings of the Audit.

Audit Findings

Procurement by Ministry of Defence and Ordnance Factory Board

Nalanda Factory

Transfer of Technology

Cabinet Committee on Security accorded sanction in November 2001 for setting up facilities at Nalanda in Bihar at an estimated cost of Rs 941.13 crore to manufacture two lakh Bi Modular Charge System (BMCS) per year. The approval included transfer of technology (TOT) from Denel, a South African firm at a cost of Rs 60.51 crore. The technology was to be acquired along with procurement of 4 lakh modules to meet the Army's immediate requirement from Somchem. The estimated cost of the factory was revised to Rs 2161 crore in January 2009. The overall progress of Nalanda factory has been dismal despite an expenditure of Rs 786 crore till March 2010.

Contract agreement for transfer of technology was signed between OFB and Denel on 15 March 2002. It envisaged supply and delivery of TOT documents which comprised Product specifications including detailed dimensional drawings and designs, Quality and Inspection procedures, Process descriptions and Production methods in respect of raw materials, intermediate products and final products. The Seller's warranty and the Performance Bank Guarantee provided by Denel have expired on 31 March 2010.

Establishment of the Factory.

The factory comprises three plants, two of which are for producing Nitro Cellulose and Nitro Glycerin, which are to provide inputs to the main plant to produce BMCS. It was decided that the main BMCS plant would be procured as a package. The plants for the manufacturing of primary ingredients Nitro-glycerin (NG) and Nitro-cellulose (NC) being standard plants were to be procured separately on turn-key basis. The project of setting up of the factory was effectively converted into three independent and uncoordinated procurement decisions.

This was a fundamentally flawed strategy which led to the situation where contracts for two feeder plants have been awarded but the main BMCS plant which will use output of these plants is nowhere in sight.

The factory has also been mired in controversies. All dealings with the technology provider Denel was put on hold in June 2005 due to allegations of corruption. By that time, however, Denel supplied all the required documents and received payments for them. Further work on factory was also put on hold from June 2005 to July 2006, which required retendering for all the plants, which led to sharp hike in price.

The contract with IMI Israel for the main BMCS plant has now been mired in controversies and corruption charges and has put the future of the Nalanda plant in jeopardy.

Contract of the Main BMCS Plant to IMI Israel

Tender Enquiry for BMCS plant was issued first in March 2004. The price bid was opened in October 2004. IMI Israel emerged as the L-1 firm at a cost of Rs 571.71 crore. The matter did not progress since project was kept in abeyance by Ministry in June 2005.

After the project was restarted in July 2006, IMI was called for negotiation meeting in August 2006 and asked to reduce the price as assessed by a committee constituted by OFB. IMI however insisted on a price increase from original 2004 price of Rs 571.71 crore to Rs 654.79 crore. OFB decided to issue global tender enquiry to generate more competition.

Fresh Tenders were issued in February 2007. However, hardly any fresh competition was generated as a result of the fresh tenders. Against five companies to whom tenders were issued, only three responded within time. One of them, DMP Italy refused to sign the Integrity Pact and to pay the earnest money deposit of Rs 3 crore. As a result only two companies namely IMI, Israel and Simmel Difesa, Italy remained in consideration. The price bid was opened on 28 January 2008. The offer of IMI Israel was the lowest at Rs 1090.83 crore and the next higher quote of Simmel Difesa was at Rs 1885 crore.

During the earlier negotiations, the escalation demanded by the IMI was 15 *per cent* over a period of two years from July 2004 to August 2006. Against the fresh tender, the escalation was 67 *per cent* over a period of one year. The scope of supply in the quotes in March 2004, September 2006 and February 2007 remained the same.

Internal assessment indicated that the rate quoted by IMI was very high

The internal assessment of OFB also indicated that compared to the quotation of IMI Israel in 2004, the rates quoted by IMI in January 2008 was on a high side. By adding escalation factors to the estimates quoted in October 2004, the base price came to Rs 800.34 crore as against Rs 1050.01 crore quoted by IMI in the fresh tender. Another estimate carried out by University Institute of Chemical Technology Mumbai arrived at a cost of Rs 832.22 crore. For the Single Base Propellant Plant, Ordnance Factory Bhandara calculated the basic cost at Rs 269.1 crore as against the cost of Rs 747.23 crore demanded by IMI.

Cost Negotiations Committee did not recommend any firm negotiated price for procurement of BMCS Plant

Against this background, MOD constituted a Cost Negotiation Committee (CNC) on 27 March 2008 with DGOF as Chairman. The basic objective of the CNC was to negotiate price and other commercial terms and conditions. However, CNC did not take any firm decision regarding the final negotiated cost of the plant.

Cabinet approval to the procurement of the BMCS Plant was assumed as implicit in the approval of the cost revision of the project

The Competent Financial Authority for approving the contract of the BMCS plant was Cabinet Committee on Security (CCS). Ministry of Defence in December 2008 put up a note to Cabinet seeking approval for revision of the estimated cost of project from Rs 941.13 crore to Rs 2160.51 crore. The “approval para” of the note to the Cabinet did not refer to the BMCS plant at all and sought only the approval of the revised costs of the project. In the note, the facts of the increased cost of the BMCS plant and IMI’s offer of reduction of only US \$ 3 million were mentioned as contributing reasons to the escalation of the costs. The lack of resolution on the issue in the CNC was not mentioned. Similarly, the issue of the price variation formula was not brought to the notice of the Cabinet. CCS approved the revision of cost of the project.

Ministry took this approval as “implicit approval” by the CCS of the procurement of BMCS plant and conveyed to OFB on 5 February 2009 sanction for the revised cost of project. OFB in a fax on 6 February 2009 requested to authorize it to conclude contract for BMCS plant “at the rate negotiated and approved by the Competent Financial Authority.” Ministry on 10 February 2009 informed OFB that the revision of the cost of the project as a whole has been approved by the competent authority and OFB may conclude the contract for BMCS plant “at the approved and negotiated cost.” Neither the Ministry nor

the OFB clarified in their correspondence at any time as to what exactly was the “negotiated and approved cost.”

Deputy Director General New Capital in the OFB in his note dated 10 February 2009 which was endorsed and approved by the former DG, clearly stated that “from the minutes of the meeting of CNC dated 22 July 2008, it is seen that the CNC did not make any conclusive decision or recommendation to MOD with regard to acceptance of the negotiated price. Also the terms for advance payment of 20 *per cent* demanded by IMI in their offer were not specifically referred to MOD for approval (being beyond OFB powers), it may be presumed that MOD has considered the entire issue covering all aspects in its totality and conveyed their sanction accordingly.” The note was endorsed by the former DG.

Interestingly, Ministry took the stand that CNC was aware of such an advance demanded and therefore should be treated as integral part of the CNC proceedings. Seeking a separate approval for the payment of advance beyond admissible limit was considered a “redundant exercise”. In no meeting, did CNC consider the issue of recommending the payment of advance.

Thus based on the “presumption” regarding the negotiated cost having been approved by the Competent Financial Authority, which in this case was the Cabinet, OFB concluded the contract for the BMCS plant IMI Israel in March 2009 at the total cost of Rs 1175 crore. It also paid an advance of Rs 174 crore to IMI in March 2009 which would remain idle as transactions with IMI were put on hold in June 2009 by Ministry.

The main audit findings relating to the contract are :

- (a) In order to execute the contract of main BMCS plant for Nalanda factory, the normal procedures were significantly undermined;
- (b) OFB’s refusal to accept the revised offer of IMI of Rs 654.79 crore and the consequent decision to retender to generate more competition was ill advised. Both OFB and Ministry were aware that the number of firms capable and willing to supply BMCS plant were very few;
- (c) OFB and Ministry executed the contract with IMI despite the steep increase in costs from the previous quotations ignoring available internal assessments that the hike was unreasonable;

- (d) Ministry took the doubtful stand that the approval of the Cabinet to revision of costs of the entire project amounted to “implicit approval” of the procurement of main BMCS plant;
- (e) Ministry misled Ministry of Finance stating that no escalation is foreseen knowing fully well that IMI has insisted on price variation formula for the Indian portion of the project;
- (f) Ministry and OFB between themselves obfuscated the issue of “negotiated and approved cost.” While Ministry did not hesitate to even put up before Cabinet that such price has been negotiated by CNC, OFB took the stand that CNC did not recommend any “negotiated and approved” cost to the Ministry; and
- (g) Ministry allowed payment of 20 *per cent* advance arguing that CNC was aware of the issue and therefore it should be treated as integral part of the CNC considerations on the whole issue. OFB took the stand that this was not recommended by the CNC. In fact, the issue indeed was never considered by the CNC;

In the case of all three plants, decisions were taken to retender to generate more competition. In all three cases, the retendered cost was much higher than the negotiated price.

Dealings between Singapore Technologies and OFB on procurement of Close Quarter Battle Carbines by Ministry of Home Affairs

On 12 Jun 2008, OFB received a communication from the Singapore Technologies Kinetics (STK) addressed to the former DG. In this, a meeting in September 2007 was referred to in which discussions had taken place regarding collaboration between OFB and STK on offset arrangements for selected programmes of the Ministry. It was stated in that letter that STK had then received from Ministry, RFPs for Close Quarter Battle Carbines and ammunition and also other items like Light weight Howitzer and Towed Gun system. STK requested OFB to offer the draft terms and conditions for provision of offset.

In the backdrop of the above, a meeting took place on 8 July 2008 between former DG and other officials of OFB Headquarters and the representatives of STK at OFB. STK informed that Ministry of Home Affairs (MHA) was likely to make outright purchase of CQB carbine and they would like to participate in the same. Chairman / OFB stated that the subject matter can be taken up with MHA stating that “an offset agreement has been signed between OFB and STK and the latter has developed the carbine using Indian components so that the indigenization process becomes faster for supply to MHA”.

Falsification of facts by OFB before Ministry of Home Affairs

The decision to "take up" the matter with the Joint Secretary, Ministry of Home Affairs stating that "an offset agreement *has been* signed between OFB and STK and that STK has developed the Carbine by using Indian Components so that the indigenization process becomes faster for supply to MHA" was incorrect and amounted to falsification of facts. The fact was that as on that date, neither any offset agreement had been signed nor had STK developed any carbine "by using Indian Components". As subsequent developments would indicate, this was the beginning of a web of falsifications and conspiracy that surrounded the deal between STK and OFB.

Though it was further decided in that meeting that the above can be taken up with the Ministry of Home Affairs only when the Carbine with Indian Component is developed and test fired in India in the presence of OFB, subsequent actions of the OFB belied that decision and confirmed the intention to mislead the MHA.

Close on the heels of this meeting, another meeting took place between MHA and officers from the OFB Headquarters on 24 July 2008. MHA expressed the need for acquiring 5.56 mm Carbine on most urgent basis as the plan for modernization of police forces was coming to an end on 31 March 2010. It was pointed out that 5.56mm carbine provided by OFB earlier for carrying out trial evaluation had failed. OFB officials informed that fresh trials for ammunition would take place soon but OFB's representative also suggested that they can supply for trial 5 Nos Carbine developed by "one Singapore firm" with which OFB "will have Transfer of Technology (TOT) arrangements".

In an internal note on 29 July 2008, on a proposal whether OFB should provide the carbines offered by STK for trials by MHA, it was opined by Member (Ammunition & Explosives) and Member (Weapons, Vehicles & Equipments) that the carbines should not be offered to MHA since they had not been evaluated by the Ordnance Factories. The former DG on that note directed to call STK for a meeting.

The meeting was convened on 11 August 2008. In Phase I of the meeting which was internal, it was decided to offer to MHA the STK carbine having minimum 50 *per cent* work share with OFB along with OFB's own AMOGH carbine. In the Phase II of the meeting in which STK participated, it was decided that six carbines should be provided by STK out of which five should be offered to the MHA. STK assured that they would send two carbines immediately by 25 August which could be used by Ordnance Factories for their

trials. To facilitate import, it was decided to sign the end user agreement and non disclosure agreement "today (11 August 2008) itself".

The Performance of the Carbine differed widely in trials by Small Arms Factory Kanpur and by paramilitary forces

Arrangements were then made for carrying out trials of the two STK SAR 21 MMS¹ carbines at SAF² Kanpur on 15 September 2008. Trials were conducted at 50 m and 200m range beyond which facilities were not available. Ability to fire with One Hand grip was found "Not suitable". Sustained firing was conducted where 720 rounds were fired in 10 minutes. Overheating was noticed at various points. At the end of the firing, safety lever became loose and could not be rectified on the spot. At the drop test at 5 metres, major misalignment problem was observed in one machine and it became non-functional. In case of the other machine, minor problems cropped up which, however could be rectified on the spot. Effect of dust as in a desert like condition was not evaluated.

MHA trials were held from 17 November to 21 November 2008 at NSG premises at Manesar. Prior to the trials STK apprehended that there might be technical complications if their carbine is subjected to reliability test specifications as spelt out in the MHA's trial directive and requested for safety certificate from OFB. This would be required as the carbines were being offered as OFB's carbines that would be produced through a TOT arrangements. OFB did not hesitate to provide the required safety certificate and other certificates for recoil forces, noise levels etc. that were issued by DDG/R&D based on the certificate issued by STK. Without formal collaboration with STK, issuing safety certificates by OFB to facilitate trial by MHA was incorrect as the carbine was fully imported and it had failed on several parameters when tested in SAF Kanpur.

On several parameters, in which SAR 21 was found deficient in SAF Kanpur, NSG trials found the carbine completely satisfactory. The drop test was done at the height of 5 feet as against 5 meter tested at SAF. While SAF complained of smoke, NSG trial did not find any trace of smoke. NSG also found that the weapon could easily be handled and fired with one hand.

¹ Singapore Assault Rifles Modular Mounting System

² Small Arms Factory, Kanpur

DDG/R&D who was nominated as OFB's representative at MHA trial brought out that large numbers of stoppages were observed during the firing of OFB's own 'AMOGH' carbine of Small Arms Factory being fielded by OFB. These stoppages were primarily on the account of defective feeding of ammunition by the magazine. DDG opined that the gun has otherwise performed satisfactorily as far as accuracy, consistency and other parameters are concerned. He further observed that **"Poor performance of SAF Carbine during trials of NSG could have been avoided, had SAF taken more care in preparing the Weapons Systems before sending to NSG."**

In a meeting in the MHA on 18 February 2009 regarding procurement of Carbines, OFB committed that they can supply the first batch of 2627 carbines on 1.9.2009, 18369 by 31.3.2010 at the same monthly rate and the total quantity by 28 February 2011. BSF opted to procure the weapon from the OFB. CRPF also agreed with that.

It was only after this commitment, the issue to undertake productionization of STK make Carbine was deliberated in the Board meeting held on 26 February 2009 which passed the following resolution:

"Production of 5.56 mm Carbine of Singapore Technology with 45mm chamber length would be undertaken subject to (a) MOD's approval of collaborative instrument with Singapore Technologies and (b) MHA's commitment to procure economically viable quantities from Ordnance Factories. The background of selection of Singapore Technologies for obtaining technology for production of 5.56 mm carbine inter-alia bringing out that no RFP was issued to identify the collaborator would be spelt out to MOD at the time of sending the collaborative instrument for their approval."

The cost of STK carbine was likely to be more than six times the cost of in-house developed carbine.

The case could not proceed further as the transaction with STK was put on hold in June 2009 by MOD after STK had indirectly been mentioned in the FIR registered by the CBI against former DGOF.

On the day OFB committed supply of carbines to MHA, OFB did not have any production arrangements with STK for production of these in India. There was no authorization from the Ministry to commence any production arrangements. OFB by committing the supply to the MHA, created a *fait accompli* situation to facilitate STK to supply the carbines piggybacking Ordnance Factories. While MHA could avoid floating the normal tendering

procedures by procuring it from OFB, the fact is that OFB in absence of any co production arrangements would have supplied carbines produced by STK. The process amounted to a sophisticated connivance by OFB and STK to sell STK carbines to MHA without going through the approved laid down procedures.

Assertion of OFB before MHA that it will have TOT arrangements was not based on facts and was intended to mislead the MHA. Even the rudimentary terms and conditions of TOT and co-production arrangements had not been contemplated at that stage. OFB falsely presented before MHA the SAR 21 MMS as OFB's offer, with production and TOT arrangements with STK. The officials from the MHA and the Para Military forces accepted OFB's offer without any further examination or investigation. Such lack of diligence was unbecoming of senior management dealing with such procurements. Officials from the MHA never enquired about the production facilities knowing fully well that SAR 21 MMS is not an indigenous carbine.

Ministry of Defence was not even aware of these developments. They came to know only after the receipt of two anonymous complaints in February 2009 through MHA and initiated disciplinary action thereafter.

Dealings between Defence Corporation Russia and OFB

In a similar case, Ministry of Defence issued two RFPs for the procurement of Light Bullet Proof Vehicles (BPV) and Light Strike Vehicle (LSV) with accessories in June 2008 and August 2008 respectively. Against the above backdrop, Defence Corporation Russia (CDR) showed interest in a letter dated 8 October 2008 in formulating strategic alliance with OFB for joint production of BPV and LSV in India. OFB invited CDR on 13 October 2008 to a meeting on 23 October 2008. The decision for collaboration with CDR for participation on BPV was taken in the OFB Meeting dated 31 October 2008. Thus, the whole exercise was concluded in one month at an astonishing speed. Two Collaboration Agreements (CAs) were signed on 15 April 2009 between CDR and OFB to enter into strategic long-term collaboration for the production and supply of the LSV and BPV to OFB.

Such collaborative arrangements with CDR were entered into by the OFB without exploring the market. The work share arrangements also did not favour OFB in any way. Work-share in respect of LSV was distributed between CDR and OFB as 84.87 per cent and 15.13 per cent respectively. Similarly, in respect of BPVs, the share of CDR and OFB was distributed as 64.92 per cent and 35.08 per cent respectively. It included all the

above low technology items. OFB was not to get any benefit from these CAs from technology point of view as all the major components were to be supplied by CDR and only to be assembled by OFB. On the other hand, CDR would supply their product at the cost fixed by them and without entering into any competitive bids. It was noted that there was no oversight by the Ministry of Defence to ensure that such actions are scrutinized at different levels.

Procurement by Factories

Procurement through Open Tender Enquiry and Limited Tender Enquiry

Ordnance Factories normally resort to two channels to procure stores. Limited Tender Enquiry (LTE) is issued to established suppliers who are registered with the factory concerned. Open tender enquiry (OTE) is open to any supplier. OTE channel is designed to encourage new suppliers to participate in the Ordnance Factory procurement process and thus to expand the base of suppliers to the Ordnance Factories. However, established suppliers are not barred from quoting against open tender enquiries. For materials which are proprietary or are not available widely in the open market, Single Tender Enquiry (STE) is issued.

According to Paragraph 4.6.1.1 of MMPM³, 80 per cent of annual ordering quantity is to be procured through Limited Tender Enquiry (LTE) from established sources and 20 per cent quantity is to be procured through Open Tender Enquiry (OTE) with wider publicity for source development.

Scrutiny in audit indicated that LTE channel continued to be the dominant channel of procurement and a miniscule part of procurement was carried out through OTE channel. Out the 18 Factories selected, the information on the OTE / LTE/ STE was available in the database of seven Factories only. The data of OTE in these seven Factories during the last three years was meagre and varied from 0.07 per cent to 1.91 per cent only.

The system of open tender enquiry has been so distorted that in Ordnance Factory Khamaria the response to the OTE ranged from Re. 0.07 (7 paise) to Rs. 3700.00. Two companies namely Hyderabad Precision Co and Mech Components Ltd, both located in Hyderabad, quoted 7 paise only. Both these companies were otherwise established suppliers. The last purchase rate of the item was Rs. 4401.90 per set through LTE and the lowest offer of Re 0.07 per set was obviously "freak". Despite this the factory placed in September 2008 supply orders for the item on these two firms for 4289 and 4288 sets respectively at an absurd price of 7 paise. Needless to say, no supply of the item has been received from either of the firms. Incidentally, both the companies shared the same fax number for another tender enquiry in Ammunition Factory, Kirkee.

³ Material Management Procurement Manual is OFB's Procurement Manual.

Tell-tale evidence of collusion of suppliers ignored

As per Rule 142 (ii) of General Financial Rules (GFR), credentials of the suppliers should be carefully verified before registration of the suppliers. Further as per Rule 142 (iv) of the GFR, performance and conduct of every registered supplier is to be watched by the Department. The suppliers are liable to be removed from the list of approved suppliers if they make any false declaration to the Government or for any ground, which in the opinion of the Government is not in public interest.

Scrutiny of the procurement files of the past three years indicated that the Ordnance Factories registered and placed orders on a large number of companies which shared the same telephone numbers, or fax numbers or registered addresses. 23 such cases are listed in Annexure III. Such cases indicate on one hand, lack of basic verification of the credentials of the companies and lack of application of mind by the authorities in the Factories on the other. It is apparent that many shadow firms were operating and cornering supply orders from various Factories. The factory authorities however did not take into account even the most obvious evidence of such malpractices which enabled the suppliers to manipulate the prices

Several individual cases of such collusion are narrated in Paragraph 6.4 of this report.

Cases of clear cartelization ignored by the Factory Officials

During audit at least 108 cases were seen in different Factories, where firms from different cities have quoted the same price for same item. All were through limited tender channel. Details are at Annexure IV. As an example, in the first case in Annexure IV, in Ordnance Factory Khamaria, five firms from Mumbai, Delhi, Pune, Gurgaon and NOIDA quoted exactly the price of Rs 398 per item for ball insert. Supply order was placed on all firms and the tendered quantity was equally distributed.

In order to stop cartelization, OFB on 18 July 2007 introduced a new measure. It prescribed that L2 and L3 tenderers should also be allowed to supply provided they accept the counteroffer of the rate quoted by L1 at a ratio of 50:30:20. However the measure did little to improve the situation as the suppliers quoted the same rate and all became L1 as a result.

One of the reasons why firms registered themselves under different names was the usual practice of Ordnance Factories to distribute the ordered quantity among different suppliers if they were found to have quoted same rate or accepted, being L2 or L3, a counter offer of the L1 rate. Such firms who operate under different names, in the event of equal distribution of tendered quantity will get a larger share through a sister concern or a ghost firm. In one extreme case, Ordnance Clothing Factory Shahjahanpur placed supply orders on 13 suppliers at the same rate by distributing the quantity of Yarn Woolen 450 Tex Type Natural Grey.

Unwillingness of TPC⁴s headed by the Head of the factory and comprising other senior factory officials to take action on blatant cases of price manipulation by suppliers and in some cases their active connivance to favour suppliers, absence of independent assessment of the rates quoted and treating the last purchase rate as the only benchmark coupled with the practice of distributing the ordered quantity among all suppliers reinforced and encouraged the practice of cartelization even more.

It also came to notice that prices quoted under OTE were significantly lower than the prices under LTE. The opinion among the factory officials was that suppliers quoted cheaper rates to grab the contracts as the first step to enter into the supply chain of the Ordnance Factories. While this may be partially true, many cases were seen in which established suppliers also participated in open tender enquiries and quoted cheaper rates. The belief also presupposes that suppliers will be making losses to make entry through the open tender channel which may not be wholly true. Cases were seen that suppliers through shadow firms also were able to suppress effective competition.

In none of the cases mentioned in Annexure IV, where cartelization was prima facie evident, Ministry or OFB or the concerned factory made any enquiries or took any effective action. On the other hand, such a situation was allowed to continue in almost all the Factories. In factory after factory the same firms responded to various tender enquiries both through LTE and OTE channel and manipulated the prices, as would be evident from Chapter VII of the Report. In many cases, in replies to audit observations the Factories justified the action by the fact that they were following the provisions of the MMPM. No initiative was taken by Ministry, OFB or the factory officials to stop the brazen manipulation of the system.

Price Discovery process in procurement

To achieve the best price in competitive tendering, open and competitive tendering is the *sine qua non*. Dependence on the limited tender, cartelization, lack of independent assessment of the reasonableness of pricing and very high delegation among different levels of officials in an environment which has little internal control have created a situation in the Ordnance Factories in which the possibility of a fair price through competitive bidding was remote. During audit, a large number of cases were seen where the prices have been manipulated and the officials had not taken any effective action to ameliorate the situation. This has emerged as the fundamental flaw in the system.

Paragraphs 6.18 and 6.18.1 of MMPM lay down the elaborate guidelines to determine the reasonableness of prices for procurement in case of competitive tendering where two or more suppliers are competing independently to secure a contract. The Manual envisages that the

⁴ Tender Purchase Committees

reasonability of price proposed has to be established by taking into account the competition observed from the responses from the trade, last purchase price, estimated value, database maintained on costs based on past contracts entered into, market price wherever available, changes in the indices of various raw materials, electricity, wholesale price index and statutory changes in the wage rates etc.

Para 6.18. (e) also required that the reasonability of price be examined by resorting to Cost analysis in situations where there is wide variance over the Last Purchase Purchase not explained by corresponding changes in the indices.

Further, as per Paragraph 9.17 of MPPM, OFB was to make arrangement for data base on past contracts showing details of the items procured, their essential specifications, unit rate, quantity, total value, mode of tender enquiry, number of tenders received, number of tenders considered acceptable, reasons for exclusion of overlooked tenders, un-negotiated rates of L-1, and contract rates were to be maintained to help in ascertaining reasonability of price of future procurements. The data in respect of supply orders in excess of Rs 20 lakh was to be made available in OFB website for information of all Factories. Further, as per the Manual, database maintained on costs based on concluded contracts, prices of products available through market should also be used to assess reasonableness of prices offered.

It was noticed during audit that neither the Factories nor OFB had maintained any database as per OFB Manual. The Factories do not have any database of the estimated cost of the stores procured or the prices of the product available through market. The various TPCs determined the reasonability of the rates with reference to the last paid rate (LPR) only.

In most of the Factories, LPR was the main index to assess price reasonableness. There was no cost expert either at the OFB level or at the factory level. In one or two Factories rudimentary efforts were made in a few cases to independently arrive at an estimate.

Contract Management

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.”

It was noticed in audit that in many cases the Factories did not take security deposit.

Similarly, cases were noticed about non-inclusion of option clause which favoured the suppliers. In HVF Avadi, Audit noticed that option clause was manipulated to favour R K Machine Tools.

Internal Control

Internal Audit and Vigilance

It was seen that internal control mechanisms both at the Board and Factory level were allowed to collapse and become dysfunctional.

The Chief Internal Auditor of the Factories in a response to a query in audit on the functioning of the internal audit mechanism admitted that the internal audit teams could not raise objections against Ordnance factory organizations, as they functioned under their administrative and functional control of the executive. He stated in November 2009 that during 2006-07 to 2008-09, the internal audit mechanism failed to uncover any financial irregularities both at factory level and at the level of OFB.

The malaise was however deeper and structural. Between 2006-07 and 2008-09, the Internal Audit was under the control of OFB. The Chief Internal Auditor (Factories) was under direct functional and administrative control of the Member (Finance) of OFB. He functioned with the help of five Regional Internal Audit Officers (RIAO) who were primarily responsible for functions relating to finance and accounts and only additionally, Internal Audit. The Material Planning Sheet⁵ was required to be approved by the Local Audit Officer (LAO), who was also the accounts officer in the factory. The RIAO were under functional and administrative control of the respective GMs/Sr. GMs of the Ordnance Factories. Such an arrangement violated the fundamental principles of independence of internal audit. The internal audit wing did not develop any Manual, checklists or guidelines for conduct of such audit and functioned in an ad hoc manner.

The dysfunctional state of internal audit was reflected in the fact that as of March 2010, a total of 2137 audit objections were still outstanding. At the OFB level, there is a Networking Committee chaired by one DDG to monitor the internal audit objections. Only two meetings of the Committee were held in two years. As of November 2009, the last meeting was held in March 2008. At the Factory level, even though there was an ad-hoc Committee in each factory under the Chairmanship of Sr GM/GM and these committees were required to meet quarterly, such meetings were infrequent. In the past 15 quarters from quarter ending December 2005 to June 2009 in 39 Factories, 585 such meetings should have been held. Only 120 meetings were held.

⁵ Material Planning Sheet is required to be generated by every factory to initiate procurement action. It shows the requirement, existing stock and dues in from previous supply orders if any to arrive at the net requirement for which procurement action is to be initiated.

80 per cent of the meetings required to be held were never held. In some of the Factories, from 2005-06 to date, only one or two meetings had taken place.

As with Internal Audit, in case of Internal Vigilance also, the dysfunctional state of vigilance was reflected in the fact that 15 Factories submitted to the Board 'Nil' reports on 18 vigilance sub topics continuously for the past three years. Even these 'Nil' reports were usually delayed by six to nine months indicating lack of attention to the reports by the CVO and the OFB. Three Factories did not even submit these reports.

Delegation of financial powers without Internal Audit and Vigilance

It is in the backdrop of collapsing internal control that Ministry of Defence in December 2006 issued orders significantly enhancing the financial powers of the Ordnance Factory Board. The objective of such enhancement of powers was to enhance autonomy and increase the efficiency of the Ordnance Factories in its day-to-day functioning. Following this, OFB on 11th April 2007 enhanced financial powers of various functionaries in Ordnance Factories for procurement of stores, plant and machineries. For procurement of stores through open tender or limited tender which is the main source of procurement of stores in the Factories, the power of GM was enhanced from Rs 1 crore to Rs 20 crore. For procurement of Plants and Machinery through limited tender or open tender in replacement of BER⁶ Plants and Machinery, against projects sanctioned by government or to improve production under NC⁷, the powers of General Managers were enhanced from Rs 10-25 lakh to Rs 20 crore.

Tender Purchase Committee exercising functions of Competent Financial Authority

Procurement through Tender Purchase Committees in the Factories represented a structural problem of decision making in the Factories. TPCs performed the functions of the CFA⁸. While such TPCs were headed by the CFA, the procurement cases were not considered separately on files based on the recommendations of the TPCs and no separate sanction order was issued for these procurements. While it promoted collegiate decision making, the accountability of the individual CFA could not be established in this process.

⁶ Beyond Economic Repair

⁷ New Capital

⁸ Competent Financial Authority

Recommendations

1. Ministry should review the role and composition of the Ordnance Factory Board. The Board should be expanded to include senior representatives of Department of Defence Production, Integrated Finance, DRDO and Army Headquarters. The Factories and the OF Secretariat should be Board managed.

Ministry accepted the recommendation.

2. The responsibility of the Board should be to oversee the functioning of the Ordnance Factories rather than taking decisions relating to procurement and the day to day functioning of the Factories. In other words, Board should function similar to a Board of a company.

Ministry accepted the recommendation.

3. Day to day running of Factories including procurements should be function of the DGOFF, who should be assisted by the Members and other officials. The decisions taken by DG should be subject to the review by the Board. DG should function as the CEO with responsibility and accountability commensurate with CEO of any Organization.

Ministry accepted the recommendation.

4. In view of the fact that the internal control in the Ordnance Factories including OFB Headquarters has become dysfunctional, there exists a case for completely overhauling the same. Ministry may review the position and put in place a comprehensive and functional internal control system in the Ordnance Factories.

Ministry stated that it would be incorrect to say that the internal control system has become dysfunctional. The performance of Factories is closely monitored by the Members concerned as well as Board level. The performance of the OFB is also monitored by the Ministry. A comprehensive e-procurement system has been put in place which would become operational from 01 August 2010. This would enable, the Ministry stated, to make the procurement procedures of Ordnance Factories transparent and accountable.

Appreciating the steps taken by the Ministry, it is stated that the internal control in an organization denotes a robust control environment, which sets the tone of the organization including tone at the top, risk assessment, control activities which comprise policies and procedures that help ensure that management directives are carried out. It also requires dissemination of pertinent information and continuous monitoring.

Ministry should broad base the concept of the internal control beyond narrow supervisory controls, which as would be evident from the present audit report, failed completely.

5. The Chief Internal Auditor (Factories) should have his own dedicated set up and should be completely independent from DGOF and Factories. He should report directly to the Board. Copies of his reports should be invariably endorsed to the Secretary, Department of Defence Production.

Acknowledging that the internal audit system needed to be strengthened, Ministry stated that action will be taken in consultation with the CGDA who is responsible for internal audit.

6. Secretary, Department of Defence Production should immediately form a standing audit committee to monitor the internal audit reports.

Ministry agreed to form an audit committee. The recommendation of audit would be considered to include suitable external representatives in the audit committee.

7. The Chief Vigilance Officer of the Ordnance Factories should have complete independence and should preferably be from outside the Indian Ordnance Factory Service. The guidelines issued by the CVC should be followed strictly.

Ministry informed that an officer of Railway Engineering Service has been appointed as Chief Vigilance Officer of the OFB.

8. The MMPM should be reviewed thoroughly to ensure procurement in accordance with the General Financial Rules. The artificial restrictions on the firms coming through OTE channel should be reviewed.

Ministry informed that the procurement manual is under complete revision According to the proposed revised manual, the Ministry stated, procurement would hereafter be

made mainly through open tenders and limited tenders will be resorted to avoid stock out situations and to meet unforeseen requirement of armed forces.

9. The roles and responsibilities of competent financial authority and tender purchase committee should be separated. Accountability of individual CFA both at DG level and factory level should be established. The role of the tender purchase committees should be recommendatory.

Ministry assured to examine the recommendation.

10. Ministry may review the composition of tender purchase committees and reduce the levels of such committees. Inclusion of representative from another factory in the same location should be considered.

Ministry assured to examine the recommendation.

11. Separate sanction order should be issued for each procurement and copies of such orders should be endorsed to all concerned in terms of General Financial Rules.

Ministry accepted the recommendation. It assured that separate sanction order will be issued in all procurement cases.

12. The present system of procurement through the channel of Memorandum of Understanding should be discontinued forthwith. Co-production, Co-development and Collaboration agreements should be subjected to prior approval of Ministry of Defence or the reconstituted Board. The user directorate and DRDO should be involved in these decisions.

Ministry stated a standard operating procedure for cases of collaboration has recently been prepared. In all cases in which foreign technology collaboration is involved, prior approval of the Ministry of Defence would be required. The user directorate and DRDO would also be consulted, if necessary.

13. Ministry should on a priority basis invest required resources to computerize the procurement process completely in line with the e-procurement initiative of Government of India and ensure that all Factories maintain compatible databases. Suitable procurement application also should be developed.

Ministry stated that action is under way and it is in accordance with the recommendations made by Audit.

14. All databases should be networked so that Factories can reap the benefits of networked databases in procurement. Suitable triggers should be included in the procurement application so that unusual cases according to pre determined parameters are thrown up by the system itself.

Ministry agreed to initiate action according to the above recommendation.

15. Generic and widely available items should be identified and should be procured through open tenders only. List of such items should be published in the website of OFB. Such open tenders should be published in the websites of OFB and Ministry of Defence.

Ministry stated that the procurement manual were under revision and open tender channel would be the main channel for procurement.

16. The proposed independent CVO and Internal Audit should investigate all cases where a number of firms quote the same price.

Ministry agreed to include stringent measures against cartelization in the revised procurement manual.

17. A cost audit cell should immediately be set up and procurement must be done, specially in cases of limited tender and single tender taking into account the advice of the cost audit cell.

While noting the recommendation and acknowledging that induction of qualified cost accountants will help, Ministry noted that there are industrial engineering units within the Ordnance Factories.

18. OFB should recheck the credentials of all the vendors registered with the Factories, so that ghost firms can be rejected. Such check should include a one time check of the owners of the firms, their addresses and other details and most importantly, their manufacturing capacity by site visits/ inspections.

Ministry agreed with the recommendation.

19. OFB should also place a list of all such vendors with all details about their ownerships, nature of business etc. in its website.

Ministry stated that action would be taken to include the details in the upcoming e-procurement portal of OFB.

20. Ministry should instruct OFB Headquarters and Factories that subject to compulsions of national interest, all limited and single tenders should be published on the website till the time limited tender channel is used for procurement.

Ministry stated that all tenders would be published in the upcoming e-procurement portal.