

Chapter 2 Selection of Private Partners

Audit objective 1

To obtain reasonable assurance that the assessment of IRR was realistic, identification and selection of private partners for equity share participation was judicious and transparent.

Sound investment decisions are fundamental as they significantly affect the financial health of an organization in the long run. The economic viability of an infrastructure projects is decided on the basis of Internal Rate of Return⁵ (IRR) of the project. The higher the IRR, the more viable is to undertake the project. While working out the IRR, factors such as estimated cost of the project, future estimated earning from the project, period of construction and cost of operations etc. are taken into consideration. In IR, IRR is generally calculated by Rail India Technical and Economic Services (RITES). The minimum IRR prescribed by the Ministry of Finance (MoF) for qualifying a project as viable was 14 *per cent*.

This chapter highlights the deficiencies noticed in selection of private equity partners including assessment of IRR and completeness of the Shareholders Agreement.

2.1 Viability of Projects

The IRR of the four projects⁶ were in the range of 14.71 *per cent* to 23 *per cent*, above the prescribed benchmark of MoF. IRR was, however, less than the benchmark in case of HMRDC (10.5 *per cent*) and KRCL (11.8 *per cent*).

2.2 Agreement with SPVs

MoR /RVNL executed the following agreements with the SPVs for effective execution of PPP projects:

⁵ Internal Rate of Return (IRR) of a project is the annualized effective compounded rate that makes the Net Present Value of all cash flows (both positive and negative) from a particular investment equal to zero.

⁶ PRCL-14.71 *per cent*, VMPL-22 *per cent*, KutchRailway-17.81 *per cent* and HPRCL- 23 *per cent*

- i. Shareholder Agreement;
- ii. Concession Agreement which includes Lease Agreement;
- iii. Construction Agreement;
- iv. Operation & Maintenance Agreement; and
- v. Traffic Guarantee Agreement

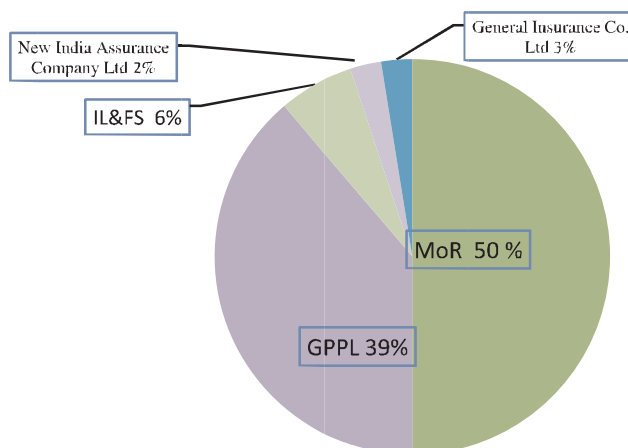
Audit Observations

2.3 Gauge Conversion Projects

2.3.1 Pipavav Railway Corporation Limited

A Memorandum of Understanding (MoU) was signed in January 2000 between MoR and Gujarat Pipavav Port Ltd (GPPL) for conversion of Metre Gauge (MG) line between Surendranagar and the Pipavav Port into Broad Gauge (BG). IRR of the project was estimated at 14.61 *per cent*. Pipavav Railway Corporation Limited, a Special Purpose Vehicle (SPV) was formed (May 2000) with the following equity participation:

Figure 1-Shareholding Pattern of PRCL



Scrutiny in Audit revealed that

The Shareholder Agreement did not specify the associates of GPPL for 11 *per cent* equity share. Three associates⁷ of GPPL were included subsequent to the signing

⁷ IL&FS, New India Assurance Company Limited and General Insurance Company Limited

the Shareholder Agreement. Therefore, the Shareholder Agreement was incomplete at the initial signing stage itself.

- i. RITES in May 2000 had estimated that the traffic would increase from 2.62 million tonnes to 10.34 million tonnes in 2008, an increase of nearly 400 *per cent* over a period of eight years. The IRR was accordingly assessed as 14.61 *per cent*. The projected growth of traffic was, however, never materialized and the project has been suffering losses since 2003.

MoR admitted (June 2013) that three associates of GPPL which accounts for 11 *per cent* equity share of PRCL were included subsequent to signing of the Shareholders Agreement. Further, MoR in their reply also accepted that the traffic projections could not materialise due to delay in development of the port.

2.3.2 Viramgam Mahesana Project Limited

The Gauge Conversion project between Viramgam and Mahesana (64.81 Km) was conceived to cater to the Defence requirements along with transportation of petroleum products from Kandla port to the oil refineries located towards north western parts of the country. The project was initially identified for execution under BOLT scheme (1995-96). The project could not materialise due to financial constraints. The project was again taken up in March 2001 for execution under BOT model on payment of access charge⁸ as an alternate mean of funding the project. Viramgam Mahesana Project Limited (VMPL), a Special Purpose Company (SPC) was formed in October 2002 for implementing the project under Build, Operate and Transfer (BOT) scheme. MoR estimated (February 2001) the project cost at ` 63.39 crore with IRR as 22 *per cent*.

Scrutiny in Audit revealed that:

- i. The project was initially approved by the CCEA for implementation under BOLT scheme. In March 2001, MoR modified (March 2001) the modus operandi for execution under BOT scheme by creating a SPC. This revised approach was not got approved from the CCEA;
- ii. Despite the estimated high IRR of 22 *per cent* of the project, no funds were allocated by MoR for the project during 2003- 05;

⁸ Access charges are the payment made by the Railways to the concessionaire after COD for use of the project asset and facilities.

- iii. Annual earning from the project was only ₹6.45 crore as against an annual access charge payment of ₹15.94 crore to the SPC. The project suffered loss despite its IRR of 22 *per cent* as estimated by MoR;
- iv. As per the agreement, MoR was required to pay access charges to the concessionaire at the rate of ₹15.94 crore per annum for a period of 12 years commencing from the date of financial close of the project. This resulted in additional expenditure of ₹127.88 crores⁹ over a period of 12 years.

MoR replied (June 2013) that in view of financial constraints, IR experimented with the BOT model on payment of access charge as an alternate means for funding Railway Projects.

Reply of the MoR is not acceptable as it was observed that though IR spent ₹15382 crore on capital projects during 2003-05, no funds were allotted for this project with IRR estimated as high as 22 *per cent*. Moreover, approval of CCEA was not obtained for adopting revised mode of implementation of the project from BOLT to BOT scheme, which resulted in additional expenditure of ₹127.88 crore.

2.3.3 Hassan Mangalore Rail Development Corporation Limited

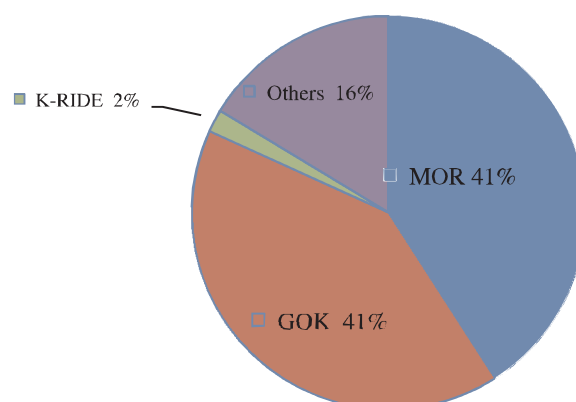
Gauge Conversion of Arsikere-Hasan-Mangalore (230 Km) was taken up by the IR in 1994-95. The section between Arsikere and Hassan (47 Km) was commissioned in March 2002 at a cost of ₹141 crore. For conversion of the remaining section Hassan-Mangalore (183Km), CCEA approved (April 2003) formation of a new company called Rail Infrastructure Development Company (Karnataka) Ltd (K-RIDE). The estimated cost of the project was ₹278.71 crore with IRR estimated as 10.5 *per cent*. An SPV called Hassan Mangalore Rail Development Company Limited (HMRDC) was formed in July 2003.

The Share capital of ₹110 crore of the SPV included 41 *per cent* share each of MoR and Karnataka Government, two *per cent* share of K-RIDE and the balance 16 *per cent* from the strategic partners¹⁰. The Shareholder Agreement provided for treating the expenditure of ₹141 crore, already incurred by IR for gauge conversion of Arsikere – Hassan section prior to formation of SPV as subordinate debt to HMRDC. Shareholding pattern of HMRDC is shown in the pie diagram as follows:

⁹ Difference between the payment of ₹191.27 crore as access charges for 12 years and the Project Cost of ₹63 crore

¹⁰ New Mangalore Port Trust, Mineral Enterprises Pvt Ltd, Kudremukh Iron Ore Company Ltd and National Mineral Development Corporation Ltd.

Fig.2 –Shareholding pattern of HMRDC



Scrutiny in Audit revealed that

- i. Shareholder Agreement did not provide for any modalities for annual repayment of subordinate debt of ₹141 crore to MoR by HMRDC. HMRDC paid only ₹62 crores up to March 2013 (44 *per cent*) towards repayment of subordinate debt of October 2003;
- ii. Necessary provision was not incorporated in the agreement towards interest payment on the subordinate debt; and
- iii. IRR of the project was estimated as 10.5 *per cent*, which was below the benchmark prescribed by MoF. The SPV, however, earned an overall profit during 2006-12. This indicated that the assessment of IRR was faulty.

MoR stated (March 2013) that as stipulated in the Cabinet Note, net operating cash flow of the company after servicing of senior debt was to be distributed among the subordinated debt and equity shareholder in proportion to the investment made by them in HMRDC. MoR further stated that no dividend was declared by HMRDC since 2006-07. MoR admitted that no agreement could be signed with HMRDC on subordinate debt due to disagreement among the shareholders. MoR also asserted that after the Company liquidated its senior debt by March 2010, the Company repaid ₹62 crore between June 2010 and March 2013 towards subordinate debt.

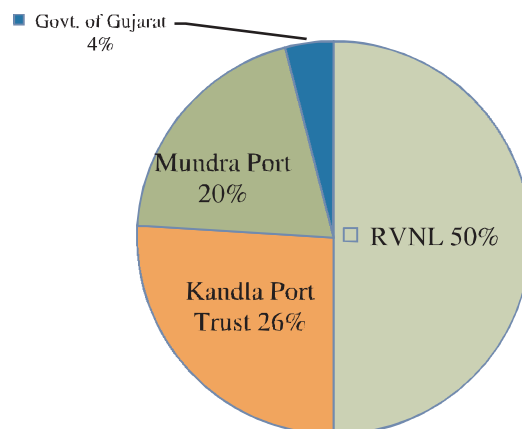
Reply of the MoR is, however, not acceptable as the Company registered an overall profit of ₹135.72 crore during 2006-12. Despite surplus earnings during 2007-11, interest on subordinate debt was not paid on the consideration that no dividend was declared since 2006-07. Failure of the MoR to enter in to an agreement with HMRDC in respect of repayment of subordinate debt resulted in blockade of capital at the time when IR was facing severe resource crunch.

Moreover, IR had been paying dividend to the General Revenues¹¹ on the subordinate debt provided to HMRDC. During the period (2004-12), IR paid ₹73.47 crore towards dividend on the subordinate debt.

2.3.4 Kutch Railway Company Limited

Gandhidham – Palanpur Gauge Conversion Project (301 kms) was taken up in 2002 under National Rail Vikas Yojana (NRVY). The main objective of this line was to provide shortest route for the north bound traffic from Kandla Port and Mundra Port. The estimated cost of the project was ₹344.63 crores and the IRR was 17.88 *per cent*. A SPV named Kutch Railway Company was formed in January 2004 with a share capital of ₹200 crore comprising four *per cent* by the Gujarat Government, 26 *per cent* by Kandla Port Trust, 20 *per cent* by Mundra Port and balance 50 *per cent* by Rail Vikas Nigam Limited (RVNL), a PSU of MoR.

Fig.3 Shareholding pattern of Kutch Railway Company Ltd.



Scrutiny in Audit revealed that;

- i. The project was initially approved (October 2000) by the CCEA for implementation under BOLT scheme. MoR modified the modus operandi for execution under BOT scheme by creating a SPV in May 2004. The approval of the revised approach was not obtained from the CCEA;
- ii. Expression of Interest (EOI) was not invited by MoR for identifying stakeholders as Kandla Port Trust and Gujarat Adani Limited (Mundra Port)

¹¹ Railway expenditure is financed from capital provided by General Revenues. On the capital invested out of general revenues in the railway undertaking, the general revenues would receive a fixed dividend at 4 *per cent* per annum for a period of five years except on the capital invested in un- remunerative strategic lines.

expressed their interest in the project. Despite the interest expressed by the stake holders, MoR failed to secure minimum traffic guarantee;

- iii. Gandhidham- Palanpur section is the shortest route for the North bound traffic. The other alternative route is via Ahmedabad-Palanpur which is longer by 133.62 Km. Test check in Audit revealed that WR diverted two rakes per day via longer route during 2010-11 despite 42 *per cent* utilization of the shortest route, Gandhidham- Palanpur section. This resulted in loss to the IR towards extra haulage of traffic through longer route.

MoR in their reply stated (June 2013) that the efforts were made to secure traffic guarantee without success as the equity partners did not agree to execute traffic guarantee.

Reply of the MoR is, however, not acceptable as IR should have ensured the minimum traffic guarantee from the investors keeping in view the high IRR (17.81 *per cent*) of the project and also expressed interest of the stakeholders. Further, approval of CCEA was not obtained for adopting revised mode of implementation of the project from BOLT to BOT scheme.

2.4 New Line Projects

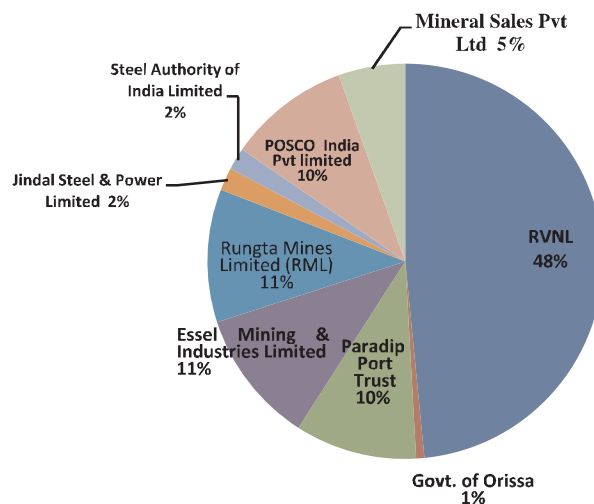
2.4.1 Haridaspur Paradip Railway Company Limited

Paradip Port is a major port in the State of Orissa which provides traffic connectivity in the States of Orissa and Jharkhand. The port transports mainly iron ore, coal, fertiliser and petroleum oil and lubricants (POL) products. Initially, the Cuttack-Paradip line was the only rail link available to access the Paradip port. Subsequently, the line capacity of the section reached its saturation stage resulting in regular shortage of rakes, delays in the movement etc. MOR planned a new 82 km long rail link between Haridaspur (on Howrah-Chennai Trunk line) and Paradip Port to overcome these capacity bottlenecks.

The IRR of the Haridaspur- Paradip new line project was estimated at 23 *per cent*. The project was estimated to cost ₹379.80 crores in 2004 which was revised to ₹598 in 2006. The project was transferred (2005) to RVNL for speedy execution. An SPV called Haridaspur Paradip Railway Company Limited (HPRCL) was formed in September 2006. RVNL invited an Expression of Interest (EOI) in January 2006 to finalise the partners for HPRCL. The shareholders agreement for ₹275 crore equity

contribution was signed with nine partners. The shareholding pattern was as follows:

Fig.4 Shareholding pattern of HPRCL



Scrutiny in Audit revealed that;

- i. Memorandum of Understanding (MoU) was signed between RVNL and Government of Orissa, Paradip Port Trust in May 2005. HPRCL was, however, formed in September 2006. Thus, there was inordinate delay of about 15 months between signing of MoU and formation of HPRCL.
- ii. Share holders Agreement signed in October 2006 provided that POSCO would cease to be a party to the said agreement if the license for mining was not granted within a period of three years from October 2006. License for mining was neither granted to POSCO nor any effort made for replacing POSCO as of June 2013.

MoR stated in their reply (June 2013) that the equity contribution from the prospective stake holders could only be firmed up after the finalization of EOI. MoR added that POSCO is the largest potential FDI in India and the grant for mining lease for POSCO for iron ore was recommended by Government of Odisha. MoR further added that the matter of granting license is sub-judice and pending in the Hon'ble Supreme Court of India.

MoR's reply is, however, not acceptable as the reason cited for the delay of 15 months in formation of SPV from the date of signing of the MoU was not justified on the ground that RVNL was mandated to implement project on fast track basis. Further, despite failure on the part of POSCO to obtain mining license within the

stipulated period of three years, MoR continued granting extensions instead of exploring other interested private partners.

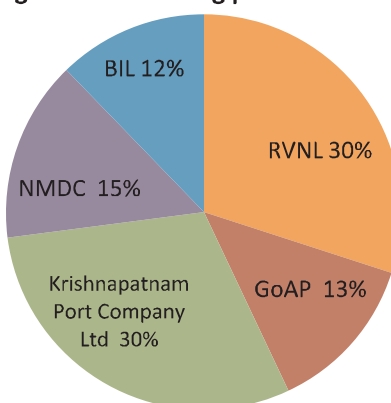
2.4.2 Krishnapatnam Rail Company Limited

New Line between Obulavaripalle - Krishnapatnam (114 Km) was one of the 53 projects considered under NRVY. This connectivity to the port was considered essential for import/export of commodities to and from by the Krishnapatnam Port. Coal constitutes about 75-80 *per cent* of the imports and iron ore constitutes 90 *per cent* of the total export at the Krishnapatnam port. This project was entrusted to RVNL in April 2003. The project cost was estimated as ₹587.50 crore with an IRR of 11.8 *per cent*.

Krishnapatnam Railway Company Limited (KRCL), a SPV was formed in October 2006 for implementing the project. This project was to be funded through equity of ₹270 crore with Viability Gap Funding (VGF) of ₹50 crore, and the balance ₹267 crore through debt financing.

Expression of Interest was invited (February 2006) from strategic investors for 27 per cent shareholding in the SPV. NMDC and Brahmani Industries Limited agreed to participate for 15 and 12 per cent shareholding in April 2006 and February 2008 respectively. The shareholding pattern of KRCL is shown in the pie diagram below.

Fig.5 Shareholding pattern of KRCL



Scrutiny in Audit revealed the following:

- i. The project was transferred to RVNL in April 2003 and final location survey was completed in June 2005, after 26 months since the transfer of project. Railway Board sanctioned the project (March 2006) after nine months. The delay was mainly on account of the decision on the ruling gradient of the new

line;

- ii. Shareholders agreement was signed in October 2006 with 73 *per cent* of the equity share holder. The identification of partners for the balance 27 *per cent* equity was finalised in February 2008 after 18 months of signing of the Shareholder Agreement in October 2006; and
- iii. IRR of the project (11.8 *per cent*) was far below the bench mark of 14 *per cent* prescribed by the MoF for viability of the project.

MoR stated (June 2013) that the time taken for detailed technical survey and bankability studies could not be taken as delay. MoR further added that preparation of final location survey took a considerable time as the proposed new line passes through the hilly terrain and dense forest area.

The reply of the MoR is not acceptable in view of the fact that RVNL took unduly long period of 26 months in completing final location survey of the project, which defeats the mandate of formation of RVNL for fast track implementation of the projects. Further, Shareholders Agreement was signed before identification of stakeholders.

Thus, the Shareholder Agreements with PRCL and KRCL were incomplete as the same was executed before finalization of the stakeholders. The modalities for recovery of subordinate debt were not specified in the Shareholder Agreement with HMRDC. Projected IRR for PRCL and VMPL was not realistic as the projects have been suffering loss since commencement of operation. Modus operandi of implementation of VMPL and Kutch Railway Company Ltd was changed from BOLT to BOT without the approval of CCEA. Despite profitability of Kutch Railway project and expressed interest of the stakeholders, IR failed to secure minimum traffic guarantee. IR also could not optimally utilize the shortest route resulting in loss towards extra haulage of traffic through longer route. There was inordinate delay in signing of MoU