Chapter 3 Concession Agreement

Audit Objective 2

To obtain reasonable assurance that the provisions of the agreements pertaining to the concession period, lease rent and transfer payments were complete and clearly defined without any ambiguity.

Concession Agreement is an agreement between MoR and the SPV through which latter acquires the right to Develop, Finance, Design, Construct, Operate and Maintain the railway line, enjoys the rights and benefits etc during the Concession Period. The agreement grants several rights to SPV which inter-alia include:

- Right to receive from MoR, its share of revenue in accordance to the rule of inter-railway apportionment of earnings, of the tariff collected from the freight traffic originating, terminating and moving on the project after deducting operation and maintenance cost;
- Right to commercially exploit the project assets;
- Quantum of transfer payments that are due on completion of the concession period or in the event of termination of the project on account of default by either party; and
- Terms and conditions in respect of leasing of the existing assets, additional assets acquired during the implementation of the project including lease rent to be recovered from the SPV for entire duration of the concession period.

This chapter contains the issues noticed during the review of Concession Agreements including duration of the Concession Period, Lease Agreements and Transfer of Assets.

3.1 Concession Agreement

Concession Agreement is a major document which defines the nature of concession provided to concessionaires. Audit reviewed the Concession Agreements executed by the MoR or RVNL in respect of six projects undertaken by the IR. The details regarding duration of concession period along with the time taken for formation of SPV are indicated in Table 2:

Table 2 –Statement showing the time taken for signing of the Concession Agreement and duration of Concession Period

SPV	Date of formation of SPVs	Date of signing the Concession Agreements	Time taken[12]	Concession period (in Years)
PRCL	May 2000	June 2001	390 days	33
VMPL (SPC)	October 2002	May 2003	180 days	12
HMRDC	July 2003	March 2004	270 days	32
Kutch Railway Co.	January 2004	November 2005	540 days	32
HPRCL	September 2006	December 2007	450 days	30 or less
KRCL	October 2006	November 2007	407 days	30 or less

From the Table above, it is observed that the Concession Period granted to the concessionaires ranged between 30 - 33 years except in case of VMPL where the concession period was for 12 years. Scrutiny in Audit during 2011-13 revealed the following;

i. IR did not adopt any Model Concession Agreement in line with the one prescribed by the Planning Commission for PPP projects in infrastructure sector. MoR opted to develop individual Concession Agreement model on trial and error basis broadly with its experience in case of PRCL. Concession Agreement of PRCL was used as a benchmark for finalising agreement with HMRDC and Kutch Railway Company Limited;

ii. MoR took considerable time for processing and scrutinizing each Concession Agreement resulting in delay in signing of the Concession Agreements. The time gap between formation of SPV and signing of Concession Agreement was in the range of 270 to 540 days.

iii. IRR of the Kutch Railway project and HMRDC was 17.88 *per cent* and 10.5 *per cent* respectively. The concession period granted to Kutch Railway Company Ltd and HMRDC was, however, 32 years. Thus, for two projects with different IRR, identical concession period of 32 years was adopted without adequate justification; and

iv. Date of commencement of the concession period was not mentioned in the Concession Agreement signed with the HPRCL and KRCL. As per the Model Concession Agreement formulated by the Planning Commission for PPP in

[12] Time taken in signing the Concession Agreement has been calculated from the month/year of formation of the respective SPV.

National Highways, Concession Period commences from the date of signing of the Concession Agreement.

MoR while accepting the delay in processing and finalizing the concession agreement stated (June 2013) that IR reviewed the provisions of the agreement executed with the SPVs based on experience of previous SPVs which took some time in finalizing Concession Agreement. MoR also stated that the concession period initially decided (32 years) was not linked to traffic materialization and in subsequent SPVs, a clause was included to adopt 30 years as concession period or till the time the NPV payback (at a discount rate of 14 *per cent*) equal to the equity investment was arrived at, whichever was earlier in case of the future agreements by IR.

The reply of the MoR is not acceptable as the financial prudence inter-alia requires systematic approach of benchmarks with reference to IRR, traffic trends etc. before fixing the duration of the concession period. The basis for adoption of 32-33 years as concession period was not available on record. Moreover, the provisions of the Concession Agreement were static and rigid leaving no scope for any flexibility to equate with the future trend of traffic movement. MoR in their reply admitted that the concession period fixed in the initial agreements in respect of PRCL, HMRDC and Kutch Railway Company Ltd were not linked to traffic materialization. The lacuna in their approach was addressed subsequently by inserting a clause to cap the concession period with upper limit of 30 years of operation from the COD. However, the fact remains that the date of commencement of concession period was not defined as it was to start from COD. This date was also left undefined as the time period for construction was not agreed upon. Thus, the Concession Agreement with SPVs was not complete and lacked clarity.

3.1.1 Kutch Railway Company Limited

Gandhidham – Palanpur gauge conversion project (301 kms) taken up by Kutch Rail Company Limited was completed within the prescribed time frame. It started its operation in December 2006 and recovered the cost of the project within six years. In November 2008, MoR approved doubling of the line in order to derive additional benefits from this project. General Manager (GM), Western Railway, however, made a reference (December 2010) to the Chairman, Railway Board (**Annexure I**) to review the concession agreement as the continuation of the existing agreement severely undermining the earnings of WR as also its Operating Ratio. MoR, however, did not initiate any action on the suggestion of the WR.

On being pointed out by Audit (December 2012), MoR stated (June 2013) that the SPV's share of gross apportioned earning was only about 12 *per cent* of the total originating earning of the IR and it was prudent for Railway to augment line capacity by utilizing funds provided by such SPVs in view of the resource crunch of IR.

The reply of MoR is, however, not acceptable as the concerns raised by GM (WR) were not addressed by IR and the Concession Agreement lacked provisions for review and modification of the terms and conditions of the agreement to safeguard against unforeseen eventualities to protect the financial interest of the IR.

3.2 Lease Rent

The Concession Agreement includes Lease Agreement as a schedule for payment of lease rent on existing assets of the Railways transferred on lease to the SPV. The Concession Agreement provides for handing over / leasing of existing assets[13] available at the project site to the SPV for the entire duration of the concession period. The lessee acquires the existing assets on lease from lesser on payment of annual lease rent to the lessee.

As per Railway Board's letter No. 2001/LML/13/53 dated 04-10-2001 leasing of land to Government Departments on long term basis for a period of 35 years attracts a one-time lump sum payment equivalent to 99 *per cent* of the market value of the land on the date of lease along with an annual license fee of `1000. This order was subsequently revised by MoR vide letter No. 2005/LML/18/8 dated 10-2-2005 which provides for recovery of the amount from lessee at six *per cent* of the market value of the land leased. The deficiencies noticed in the Lease Agreement with the SPVs in respect of completeness of the clauses of the agreement, area of land leased to the SPVs, enforcement of extant orders of IR for leasing of land and recovery of lease rent from the SPVs are discussed below:

3.2.1 Gauge Conversion Projects

3.2.1.1 PRCL

Lease Agreement of the PRCL provides that the annual lease rent is recoverable as percentage of the book value of the assets leased to PRCL. This percentage shall be equal to State Bank of India Prime Lending Rate on the date of execution of the agreement. Chief Engineer (CE), Western Railway (WR) vide his letter No.

[13] Existing assets means (a) original land of the Railway for the project and (b) fresh land acquired by Railway for the project.

W580/12/51Pt III Vol. I (W 5) dated 11-10-2001 (**Annexure II**) to Additional Member /Planning, Railway Board stated that cost of the assets leased to PRCL was ₹44.18 crore instead of ₹14.06 crore as stated in the agreement. The observation of Finance Wing of the WR is reproduced in verbatim;

"The book value of the assets in the matter has been taken as Rs. 44.18 crores by the two member committee on WR. The basis of the Board advising the same as only Rs.14.06 is not clear. Further, no accounts/finance concurrence has been taken for the same. It appears that only the capital at charge portion has been taken which is not backed by the Competent Authority orders"

In view of the above, CE/WR requested MoR to review the position. Scrutiny of records in audit did not reveal any evidence of review in this regard. This resulted in short recovery of lease rent amounting to ₹3.60 crore per annum with effect from June 2001 onwards.

3.2.1.2 VMPL, HMRDC and Kutch Railway Company Limited

As per clause 4.2 of the Lease Agreement with VMPL, HMRDC and Kutch Railway Company, an amount of ₹1000 per annum was recoverable as the lease rent from the SPVs. Audit observed that:

i. In case of PRCL, the lease rent was fixed as a percentage of the book value of assets. MoR in their reply stated that the agreement executed with PRCL was treated as the bench mark for all future agreements entered with VMPL, HMRDC and Kutch Railway Company Ltd. MoR, however, adopted a different standard for fixation and recovery of lease rent from VMPL, HMRDC and Kutch Railway Company Limited violating Railway Board's guidelines of October 2001 and February 2005;

ii. SPVs were also granted the right for commercial exploitation of the land leased to them with effect from commencement of operations on payment of nominal lease rent of only ₹1000 per annum;

iii. In the case of HMRDC, the area of land leased was not clearly mentioned in the Lease Agreement signed in March 2004. Audit calculated[14] that an amount of ₹8.31 crore **(Annexure- III)** as lump sum onetime payment of lease rent was to be recovered from HMRDC on the basis of 310 acres of land acquired for the broad gauge line project.

[14] Calculated at the average market value of land as advised by Revenue Authorities between Hassan and Kankanadi.

iv. The Lease Agreement with Kutch Rail Company Limited was signed in November 2005. Therefore, the MoR's guidelines (February 2005) should have been taken into consideration while incorporating provision in the Lease Agreement for fixing lease rent. The Lease Agreement with Kutch Rail Company Limited, however, provided for recovery of lease rent at the rate of ₹1000 per annum. Moreover, the area of the land leased to Kutch Rail Company Limited was not mentioned in the Lease Agreement.

Western Railway, therefore, raised (March 2008) a demand of ₹4 crore per annum as lease rent due from Kutch Railway Company calculated on the basis of Railway Board's instructions (November 2005). The demanded amount could not be recovered from the SPV in view of the expressed provision of payment of lease rent at the rate of ₹1000 per annum.

3.2.2 New Line Projects

3.2.2.1 HPRCL and KRCL

Clause 4.1 of the Lease Agreement with HPRCL and KRCL provided for recovery of annual lease rent for land as follows:

i.	Original land leased -	As per extant policy of MoR as revised from time to time
ii.	New land acquired -	At the rate of ₹1 per annum

Scrutiny of the Lease Agreement in the case of HPRCL and KRCL revealed the following:

i. The area of land leased to the HPRCL and KRCL was not mentioned in the Lease Agreement;

ii. In case of HPRCL, 924.433 acres of land was leased prior to the date of signing the agreement and only 235.739 acres was acquired after signing of Concession Agreement. Therefore, as per the MoR's guidelines (February 2005), the lease rent due from HPRCL was ₹2.34 crore for the period December 2007[15] to March 2013. This amount was not recovered up to June 2013; and

iii. The land acquisition in case of KRCL was to be completed within six months from the commencement of the project (March 2006) as per project implementation schedule submitted by RVNL to MoR. However, even after lapse of five years from the commencement of the project, only 1116 acres

[15] Month of signing of concession agreement

(44 *per cent*) of land was acquired by March 2011. No further progress in this regard was seen. Against the initial provision of ₹41.85 crore towards the cost of land, an amount of ₹79.50 crore has already been spent.

MoR in reply (June 2013) accepted the audit contention and stated that as suggested by Audit, the matter would be again scrutinized by legal experts to remove ambiguity, if any.

Thus, the Lease Agreements in respect of HMRDC, Kutch Railway Company Ltd, HPRCL and KRCL were incomplete as the crucial information like the area of land leased to the SPV was not mentioned in the agreement. The Lease Agreements provided only nominal lease rent to be recovered from the SPV though the SPVs were permitted to commercially exploit the land. Reasons for permitting commercial exploitation of land to the SPV on nominal lease rent were, however, not available on record.

3.3 Transfer of Assets

The Concession Agreement defines the transfer[16] payments to be made at the time of the normal transfer or in the event of a default by other parties. This agreement specifies transfer payments in case of transfer of assets on completion of the project as mention in Table 3 below.

Table 3 – Statement showing amount payable by Railways in case of normal transfer

SPV	Payment in case of Normal transfer
PRCL	The assets created by PRCL within the project area shall revert back to MoR for the consideration equivalent to the DRV of these assets. The assets leased to PRCL by MoR shall revert back to MoR without any financial consideration
VMPL	Not Applicable as no assets were transferred to the SPV
HMRDC	HMRDC shall be entitled to receive an amount equal to DRV. The existing assets leased to HMRDC by MoR shall revert back to MoR without any financial consideration
Kutch Railway Company Limited	Kutch Railway shall be entitled an amount equal to Book Value. The existing assets leased to KRC by MoR shall revert back to MoR without any financial consideration
KRCL	MoR shall pay to the SPV an amount equal to Book Value. The original existing assets leased to SPV by MoR shall revert back to MoR. The fresh land acquired by MoR and leased to SPV shall also revert back to MoR on payment of an amount equal to the cost of acquisition.
HPRCL	MoR shall pay to HPRCL an amount equal to Book Value. The existing assets leased to HPRCL by MoR shall revert back to MoR and MoR shall pay HPRCL an amount equal to the cost of land, which was financed by KRCL at the time of acquisition of land without any interest.

[16] Normal transfer means the transfer of project as well assets on completion of the concession period, whereas transfer in the event of default means transfer of project in the event of default either by the SPV or by the Railways.

Thus, a uniform policy was not adopted for making payments to SPVs at the time of transfer of the project assets on completion of the concession period. In the case of PRCL and HMRDC, the transfer payment was an amount equal to Depreciated Replacement Value[17](DRV) of the assets as per the agreement. Increase in cost of replacement of assets due to inflation would result in significantly higher expenditure of MoR while taking over the assets after expiry of concession period. This clause was subsequently modified in the case of Kutch Railway Company Ltd, HPRCL and KRCL wherein an amount equal to the book value of the assets was to be paid by Railways as transfer payment.

Transfer payments conditions as specified in the Concession Agreement in the event of termination of agreement due to default by either partners are indicated in Table 4 below:

Table 4 - **Statement showing amount payable by Railways on transfer in the event of default by SPV or by Railways**

SPV	Payment in case of termination in the event of default	
	SPV's default	Railway's default
PRCL	MoR shall acquire all the moveable and immoveable assets of PRCL existing in the Project area at 50 *per cent* of the book value of such assets	PRCL may require the MoR to purchase all the moveable and immoveable assets in the project area for consideration equivalent to • DRV of such assets plus 30 *per cent* of DRV if default occurs within 15 years of COD • DRV of such assets plus 20 *per cent* if default occurs after 15 years but within 25 years of COD • DRV of such assets if default occurs after 25 years of COD
VMPL	An amount equal to the market value of the project assets and facilities created by the concessionaire	An amount equal to the market value of the project assets and facilities created by the concessionaire
Kutch Rail Company Limited, HMRDC, HPRCL and KRCL	MoR shall pay an amount equal to 50 *per cent* of the book value of assets.	MoR shall pay the following as transfer payment: • 130 *per cent* of DRV if default occurs within 15 years of COD • 120 *per cent* if default occurs after 15 years but within 25 years of COD • 110 *per cent* of DRV if default occurs after 25 years of COD

[17] DRV is defined in the agreement as depreciated replacement value of new assets and is the aggregate cost of replacing each asset on Termination Date minus aggregate depreciation on straight line method.

From the Table above, it is clear that in all cases except VMPL in the event of termination due to Railway's default, compensation was to be calculated on the depreciated replacement value of new assets. On the contrary, SPVs were losing only 50 *per cent* of the book value of the assets created by them. Thus, this would result in MoR paying a higher amount as transfer value in the event of termination of the Concession Agreement due to Railway's default. This indicates that the provisions in the agreement were grossly in favour of the SPVs.

MoR in their reply (June 2013) stated that the book value of the assets would be much less after the end of the concession period. MoR further stated that the life of assets is normally taken as 30 years and therefore, the depreciated value in such a case would be nearly zero.

The reply of MoR is not acceptable as MoR has not taken into account inflation and resultant price increase in the replacement value of the assets to be taken over by the MOR at the end of the concession period. Further the improvement element also takes in to account the current value of the renewed assets to the current market value. Therefore, the DRV cannot be zero as assumed by MoR.

3.4 Financial Close

'Financial Close' is a crucial decision for prudent financial management by the SPV for implementing the project economically. Financial close date is the date on which all the funding documents viz loan agreement, guarantees, notes, debentures, bonds and other security agreements provided by the lender are effective. 'Financial Close' implies fulfillment of all the conditions precedent to availability of the funds for the concerned PPP projects under the Financial Document arrangements entered between the concessionaire and the lender. The Model Concession Agreement for PPP projects in National Highways provides for well defined 'Financial Close' provisions with such time lines as agreed between the Concessionaires and the Concessioning Authority.

Audit observed that there was, however, no provision in the Concession Agreements regarding 'Financial Close' except in case of VMPL. 'Financial Close' was not achieved in case of HPRCL and KRCL even after six years of signing of the Concession Agreements. Absence of provision for 'Financial Close' in the Concession Agreements resulted in open ended project cost with undefined interest liability on debt funding.

3.4.1 HPRCL

The project cost of ₹598 crore (2007) was planned to be funded through ₹275 crore as equity contribution and the balance ₹323 crore through debt from financial institution, banks and investors. Subsequently, the project cost increased to ₹1186 crore in 2011 resulting in increase in debt funding to the tune of ₹911 crore.

3.4.2 KRCL

KRCL was constituted in 2006 for implementing the project at an estimated cost of ₹588 crore. The project was to be funded through the share capital of ₹270 crore along with the debt funding of ₹318 crore. The project cost was revised to ₹1203 crore (September 2011) with the increase in debt funding to ₹933 crore.

In absence of provision regarding 'Financial Close' in the Concession Agreement, not only the project cost increased by about 100 *per cent*, the interest liability on debt funding also increased by about two times of the initial proposed debt amount. The increase in project cost is yet to be approved by the SPVs.

While admitting the fact that the Financial Close was not achieved , MoR stated (June 2013) that the problem of land acquisition, environment and forest clearance were the reasons for not achieving the financial close in case of HPRCL and KRCL. MoR also stated that the SPVs had saved substantial financial cost by not borrowing money when it could not have been spent.

Contention of MoR is, however, not acceptable as the reason cited by MoR for not achieving the financial close in case of HPRCL should have been addressed at the planning stage itself before commencement of the project. Further, the contention of the Ministry regarding savings for not borrowing money was not based on logical reasoning as the liability towards debt funding would be inevitable to match increase in project cost.

To sum up, absence of a Model Concession Agreement led to adoption of varying approaches towards fixation of concession period, lease rent and liability of Railways at the time of transfer of assets by the SPVs. Considerable delay was observed between formation of SPVs and signing of the Concession Agreement. IRR and traffic potentiality of the projects was not given due consideration while fixing concession period. Lease rent on account of land leased to the SPVs was fixed without due cognizance to the existing instructions of the Railway Board in this regard. In absence of 'Financial Close' provision in the Concession Agreements, the project cost remained open ended with increased cost of debt. This indicates that the provisions laid down in the agreement were incomplete and not clearly defined.