

Chapter 4 Project Execution and Maintenance

Audit Objective 3

To obtain reasonable assurance that the project management including execution of Traffic Guarantee Agreement was efficient.

Successful implementation of a project through concessionaires depends upon the clear formulation of terms and conditions of the execution of project with reference to the objectives that the Concessioneing Authority intended to achieve.

RVNL was mandated to implement railway infrastructure projects on fast track basis in a timely and cost effective manner with its superior project management practices. A Memorandum of Understanding (MoU) was signed (October 2003) between MoR and RVNL. The MoU allowed RVNL to create project specific SPV or any other financial structure considered suitable for a particular project. The SPV envisaged equity participation of RVNL and strategic partners. The funds required for the projects were to be raised through market borrowings.

This Chapter broadly covers the issues relating to implementation of the project, performance of the SPV in timely execution of projects, allocation of risks between the concessionaires and the executing authorities including lacunae in project monitoring.

Audit findings pertaining to Gauge Conversion and New Lines projects are discussed below:

4.1 Gauge Conversion Projects

Gandhidham – Palanpur gauge conversion project (301 kms) was taken up by Kutch Rail Company Limited. The project was completed within the prescribed time frame and started its operation in December 2006. The entire cost of the project was recovered within six years as the project was considered profitable with assessed IRR of 17.88 *per cent*. Considering the quantum of generation of revenue from the project MoR approved (November 2008) doubling of the line in order to derive additional benefits from this project. General Manager, WR, however, did not agree to continue the existing agreement as it would adversely affect the earnings of WR. General Manager, WR made a reference to the Chairman, Railway Board vide his letter No. FA/T/Kutch/KRCL dated 20th December 2010 (**Annexure I**). The suggestions of GM, WR is reproduced in verbatim:

- i. Take the legal and financial opinion on the provisions of the Concession Agreement for termination of the said agreement under clause 8.2 for taking over the assets of the company.
- ii. Seek a revision of the Concession Agreement which would put a 'CAP' on the return on equity. This could also be translated into a ceiling on the revenue share which needs to be remitted by Western Railway to KRCL. Railway Board has already laid a stipulation in their policy of SPVs vide circular No. 2008/PL/9/16 dated 20th July 2010 that the assets created by SPVs would revert back to MoR once the company attains a return on capital of 14 *per cent* per annum.

MoR, however, did not initiate any action on the suggestion of the WR.

4.2 New Line Projects

4.2.1 HPRCL

The Construction Agreement between RVNL and HPRCL was signed in August 2009. As per the agreement, RVNL would complete the project within a mutually agreed date. The Concession Agreement was signed (December 2007) by the SPV.

Audit scrutiny revealed that:

- i. Target date for completion of the project was not mentioned in the agreement. MoR allowed RVNL to proceed with the construction work even before signing of the Concession Agreement;
- ii. Though 70 *per cent* land required for the project was already available by 2006, construction of the line, however, could not be completed even after six years of signing of the Concession Agreement. Progress of the project was only 17 *per cent* till March 2013;
- iii. The original estimated (2006) project cost of ₹598 crore was revised to 1186 crore (98 *per cent* increase). Reasons for substantial increase in estimated cost could not be established as the revised cost was not approved by the SPV.
- iv. A private company named Dhamra Port Company limited' (DPCL) constructed a 62.5 km new rail line from Bhadrak to Dhamra within four years (2007-11). This line is parallel to the proposed new line to be constructed by HPRCL. DPCL is transporting coal, iron ore etc. HPRCL project was also conceived for transporting these commodities. Therefore, the existing private line would definitely affect the performance of HPRCL's project in future.

MoR in their reply (June 2013) stated that the work in case of HPRCL could not progress due to local agitation and failure of the contractor resulting in termination of the contract. MoR also added that the delay in the implementation of the project was not under the control of the SPV or RVNL or the MoR.

The reply of MoR is not acceptable as DPCL work was completed under identical socio-economic conditions as the HPRCL. DPCL acquired the required land for its project during the contemporary period of HPRCL. Therefore, the slow progress of HPRCL project was indicative of ineffective project management.

4.2.2 KRCL

The Construction Agreement was signed between RVNL and KRCL in September 2011. As per Clause 7.3.1 of the agreement, RVNL shall complete the work within the mutually agreed date. The mutually agreed Commercial Operations Date (COD) was decided as 31/12/ 2014. Though the Phase I of the project (Krishnapatnam - Venkatachalam ,23 kms) was completed in July 2009, Phase II (Venkatachalam – Obulavaripalle, 91 kms) is still under progress with only 39 *per cent* of the project completed up to March 2013 as only 44 *per cent* of required land could be acquired.

Scrutiny of records revealed that the COD was fixed in September 2011 nearly five years after initiation of construction work in 2006. However, no target dates for completion of a particular section on this project line were specified. It was observed that the estimated cost of the project escalated by 105 *per cent* from ₹587.50 crore to ₹1203 crore (February 2011) mainly on account of increase in the cost of major bridges, permanent way works including materials etc. Delays on account of land acquisition also resulted in escalation of cost of project. The impact of delays in land acquisition could not be quantified by audit as the revised cost was yet (June 2013) to be approved by the SPV.

4.3 Operation and Maintenance

Operation and Maintenance (O&M) Agreement is executed with the SPV for nominating the concerned Zonal Railway Administration for operation and maintenance of the project. While the operations would inter-alia include all activities associated with freight train movements, loading /unloading of freight, storage and security of the consignment etc. The maintenance generally refers to standard maintenance procedures as adopted by the Indian Railways for smooth running of the project. The SPV is required to pay O&M cost to the Zonal Railway Administration. While no Operation and Maintenance Agreement was executed in case of HPRCL, the same was not required in case of VMPL as the project was

executed on BOT mode. Provision laid down in the Operation and Maintenance Agreement for deferring overhead charges in case of other four projects is mentioned verbatim in Table 5 below:

Table 5 – Provisions for deferring recovery of overhead charges

SPV	Overhead Charges
PRCL	Western Railway shall defer the recovery of overhead on O&M cost for the first 5 years of operation of the line and the same will be fully recovered in five years from 11 th year onwards.
HMRDC	South Western Railway shall defer the recovery of overhead charges on O&M cost for the first 10 years of operation of the line and the same shall be fully recovered in a period of 20 years commencing from the 11th year of operations.
Kutch Railway Company Ltd.	Western Railway shall defer the recovery of overhead charges on O&M cost for the first 10 years of operation of the line and the same shall be fully recovered in a period of 20 years commencing from the 11 th year of operations.
KRCL	South Central Railway will defer the recovery of overhead cost on O&M cost for the first 5 years of operation of line and same will be fully recovered in a period of 10 years commencing from the 6 th year of operations.

Scrutiny of the provisions laid down in the agreement for deferring overhead charges revealed the following:

- i. Uniform approach was not adopted for recovery of overhead charges from the SPVs. In case of PRCL and KRCL, recovery of overhead charges were deferred for 5 years and the same was deferred for 10 years in case of HMRDC and Kutch Railway;
- ii. In case of PRCL and KRCL, recovery of overhead charges was spread over a period of 10 years and the same was to be recovered from HMRDC and Kutch Railway over a period of 20 years;
- iii. In case of HMRDC, CCEA approved deferring of recovery of overhead charges for five years. The provision laid down in the agreement, however, specified deferring of recovery of overhead charges for ten years. The circumstances leading to the decision of deferment for 10 years instead of five years as approved by CCEA was not available on record; and
- iv. PRCL and Kutch Railway Company with higher IRR of 14.61 and 17.88 *per cent* respectively recovered the project cost during first six years of their operations. Despite profitability of these projects, the recovery of overhead charges was, however, deferred for 10 years.

The reply (June 2013) of MoR was silent for not adopting uniform approach for deferring and recovery of overhead charges from the SPVs. In case of HMRDC, MoR

stated that CCEA approved deferring overhead charges for the first five years, which would be recovered between 11th to 15th years. MoR further stated that the Business Plan of HMRDC annexed with the Cabinet Note provided for deferment of overhead charges for 10 years.

The reply of the MoR is, however, not acceptable as the CCEA approved (April 2003) deferment of recovery of overhead charges for only five years in case of PRCL. This benchmark of CCEA was not adopted uniformly while executing agreement with other SPVs. Deferring overhead charges for additional five years in case of HMRDC was in violation of CCEA's approval.

4.4 Traffic Guarantee Agreement

Traffic Guarantee Agreement is an agreement executed with the SPV for ensuring minimum traffic and revenue thereof. MoF prescribed that the projects with IRR more than 14 *per cent* qualifies for viability of projects. The critical element that determines the IRR of a project is the estimated traffic likely to be generated on implementation of the project. Traffic Guarantee Agreement, therefore, assumes significance in achieving the intended objectives of PPP projects.

Scrutiny of Traffic Guarantee Agreements revealed the following:

- i. Out of six projects examined, Traffic Guarantee Agreement was executed only in the case of PRCL and HPRCL. Reasons for non-execution of Traffic Guarantee Agreement with the VMPL, HMRDC, Kutch Railway Company and KRCL were not placed on record; and
- ii. Agreement in case of PRCL and HPRCL was incomplete as it did not provide for revision of minimum quantum of guaranteed traffic once the targeted traffic volume was achieved. Agreement did not provide for safeguard of Railway's interest to take care of unforeseen growth of traffic as was observed in case of PRCL where no further revision of the minimum traffic guarantee could be carried out despite the target set¹⁸ for traffic volume were achieved during the eighth year of operation of the project.

4.4.1 Penal Provisions

Penal provisions are incorporated in the Traffic Guarantee Agreement to ensure materialization of projected yield from the project. The provision specifies the financial liability of Railways as well as the SPVs in the event of shortfall in achieving

¹⁸ Traffic guaranteed for PRCL for the first, second year and balance thirty one years from third year onwards was one, two and three million tonne respectively

the desired traffic. The penal provisions laid down in Traffic Guarantee Agreement executed so in case of PRCL and HPRCL is indicated in the Table 6:

Table 6 – Penalty clause in the Traffic Guarantee Agreement

PRCL	HPRCL
<p>A. In the event of offeror's default The compensation payable by GPPL shall be equal to the Rate per tonne kilometre multiplied by 264 kms (total length of the railway project) multiplied by shortfall quantity minus the Variable Costs pertaining to the shortfall quantity.</p> <p>B. In the event of Railway's default Amount equal to the Rate per tonne kilometre multiplied by Deemed Freight Traffic (DFT¹⁹) multiplied by 264 kms minus the Variable Costs pertaining to the shortfall quantity.</p>	<p><u>Penalty in the event of default by either party</u></p> <ul style="list-style-type: none"> • Up to 10 <i>per cent</i> of Annual Scheduled Quantity (Asq) - No penalty; • Shortfall between 10 and 20 <i>per cent</i> of the Asq – 25 <i>per cent</i> of freight charges on the shortfall quantity exceeding 10 <i>per cent</i> of Asq; • Shortfall above 20 <i>per cent</i> of the Asq – <ol style="list-style-type: none"> (i) 40 <i>per cent</i> of freight charges on the shortfall quantity exceeding 20 <i>per cent</i> of Asq; (ii) 25 <i>per cent</i> of freight charges on the shortfall quantity between 10 and 20 <i>per cent</i> of Asq.

Audit observed that the penal provisions in case of PRCL were complex as the determination of DFT and variable cost on shortfall quantity are vulnerable to dispute on account of assumptive factors that are taken into consideration for quantifying the penalty in absolute financial terms. In case of HPRCL, the project being at construction stage, rationality of the penal provisions could not be verified in Audit.

MoR stated (June 2013) that the traffic guarantees were not easily available and obtained through hard negotiations. Contention of the MoR is not acceptable as the basic objective of IR to opt for private participation in railways' infrastructure projects was not only to augment its network but also to enhance its share on the growth of traffic and revenue earnings thereof. The approach of IR in making investment jointly with other stakeholders without ensuring return on investment particularly in case of profitable projects such as HMRDC, Kutch Railway Company and KRCL (Phase I) lacked adequate justification.

4.5 Monitoring

Monitoring of the project is essential to ensure that the project is completed within the prescribed target date. As per the provisions contained in the Concession Agreement, each SPVs/SPC was required to furnish to MoR an Annual Report on its performance under the agreement. In addition, the Construction Agreements

¹⁹ DFT- If any indents of the party (PRCL) are withdrawn after pending as free indents for 240 hours before supply of wagons, the quantity of freight tonnage that would have accrued to the party had indents for 240 hours been supplied is the Deemed Freight Traffic.

provided for formation of a Construction Progress Review Board (CPRB) consisting of four members representing the main stakeholder/partners of the SPVs. As per the agreement, Zonal Railways²⁰ /RVNL²¹ shall prepare and submit a monthly progress and financial report to the SPV with a copy to CPRB regarding physical and financial progress of works. CPRB was expected to review the progress of project on monthly basis in the form of monthly reports and also to issue necessary instruction or to take corrective action for timely completion of the project.

Scrutiny of records relating to monitoring of progress of projects revealed that though the annual progress reports were furnished to MoR, there was no document/record to confirm that the CPRB monitored the progress of the projects regularly on monthly basis or proposed any remedial follow up action as and when required. The role of MoR for monitoring the performance of projects was not specified in the Concession Agreement executed with the SPVs/SPC. Thus, ineffective monitoring mechanism resulted in time and cost overruns particularly in respect of the two New Line projects namely HPRCL and KRCL.

Matter was brought to the notice of the MoR in December 2012. The reply of MoR on the issue was not received (June 2013).

Thus, in absence of targets, progress of the project was only 17 and 39 per cent respectively, which resulted in cost escalation in case of HPRCL and KRCL. Uniform approach was not adopted while fixing periods for deferring overhead charges and in case of HMRDC, approval of CCEA for deferring of overhead charges was violated. Despite projected profitability of the projects such as PRCL and Kutch Railway Company Limited, the recovery of overhead charges was deferred for longer duration. Traffic Guarantee Agreement was not executed in four projects despite expressed interest of the stakeholders. Traffic Guarantee Agreement executed with PRCL and HPRCL did not provide for safeguard of Railway's interest in the event of unforeseen growth of traffic in future. Penal provisions for shortfall in achieving minimum guaranteed traffic were complex. Lack of effective monitoring was observed in case of HPRCL and KRCL where RVNL was the executing agency.

²⁰ PRCL (WR), VMPL(WR), HMRDC (SWR) and Kutch Railway Company Limited(WR)

²¹ KRCL and HPRCL