CHAPTER VIII: MINISTRY OF DEFENCE

Bharat Earth Movers Limited

8.1.1 Unnecessary interest payment

Acceptance of advance without confirmation of rate of interest resulted in unnecessary interest payment of Rs.7.54 crore.

The Company received (March 2002), a Letter of Intent (LOI) from the Ministry of Defence (MOD) for manufacture and supply of 75 BRS wagons and 136 DBKM wagons. The provisional price of Rs.50.39 crore for which 100 *per cent* advance was paid in March 2002 was revised to Rs.60.06 crore in January 2006. The advance attracted interest but the rate of interest and period was not specified in the LOI.

The Company invested the advance in term deposits with commercial banks at interest rates ranging between 4 to 8.55 *per cent* during the years 2002-03 to 2006-07. The final order was issued in January 2006 stipulating the rate of interest as 9.5 *per cent per annum* from the date of LOI and also the mode of adjustment of the advance. As against the completion of supplies by January 2007, the Company completed production of 75 BRS and 80 DBKM wagons so far (September 2007). The MOD has adjusted Rs.4.19 crore towards interest as on August 2007.

Audit observed that the rate of interest and period was not specified in the LOI and the Company did not effectively pursue the matter at the appropriate level in MOD regarding rate of interest applicable on the advance received. Thus, the acceptance of advance without confirmation of rate of interest resulted in the Company bearing the differential interest burden of Rs.7.54 crore upto March 2007.

The Ministry in its reply (September 2007) stated that the Company's request for revision of rate of interest was under consideration.

8.1.2 Protracted delay in amending the purchase order resulted in foregoing of income of Rs.4.44 crore

Delay in initiating action to amend liquidated damages clause as sought for by the propriety item supplier resulted in delayed receipt of CKD components and foregoing of Rs.4.44 crore.

The Company received a supply order on 16 October 2004 from South Eastern Coalfields Limited, Bilaspur (SECL) for supply of seven BH-120-E dumpers at a cost of Rs.50.07 crore. As per the terms of the order, the dumpers were to be supplied within six months from the date of the order *i.e.*, by April 2005. Delay in supplies attracted liquidated damages (LD) at the rate of 0.5 *per cent per* week subject to a maximum of 15 *per cent.*

The Company placed a purchase order on 12 October 2004 on M/s. Komatsu America Corporation, USA (KAC) for supply of seven dumpers in completely knocked down (CKD) condition with a delivery schedule of 240 days with a request to advance the

delivery schedule by 120 days. The order also stipulated the LD clause for delay in supply. Soon after the placement of order, KAC on 19 October 2004 categorically stated that the LD clause and 120 days delivery schedule were not acceptable. On 3 November 2004 it again reiterated that the CKD components would be shipped with 240 days delivery schedule after receipt of the amended order and deletion of the LD clause. However, the Central Purchase Cell (CPC) of the Company decided only on 17 November 2004 to negotiate the LD issue with KAC. The Chairman and Managing Director's approval was obtained after three and a half months on 19 February 2005 and the formal amendment deleting the LD clause was communicated to KAC on 15 March 2005; after a further delay of one month.

Even after the shipments were received from July 2005 to November 2005 the Company took three to four months to supply the equipment to SECL against which LD of Rs.7.40 crore were levied by SECL.

Audit observed that the protracted delay of four and a half months (November 2004 to March 2005) in initiating action to amend the LD clause in the purchase order could have been avoided as the Company was well aware that KAC was the single source supplier. This resulted in delayed supply of dumpers to SECL and consequent foregoing of income of Rs.4.44 crore (based on the rate of 0.5 *per cent per* week for four and a half months).

In its response, the Ministry stated (October 2007) that though the equipment was not in their regular production range, the Company had utilised the available capacity and was able to earn profit even after paying LD.

The reply was not tenable since the equipment was mainly assembled from imported CKD components. Timely response by the Company and issuance of the amendment to the purchase order would have generated additional income of Rs.4.44 crore.

Hindustan Aeronautics Limited

8.2.1 Incorrect evaluation of tender

The Company incurred avoidable expenditure of Rs.5.99 crore due to lapse in evaluation of tender and awarding the contract to SVEC Construction Limited.

The Company issued Notice Inviting Tenders (NIT) in January 2004 for construction of 326 staff quarters at its Bangalore Complex. As per the NIT the tenderers were required to quote rates for (a) upto third floor roof level and (b) extra over (a) upto fifth floor. The Company clarified through an amendment in March 2004 that the rates quoted for (a) upto third floor roof level and (b) upto fifth floor were to be independent of each other. The last date of 10 March 2004 for submission of tender was extended to 1 April 2004. Seven bids were received by the due date.

After a Techno Commercial evaluation (April 2004/May 2004) of the bids, the Company evaluated SVEC Construction Limited, Hyderabad (SVEC) as L1 at their quoted price of Rs.22.70 crore. The Company noted that SVEC's itemised quotation had a mix of very high and low rates in comparison to other bidders and sought (May 2004) confirmation from SVEC of the rates quoted. On SVEC's request, price negotiation was held on

25 August 2004. As seen from the minutes of price negotiation, the Company informed SVEC about the high freak rates in certain cases and requested them to review and reduce rates. Based on the request, SVEC offered a rebate of 2.25 *per cent* on the originally quoted high rates and the Company reworked the negotiated price at Rs.22.18 crore. There was no specific mention about low rates in the minutes of price negotiation. However, SVEC through their letter of 26 August 2004, inviting reference to the negotiations stated that the final price worked by the Company was incorrect and stated that the rates quoted for all the items above third floor should be treated as additional rate over and above rates quoted by them for the corresponding items upto third floor. The Company in response intimated (4 September 2004) that the contract value was as per the negotiated price and awarded the contract to SVEC at Rs.22.18 crore on 29 September 2004.

Disputing the contract price, SVEC moved the High Court of Karnataka to allow them to carry out the work upto third floor and keep the agreement pending till such time the issue relating to forth floor and fifth floor was resolved. The High Court, during the arguments stage (November 2004) allowed the Company to negotiate with other tenderers and award the work. The Company however, did not initiate negotiations with other tenderers.

The High Court rejected the petition filed by SVEC on 17 January 2005 and ordered that the Company was at liberty to re-tender the contract. The Company cancelled the contract awarded to SVEC in February 2005. The work was re-tendered in July 2005 and awarded in April 2006 to National Projects Construction Corporation Limited (NPCC), for Rs.30.51 crore. This work was in progress (October 2007).

Scrutiny in Audit revealed that the Company failed to make a proper evaluation, as the comparative statement prepared by the Company for itemised rates for fourth and fifth floors showed clearly that SVEC had quoted incremental rates only beyond third floor level and not independent rates. While the other bidders had quoted rates ranging from Rs.4.40 crore to Rs.6.70 crore for work relating to fourth and fifth floors, SVEC had quoted only Rs.0.12 crore. Such a huge variation in quoted rates should not have escaped the notice of the Company. Even during the price negotiations held with SVEC on 25 August 2004 the Company discussed only the higher freak rates and ignored the lower freak rates. Besides, SVEC had also pointed out the very next day on 26 August 2004 that the rates quoted by them beyond third floor were in addition to the rates quoted upto third floor. In the given situation, the Company should have enforced clauses 36 and 39 of Company's works and contract procedure regarding freak rates and rejected the quote of SVEC. Instead, the Company went ahead with the evaluation process and ranked SVEC as L1. If the Company had made a proper evaluation, URC Constructions would have been L1 at Rs.24.52 crore and negotiations, if any, should have been appropriately held with URC.

The Management stated (July 2007) that the tenders were correctly evaluated, as per rules, taking the quoted rates in tender documents with all the amendments issued to the tenderers being considered. The L1 was arrived at on the basis of a comparative statement drawn up with the quoted rates. Hence, the notional savings of Rs.5.99 crore as worked out by Audit on the premise of the offer of URC as L1 was, therefore, incorrect.

The reply was not tenable as the Company failed to recognise the rates as quoted by SVEC even after the tenderer later immediately after negotiations disputed and asserted that the rates quoted by them for beyond third floor were in addition to the rates quoted upto third floor. The Company also failed to take action against the tenderer as per its standard procurement procedure and did not utilise the additional opportunity provided by the High Court in permitting it to negotiate with other tenderers.

Thus, due to improper evaluation of tender resulting in award of the contract to SVEC, the Company had to re-tender and award the contract to NPCC leading to avoidable expenditure of Rs.5.99 crore (NPCC awarded price of Rs.30.51 crore minus URC price of Rs.24.52 crore) and delay in the completion of the project.

The matter was reported to the Ministry in July 2007; reply was awaited (November 2007).

8.2.2 Forfeiture of revenue due to repair of engines on free of cost basis

The Company repaired 11 engines on free of cost basis though the defects were not precisely established on its part. This resulted in forfeiture of revenue of Rs.5.53 crore to the Company.

The Engine Division of Hindustan Aeronautics Limited (Company) manufactures, repairs/overhauls Adour, Artouste, Garrett, Orpheus, and Dart engines. Air headquarters (AHQ) issues firm repair/overhaul tasks for each financial year with the prior approval of the Ministry of Defence (MOD) and the supplies and services provided by the Company are governed by the Fixed Price Quotation (FPQ) approved (August 1995) by the MOD. As per the provisions of FPQ policy, the issue regarding finalisation of warranty clause was to be considered separately. In the absence of the warranty clause, the Company was entitled to realise FPQ price for the repair/re-repair work done. The warranty clause was approved in August 2006 with retrospective effect from April 2006.

For every premature withdrawal of engines from services*, defect investigation (DI) team comprising representatives of the Company and the MOD investigated the defect and suggested remedial measures. The Company used to repair on free of cost (FOC) basis if the defect/fault in the equipment was attributable to the Company.

The Company repaired 21 engines during 2002-03 to 2004-05 on FOC basis on the ground of premature withdrawal from services. A review of DI reports indicated that in respect of 11 engines it was not precisely established that the defects were those of the Company. The Company however, repaired these 11 engines on FOC basis without claiming the FPQ price of Rs.5.53 crore. It was also observed that under the delegation of powers within the Company, the competent authority for deciding on FOC repairs was not indicated and there was no formal documentation for the decision taken by the Company to undertake repairs on FOC basis.

The Management stated (July 2007) that:

* ***Even before completing the time between overhaul***

(i) Being a commercially oriented Government Company, rational commercial decision based on the facts and circumstances of the case, where the responsibility of the Company could not be unambiguously ruled out was taken and the FOC repair had demonstrated the Company's commitment to quality and long-term product support.

(ii) Out of 11 engines, no repair was done in respect of three engines, only stripping and testing costs were incurred while in respect of four engines, FOC repair was done as its fault could not be conclusively ruled out and in respect of the balance four engines, the defects were clearly attributable to the Company.

The Ministry endorsed the Management's reply in August 2007.

The reply was not tenable as:

(i) The failure of the Company cannot be justified as a 'rational commercial decision' as neither the FPQ terms/conditions nor the delegation of powers of the Company provided for FOC repairs. Further in view of Company's acceptance that there was no formal documentation for the executive decision to undertake the repair on FOC basis the reply appears to be an after thought.

(ii) As per the DI reports, in none of the 11 engines the defects were solely attributable to the Company. Thus, the Company was entitled to realise FPQ price. The Company has also confirmed the FPQ price of the repair of 11 engines as Rs.5.53 crore.

Thus, repairing of 11 engines during 2002-03 to 2004-05 on FOC basis though the defects were not precisely established on the part of the Company resulted in forfeiture of revenue of Rs.5.53 crore to the Company.

8.2.3 Procurement of unproductive inventory

The Company instead of restricting the procurement of SNFA bearings for service evaluation test alone went ahead and procured bulk quantity without clearance of AHQ resulting in unproductive inventory of Rs.5.08 crore.

The Company (Engine Division) manufactures, repairs and overhauls Adour engines. The sole supplier for mainline bearing used in the engines was Rolls Royce, (RR) UK the original equipment manufacturer (OEM). In order to develop alternate source, it was decided (October 2000) in a meeting with Centre for Military Airworthiness (CEMILAC) and MOD to procure six types of mainline bearings from SNFA France. It was also decided that the Company would apprise Air Headquarters (AHQ) about the introduction of SNFA bearings on Adour engines including the service sample evaluation of bearings at 600 hours and 1,200 hours, *etc.*

The Company placed two purchase orders in February and March 2001 for procurement of 240 mainline bearings on SNFA, France. AHQ however, was told about introducing/fitting of SNFA bearings in Adour Engines only in April 2001. SNFA, France supplied 235 mainline bearings between November 2002 and February 2004 at a cost of Rs.5.08 crore.

As per the requirement of CEMILAC, all mainline bearings were to be tested for service evaluation for minimum requirement of 600-1,200 flight operational hours. Though the Company fitted SNFA mainline bearings and sent three engines for service evaluation, it could not achieve the prescribed specification of 600-1,200 operational hours. Thus, in the absence of final evaluation report AHQ did not approve the fitment of SNFA bearings on in-service engines, even as of April 2007. Thus, the bulk procurement of mainline bearings was rendered unproductive, as the Company could not fit the mainline bearings in the engines even after a lapse of three years.

The Management stated (April 2007) that the requirements of the CEMILAC were complied with and clearance was given to use SNFA bearings as replacement for rejections during Defect Investigation (DI)/repair. The Company added that OEM had introduced SNFA as an alternate supplier for Adour bearings by Service Bulletin Mod AO1356. Further that the specialised and critical process of qualification of bearings involves a long period and requires additional tests/flight evaluation.

The reply of the Management regarding bulk procurement without the approval of AHQ was not tenable since:

(i) OEM had not introduced SNFA as an alternate supplier by Service Bulletin Mod AO1356.

(ii) As qualification of bearings required a long and specialised process of additional tests/flight evaluation the procurement of bearings in bulk quantity without quality clearance was imprudent.

(iii) SNFA bearings were recommended as replacement for rejections during DI/repair only on those engines with residual life of less than or equal to 300 hours and not on all service engines. The six sets of bearings were cleared by CEMILAC only for service evaluation in order to study the capabilities of bearings.

(iv) Service evaluation/sampling checks for 600 hours, 900 hours and 1,200 hours of Time Between Overhaul had not been achieved as specified by CEMILAC and final approval/clearance of AHQ had not been received (October 2007).

Thus, the Company instead of restricting the procurement of SNFA bearings for service evaluation test alone went ahead and procured bearings in bulk quantity, resulting in unproductive inventory of Rs.5.08 crore.

The matter was reported to the Ministry in July 2007; reply was awaited (November 2007).