CHAPTER XIII: MINISTRY OF POWER

NHDC Limited

13.1 Extra expenditure on interest

Due to not availing the opportunity of drawing loan at a lower rate of interest, the Company would be incurring extra expenditure of ₹ 30.31 crore.

NHDC Limited had (Company) drawn (June 2005) a loan of ₹ 1350 crore from a consortium of 11 bankers, with Union Bank of India as the lead banker at an interest rate of seven *per cent* per annum (payable monthly) for financing its Omkareshwar Project. This loan was to be repaid in 10 equal annual instalments commencing from 31 March 2009. The loan agreement with the consortium of bankers had a provision for put/call option at the end of three years from the date of first drawl (28 June 2005) with a prior notice of 60 days.

All member banks of the consortium exercised (April 2008) the call option and asked Company to repay the entire loan amount. The Board of Directors deliberated (May 2008) the issue of refinancing the above loan and desired that Company should make conscious study of the market and ensure raising of funds for refinancing the loan at competitive rate of interest and formed a committee of four members for the purpose.

The committee after examining the various offers recommended (June 2008) that ₹ 750 crore may be raised through issue of Bonds at the rate of 10.35 *per cent* and term loan of ₹ 600 crore from HUDCO at the rate of 10.25 *per cent* per annum. The shortfall in loan from either of these two options was recommended to be drawn from PFC, HDFC, Bank or UCO Bank. The Board of Directors did not accept (June 2008) the recommendations and directed to raise funds from PFC (₹ 750 crore) and HUDCO (₹ 600 crore). The shortfall, if any, from HUDCO was to be availed from PFC as it had quoted for the full loan amount of ₹ 1350 crore or less.

Sanction of loan of ₹ 1350 crore or less was received from PFC on 12 June 2008. HUDCO did not sanction any loan to the Company. The Company drew the full amount of ₹ 1350 crore from PFC on 28 June 2008 and the loan from the consortium of banks was repaid on the same day. The rate of interest of loan from PFC was fixed at 11.89 *per cent* with provision to reset the interest at the end of every third year beginning with date of first disbursement.

Audit observed that even though the Company had an option to raise funds of ₹ 750 crore through bonds at a lower rate of interest (10.35 *per cent*) it decided to draw entire requirement of ₹ 1350 crore from PFC at a much higher rate of interest (11.89 *per cent*), which was not justified. This resulted in avoidable extra interest payment of ₹ 23.33 crore up to September 2010. Till the date of first reset of interest (28 June 2011), the Company would be further paying extra interest of ₹ 6.98 crore. Thus, due to not availing the opportunity of drawing loan at a lower rate of interest, the Company would be incurring extra expenditure of ₹ 30.31 crore which in turn will adversely affect the beneficiaries by way of higher tariff.

Management stated (September 2010) that the option of floating rate of interest was taken in view of the then prevailing very high cost of debt so that overall cost could be reduced by taking advantage of reduced rates in future which was highly probable. Management also stated that it was premature at this stage to conclude that any extra interest has been paid as there was an option to prepay the loan at the end of 6th and 9th year.

The Ministry in its reply (January 2011) endorsed the views of the Management and stated that the decision of the Board was judicious in the prevailing circumstances. The reply further added that in 2nd and 3rd reset of interest rate, which would take place in June 2014 and June 2017, respectively, Company had the option of premature payment (without penalty) in case the rate of interest at that point of time was found on the higher side.

The replies of the Management and the Ministry were not acceptable because interest rate of PFC loan was subject to reset only once in every three years. Thus, due to not availing the option of issue of bonds at a lower rate of interest, which was available to Management till the first resetting of interest by PFC, the Management would be incurring extra expenditure of ₹ 30.31 crore on payment of interest.

Power Finance Corporation Limited

13.2 Fund Management

Introduction

Power Finance Corporation (PFC) was set up in July 1986 as a Financial Institution dedicated to power sector financing and committed to the integrated development of the power and associated sectors. It was notified as a Public Financial Institution under Companies Act, 1956 in 1990 and was registered as a Non-Banking Financial Company (NBFC)[♣] (Non-Deposit taking) by RBI in 1997. PFC was listed (23 February 2007) in the stock exchange after its Initial Public Offering (IPO). PFC is a Government Company within the meaning of Section 617 of the Companies Act as the President of India holds 89.78 *per cent* of the total equity. In June 2007 PFC was conferred 'Nav-Ratna' status. In July 2010, RBI granted the status of 'Infrastructure Finance Company' (a new category under NBFCs) to PFC. The share of PFC in power sector financing during the current Five Year Plan (2007-2012) was 11.50 *per cent*. Till 31 March 2010, PFC had sanctioned cumulative loans amounting to ₹ 2,70,480 crore against which disbursements amounting to ₹ 1,37,282 crore were made.

Scope of Audit

The audit covered various activities pertaining to fund management during the five year period from 2004-05 to 2008-09. Audit covered all cases of borrowings having monetary value above ₹ 500 crore and 20 *per cent* of the remaining cases having value less than ₹ 500 crore. Accordingly, out of total 355 cases of borrowings (for ₹ 74131 crore) 106 cases (30 *per cent*) for ₹ 38008 crore (51*per cent*) were covered.

[♣] ***A company registered under the Companies Act, 1956, engaged in the business of loans and advances etc. Functions of NBFCs are akin to that of banks. However unlike banks, NBFC cannot accept demand deposits, issue cheques drawn on itself etc.***

Audit objectives

The objective of this audit were to assess whether:

- Funds were raised after proper planning and were commensurate with the business requirements.
- Due diligence and economies were exercised while borrowing.
- Sound treasury management system existed

Audit criteria

The following criteria were used to assess performance of PFC for the period under scope:

- Operational Policy Statement of PFC
- PFC's internal guidelines relating to mobilization of funds
- Annual Resource Mobilisation Plans of PFC.
- PFC's Risk Management Policy.
- Best practices followed by the Industry.

Audit Findings

PFC mobilised total funds of ₹ 74131 crore during the five year period from 2004-05 to 2008-09 through various instruments like bonds, term loans from banks, commercial paper etc. The major sources were bank loans (47.52 *per cent*) and bonds (44.09 *per cent*). The funds mobilised during the period under review constituted 98.72 *per cent* through domestic loans and remaining 1.28 *per cent* through foreign currency loans. In addition, PFC also mobilised funds of ₹ 997 crore through its Initial Public Offering (IPO) in January-February 2007.

The examination of two main activities viz. assessment of requirement and raising of funds revealed as under:

13.2.1 Assessment of requirement

PFC assessed requirement of funds on the basis of targets given in the Memorandum of Understanding (MOU) entered into with Government of India every year, disbursement demands, debt repayment obligations, expected recoveries of existing loans and growth rate. PFC introduced (November 1990) an Operational Policy Statement (OPS) outlining its operational philosophy. As stipulated in OPS, PFC was required to maintain a primary liquidity reserve adequate to meet anticipated disbursements in next fortnight and a secondary liquidity reserve adequate to meet three months' disbursements. The liquidity reserves were mainly in the form of fixed deposits invested for periods ranging from four to 244 days[♣].

♣ ***Period of FDs and percentage of amount invested-4-7 days (11-23 per cent), 8-14 days (12-29 per cent), 15-30 days (35-55 per cent), 31-60 days (7-32 per cent), 61-182 days (0.1-6 per cent).***

Audit analysed the liquidity reserves considering total disbursements made during the years 2006-07 to 2008-09[♥]. Status of liquidity reserves worked out vis-à-vis actual fixed deposits held by PFC during the three years 2006-07 to 2008-09 was as under:

(₹ in crore)

Year	Annual Disbursements	Primary Liquidity Reserve (15 days)			Secondary Liquidity Reserve (3 months)		
		Amount required to be maintained as reserve	Lowest balance of FDs on any day during the year	No. of days when FD balance was less than the reserve required	Amount required to be maintained as reserve	Highest balance of FDs on any day during the year	No. of days on which FD balance was in excess of the reserve
2006-07	14055	600	0	213	3600	1694	0
2007-08	16211	700	171	53	4200	4675	18
2008-09	21054	900	0	127	5400	3804	0

As may be seen from the table above the Management could not maintain primary and secondary liquidity reserves up to the desired levels as stipulated in OPS.

Further, PFC required funds for its lending operations as well as debt repayment obligations and other expenses. While debt repayment obligations and administrative expenses were known in advance, lending operations entailed forecast of disbursement requirements of borrowers. Audit analysed the assessment made by PFC at the time of floating bond issues with a view to check the efficacy of the assessment mechanism. The 60 bond series in 32 issues during the five year period from 2004-05 to 2008-09 mobilised funds of ₹ 32683 crore, out of which Audit selected 24 bond series (20 issues) in which funds of ₹ 24120 crore were mobilised (74 *per cent*).

Audit observed that:

- In three out of 20 issues, requirement of funds was in the range of ₹ 600 to ₹ 1000 crore (Bond issues 27 A, B etc.), ₹ 1000 to ₹ 1200 crore (Bond series 31A) and ₹ 1500 crore to ₹ 2000 crore (Bond series 52 A&C), even for short term of 15-24 days. The variation between assessed disbursement and actual disbursement was between 11 and 50 *per cent* in nine issues and 51 and 102 *per cent* in three issues. Out of these 12 issues, six were of over assessment and six were of under assessment.
- Out of six issues of over assessment, PFC actually mobilised extra funds in two cases and incurred avoidable interest cost of ₹ 3.71 crore, due to deployment of the amount in Fixed Deposits which carried lesser interest than the interest paid on borrowings. Out of six issues of under assessment, PFC had to borrow funds, in three issues, at higher interest rates to meet the fund requirement. The higher interest cost works out to ₹ 39.64 crore**.**

Ministry replied (January 2011) that infrastructure projects including power projects were subject to uncertainty and delays and hence the borrowers were unable to predict their fund requirement accurately.

[♥] ***Reserves could not be analysed for 2004-05 and 2005-06 due to non furnishing of cash flow statements by PFC for 2004-05 on account of crashing of their computer hard disk and the cash flow statements furnished by PFC for the year 2005-06 did not show day end balances of fixed deposits***

The reply was not acceptable in view of the fact that PFC had adopted the mechanism of having drawal schedule besides provision of levying commitment charges to avoid uncertainties and delays at borrowers end from effecting its assessment and as such appropriate assessment was possible. Audit however, observed that while making disbursement forecast, PFC did not consider drawal schedules committed by the borrowers. Audit further observed that Management of PFC did not insist on obtaining drawal schedule from small borrowers. Such cases where there were no drawal schedules ranged from 17 *per cent* to 42 *per cent* during the period 2004-05 to 2008-09. Thus mismatches in assessment were due to deficiencies in the disbursement forecast mechanism.

13.2.2 Borrowing Decisions

As per the Resource Mobilisation Manual of PFC, borrowing decisions required joint authorization by Chairman and Managing Director and Director (Finance & Financial Operations). Audit observed that during the period from August 2008 to July 2009 the post of CMD and Director (F&FO) was held by the same incumbent, as such all the borrowing decisions of this period were taken by a single authority which cannot be considered as good corporate governance practice.

Ministry stated (January 2011) that the Board of Directors had delegated powers jointly in favour of CMD and D(F) to take all the borrowing decisions and CMD was holding additional charge of D(F) during this period as per directives of Ministry of Power, Government of India.

The reply was not acceptable since borrowing decisions by a single authority were against the principle of joint authorisation laid down in the Resource Mobilisation Manual.

13.2.3 Issue of Bonds

Based on GOI guidelines, PFC laid down (June 1998) internal guidelines for issue of bonds on private placement basis. Out of total borrowings of ₹ 74131 crore made by PFC during 2004-2009, ₹32683 crore (44 *per cent* of total borrowings) were mobilized through 60 series of bonds on private placement[1] basis. Examination of audit sample of 24 bond series revealed as under:

13.2.3.1 Higher Coupon rates

PFC being an AAA[2] rated company fixed the coupon rates for bonds on the basis of prevailing AAA bond rates as shown in the Reuters screen[3] and also consulted arrangers regarding pricing and structure of the bond issues. A comparative study of coupon rates of bonds issued by PFC during 2004-09 with the prevailing AAA bond rates revealed that PFC's rates were fixed higher in 13 out of 24 bond series. Due to the higher coupon rates, PFC was incurring additional expenditure to the extent of ₹ 14.54 crore annually. Accordingly, the Company would have to incur an amount of ₹ 120 crore over the tenure of bonds.

---

[1] ***Private placement means an issue offered to a select group of persons (not to the public)***

[2] ***AAA rating:-Rating symbol for highest credit safety given by CRISIL, one of the credit rating agencies approved by SEBI.***

[3] ***Reuters screen – Reuters is a trading platform, which gave AAA rates, derived from the contributed rates of 20 market players including banks, brokers and Mutual Funds.***

Management replied (December 2010) that Reuter's AAA rates might or might not be true indicator of the market levels of the particular day and quantum of the amount and market conditions play a vital role in fixation of the interest rate.

Ministry endorsed (January 2011) the reply of the Management.

The reply was not convincing since PFC considered Reuter's AAA rates as the reference rates while fixing the coupon rates for bonds. Further, Audit also compared the coupon rates of PFC bonds with those of PSUs in the power and finance sector viz. Indian Railway Finance Corporation Limited (IRFC), Rural Electrification Corporation Limited (REC), NTPC Limited (NTPC), Power Grid Corporation of India Limited (PGCIL), which were launched around the same time. Out of 19 common series in five years under review, PFC's rates were higher for similar or shorter tenor in 15 series and in one series the other Company was able to raise funds for longer tenure at equal rates. Besides, Audit also compared the rates with AAA spreads[1] as per FIMMDA[2] and found that PFC's coupon rates were higher than FIMMDA rates in 10 bond series (out of the 24 bond series). The higher interest cost in these 10 series worked out to ₹ 132.30 crore for the entire tenor of bonds.

Ministry stated (January 2011) that the bond rates with companies like NTPC, REC and IRFC were not comparable as their security structure was not the same. Regarding FIMMDA rates, it stated that these were used by banks to make investment and were generally published only at the end of the month. Further, it stated that keeping in view the frequency of PFC bond issues and volatility in the market, FIMMDA rates cannot be applied as benchmark.

The reply was not acceptable since all the companies considered by Audit had the same credit rating (i.e. AAA) and were CPSUs in the same sector viz. Power/Finance. The comparative trend analysis over a time frame of five years from 2004-05 to 2008-09 showed that coupon rates of PFC bonds were higher than that of similarly rated Government Companies and different reference (FIMMDA) rates. As regards FIMMDA, the timing of the publication of rates cannot nullify the trend analysis, which showed that PFC's rates were higher.

Apart from the above, Audit observed that economy of borrowings was being assessed by the Administrative Ministry through a parameter called 'borrowing cost-domestic' linked to Government Security rates in the MOUs, during 2005-06 and 2006-07. The parameter was deleted from the year 2007-08 and since then there were no targets for assessing economy of borrowings. The main reasons for higher bond rates identified by Audit are discussed below:-

(a) Frequent bond issues and limited investors

Comparative study of frequency of PFC bond issues with that of other PSUs revealed that PFC floated 32 bond issues in five years as against 13 on an average, by four other PSUs in Power / Finance Sector. Further as per the Companies Act, there was no upper ceiling on the number of subscribers to whom bonds could be issued on private placement by a

---

[1] ***AAA spreads – It is an indicator of risk premium for a AAA rated paper over Government securities (G sec)***

[2] ***FIMMDA - Fixed Income Money Market and Derivatives Association of India***

Public Finance Institution (PFI) as against the limit of 50 investors for other issuers. Audit observed that PFC did not avail this benefit adequately as the number of investors subscribing to PFC's bonds was less than 50 in 15 out of 24 bond series examined by Audit.

Management admitted (February 2010) that there were frequent bond issues and attributed it to the efforts made to maintain sufficient balance between liquidity and carrying cost. It further stated that it was not possible to raise the desired amount in one issue and comparison with companies like NTPC, IRFC and HUDCO was not justified keeping in view the total fund requirement of the Company. Regarding limited investors, it stated that investment by banks/merchant bankers might be on account of investors to whom the same would be transferred in secondary market deal.

Ministry endorsed (January 2011) the views of the Management.

The argument attributing the frequent bond issues to higher fund requirement in comparison to other companies was not convincing since PFC had the flexibility of approaching more investors in private placement to meet its higher fund requirement unlike those companies which, not being PFI, were required to limit the number of investors to less than 50. As regards investors who subscribe to the bonds through merchant bankers in the secondary market rather than through direct subscription, this did not help PFC in bringing down coupon rates.

(b) Lack of proper timing

Comparison of timing of bonds issues of PFC with that of REC revealed that seven bond series of PFC were issued around the same time as REC during 2004-05 to 2008-09. Out of the seven bond series of PFC, the coupon rates of four series (for equal or lesser tenure) were higher than REC rates. The higher interest cost when compared to REC rates in the four bond series worked out to ₹ 60.33 crore. Further PFC did not take care to avoid a bond issue during the time of advance/final payment of tax, when bond rates were high. Out of the 60 bond series during the last five years, 13 bond series were around the advance /final tax payment dates. Thus PFC had to bear a higher coupon rate in nine bond series when compared to the rates prevalent on nearby dates. The resultant increase in interest cost worked out to ₹ 86.25 crore.

Ministry stated (January 2011) that all efforts were made to avoid overlapping of the issues as well as particular events like advance tax payment dates etc.

The reply was not acceptable as out of 60 bond series issued by PFC, 13 were around advance/final tax payment dates and seven were around REC bond issue dates.

(c) Engagement of Arrangers

In the selected sample of 24 cases, PFC appointed arrangers in 16 series and handled eight series without arrangers. Out of the total funds of ₹ 20822.20 crore raised through arrangers, investment by arrangers and their group companies amounted to ₹ 7552.50 crore (36.27 *per cent*). Audit observed a conflict of interest in this arrangement since the arrangers were appointed to help PFC in raising funds at the minimum possible coupon rates. When the arrangers themselves became investors, the possibility of fixing high coupon rates to get high yield could not be ruled out.

Ministry replied (January 2011) that services of arrangers were availed to reach the maximum number of investors across the country and fixation of interest rates had no relevance with the launch of a particular issue through arrangers or directly.

The fact remained that PFC could mobilize more funds, with reference to issue size, when it handled the issues on its own i.e. without engaging arrangers. Further, bond issues launched with arrangers generally had coupon rates higher than AAA rates.

(d) Underplaying of the issue size

The issue size of bonds varied from ₹ 100 crore to ₹ 500 crore even though the assessed requirement ranged from ₹ 963-9400 crore. PFC retained the excess subscription received on each bond issue by exercising the Green Shoe Option[1]. In five out of 25 instances, the funds were retained even though mobilization was more than the assessed requirement. The excess funds so mobilized were deployed in fixed deposits carrying lesser interest rate, leading to avoidable carrying cost[2] of ₹ 4.77 crore. Further, in two instances during the global financial crisis of 2008, PFC retained funds amounting to ₹ 2205 crore over and above the assessed requirement, even though the AAA rates decrease between dates of opening of issue and the date of allotment. Hence the green shoe option was not judiciously exercised in these two cases, leading to avoidable interest cost of ₹ 307.41 crore. PFC initially laid down the limit of green shoe option as equal to the issue size in its internal guidelines but later the ceiling was removed. Audit observed that PFC did not declare the limit of green shoe option at the time of floating the bond issues. In one case the limit of green shoe option was declared, but subsequently the entire funds in excess of the green shoe limit, were also retained.

Ministry replied (January 2011) that the guidelines for private placement did not prohibit any issuer to keep the green shoe option open /unspecified and that the issue size was generally kept low to ensure success of a particular issue. It further stated that the amount of subscription was not related to the issue size and any investor who wants to put money, checked directly from PFC or through arrangers and PFC at times had to pre-close the issue to avoid refunds.

The reply was not acceptable since a test check of bond issues in the debt market during December 2008 to January 2009 revealed that out of 31 issues, green shoe option was kept in seven cases. In four out of the seven issues, the green shoe option was specified indicating that the general market practice was to declare the green shoe option. Further, it was not reasonable to expect that the investors should make enquiries to know the real issue size. Overwhelming response may also be due to higher coupon rate PFC was offering.

13.2.3.2 Tenure of bonds

PFC fixed tenure of bonds based on investor appetite for a particular tenure as per the market situation and advice of arrangers. The tenure of 24 bond series examined by Audit

---

[1] ***Green shoe option – It is the option through which the issuer of the bond declares their intention to retain over-subscription***

[2] ***Carrying Cost is the difference in cost of borrowing and the yield from short term deployment of funds in fixed deposits.***

ranged from 1.5 years to 15 years♣. During 2008, there was a global financial crisis and the bond coupon rates rose to 11 *per cent* as against seven to 10 *per cent* prevalent during 2004-05 to 2008-09. PFC issued six series during this period and mobilised funds of ₹ 6733 crore (20.6 *per cent* of funds mobilised during the period from 2004-05 to 2008-09) as detailed below:

Bond series No.	Date of issue	Coupon rate	Tenure in years	Amount mobilised (₹ in crore)
51 A	15.9.2008	11.15	3	495
51 B	15.9.2008	11.10	5	594
51 C	15.9.2008	11.00	10	3024
52 A	28.11.2008	11.40	5	663
52 B	28.11.2008	11.30	7	6
52 C	28.11.2008	11.25	10	1951
TOTAL				**6733**

Had PFC fixed the tenure and coupon rates of above mentioned bonds judiciously, interest cost to the extent of ₹ 259.47 crore to ₹ 1067.41 crore could have been avoided. In the 51 bond issue, PFC offered 10 years bonds at 11 *per cent* interest along with three year bonds at a slightly higher interest of 11.15 *per cent*. The pricing was not commercially prudent since the investors were more likely to opt for the 10 year bonds in view of the high return for longer period. This was proved by the huge mobilisation from the 10 year bonds. In the 52nd bond issue, three year bonds were not offered and the pricing of five and seven year bonds was not competitive enough to attract subscription when compared to the 10 year bond rate. Both these bond series were handled by arrangers who by themselves or through their group companies subscribed to 51 *per cent* of the total mobilisation indicating undue benefit to them.

Ministry stated (January 2011) that there was more demand for longer tenure paper in spite of lower coupon as compared to three years and keeping in view the fund requirement of the Company and appetite of the investors, PFC had to launch ten year paper.

The reply was not convincing considering the meagre difference (0.15 *per cent*) between the rate of interest offered for three year and 10 year bonds and also the fact that the main subscribers were the arrangers. Ministry did not reply to the observation regarding the undue benefit given to the arrangers on these bond issues.

13.2.4 Bank Loans

During the five year period under review, PFC raised ₹ 35230 crore (45.87 *per cent* of total borrowings) through 276 loan drawals from banks of which 59 loan drawals for an amount of ₹ 9213.77 crore were examined by Audit and observations were as under:

13.2.4.1 Lack of transparency in discovery of lowest rate on bank loans

PFC sent letters to various banks every quarter calling for indicative interest rates and depending on the fund requirement, the loans were availed from individual banks after finalizing the rates with them. Audit observed that the system of rate discovery lacked

♣ ***one bond for 1.5 year, 2 bonds for 3 years, 7 bonds for 5 years, 2 bonds for 7 years, 11 bonds for 10 years and 1 bond for 15 years.***

credibility since the offers received from banks were not firm offers. Moreover, the quotes received from banks were as per their own version since PFC did not specify its requirements. However, on one occasion, firm rates were called for from banks for availing a short term loan and among the nine quotes received, the annualized interest rate varied from 9.38 *per cent* to 11.30 *per cent*. Audit observed that there was better response when firm rates were called for and PFC could secure more competitive rates.

Ministry stated (January 2011) that the quarterly request letters were sent to all the scheduled commercial banks to raise funds in a particular quarter and PFC's requirement of funds was not restricted to a particular time frame and was an ongoing exercise throughout the year. It further stated that if firm quotes were asked, it may not be possible for the banks to hold firm rates for the quarter.

The reply was not acceptable since all financial institutions require funds throughout the year and scrutiny of the practice followed in REC by Audit revealed that bank loans were raised on the basis of firm quotes. Further, Audit observed that the inability to seek firm rates stemmed from the lack of proper assessment of fund requirement.

13.2.4.2 Raising of loans without pre-payment option during high interest rates period

During the period of global financial crisis of 2008, PFC availed three loans totaling ₹ 1000 crore from two private banks[*] at fixed interest rate of 11.7 *per cent*. These loans were for 22 months to three years with put and call option after two years in case of three year loans.

The decision to raise these loans was not prudent in view of the following:

- The banks did not provide prepayment option on the loans and PFC had to incur higher interest cost of ₹ 51 crore considering the lower interest rates of subsequent quarter. It could have saved interest outgo to the extent of ₹ 51.70 crore had it raised the funds on floating rate basis.
- During this period PFC had an offer from Bank of Baroda for a loan of ₹ 500 crore at a floating interest rate of 13 *per cent* which was not availed. Though the interest rate at that time was higher, the eventual cost would have been lower in view of the floating rate. There was another offer of ₹ 150 crore from State Bank of Mysore at a fixed interest of 11.5 *per cent* which was not approved by the competent authority without recording reasons.

Ministry stated (January 2011) that the said loans were raised during tight liquidity conditions in the market and banks were reluctant to give prepayment option.

The reply was not acceptable since in the absence of pre-payment option, PFC could have opted for floating rate loans or short term loans. Further, even during volatile period, PFC continued with its system of seeking quarterly indicative rates instead of calling for firm quotes.

13.2.4.3 Drawal of loans from banks and placing the funds in fixed deposits (FDs)

Audit observed that PFC frequently made loan drawals from banks in excess of requirement and placed the balance funds, the same day, in fixed deposits which carried

[*] ***Axis Bank (loan availed ₹ 700 crore) and Kotak Mahindra Bank (loan availed ₹ 300 crore)***

lesser interest. Out of 276 loan drawls made during the period 2004-05 to 2008-09, the Company made fixed deposits to the extent of ₹ 753.59 crore in 67 cases on the same day at lower rate of interest which resulted in extra cost of ₹ 7.55 crore.

Management stated (February 2010) that keeping in view the huge requirement of funds and also the uncertainty of fund required for disbursements, the amount of loan drawn may be less or more compared to the actual requirement of funds on a particular day and that sometimes loan has to be drawn before expiry of validity given by the bank.

Ministry endorsed (January 2011) the reply of the Management.

The reply was not acceptable since differential interest between borrowings and short term investments ranged from 0.91 *per cent* to 2.70 *per cent* and showed upward trend for the last three years. Hence the negative carry[1] due to drawal of bank loans should have been avoided.

13.2.5 Funds raised through United States Private Placement (USPP) at higher cost

PFC raised (July 2007) USD 180 million (₹ 732.42 crore) from the United States debt market through private placement of Senior Notes to six institutional investors at coupon rate of 6.61 *per cent.* Two arrangers[2] were appointed to handle the private placement and the notes were priced on the basis of rates for 10 year US treasury bills and the spread[3] thereon.

Audit observed that:

- Spread agreed by Indian companies which tapped the USPP market prior to PFC, ranged from 140 to 155 bps[4] as against the spread of 170 bps agreed by PFC, thus making it the costliest private placement by an Indian Company at that time.

- Historical data of US treasury bills for 10 year tenure between January 2003 and December 2007 revealed that the average annual daily rates ranged from 4.01 *per cent* to 4.78 percent. The daily rates remained relatively higher during June –July and PFC hit the US market during one such period (July 2007). Further, when PFC timed the issue, the spreads widened due to the sub-prime crisis[5] and PFC agreed for a spread of 170 bps as against the spread of 150 bps agreed by one of the CPSUs viz. IOCL, in May 2007. The higher interest cost when compared to this issue worked out to ₹ 14.65 crore.

- Arrangers were appointed on the basis of indicative spread of 125 bps quoted in April 2007. However, at the time of pricing in July 2007, PFC agreed for a spread of 170 bps proposed by the arrangers (i.e. increase of 45 bps over the spread quoted at the time of bidding). The pricing proposal was not routed through the Resource Mobilisation Committee, as per the procedure laid down, though higher

---

[1] ***Negative carry – Incurring extra interest cost due to carrying higher cost borrowings.***

[2] ***Deutche Bank and Barclays Bank***

[3] ***Spread – risk premium as per market indicators***

[4] ***bps:-basis points (i.e. 1.4 per cent to 1.7 per cent over and above the rate of US Treasury bills)***

[5] ***Sub- prime crisis means default by the borrowers on the mortgaged loan and resulting reduction of securities backing such mortgaged loans and liquidity crisis. It occurred in the United States during 2007-08.***

interest cost of ₹ 32.96 crore was involved. Out of the six investors, two were group companies of one of the arrangers indicating conflict of interest.

Ministry stated (January 2011):

- Rates of other issuers were not comparable because the price was determined by numerous factors.
- The fully hedged cost of issue was comparable with the cost of funds in the domestic market.
- As firm quotes were not available in the USPP market, the indicative quotes were taken.

The reply was not acceptable because:

- Audit compared the rates with those of other companies considered by PFC and the arrangers while pricing the issue with that of other companies.
- The comparability of cost with reference to domestic rates was not convincing since PFC considered swap costs for hedging of the principal only and did not include hedging cost for interest component. Audit observed that the Company had already incurred actual exchange loss of ₹ 18 crore in interest servicing up to September 2010.
- Arrangers were selected on the basis of indicative rates but they sought a higher rate later citing worsened market conditions. Conflict of interest could not be ruled out since a significant portion (25 *per cent* of additional interest payable due to increase in spread) of benefit went to the group companies of the arrangers.

13.2.6 Initial Public Offering

PFC raised capital of ₹ 997.19 crore through its Initial Public Offering which was floated in January/February 2007 at a price band of ₹ 73-85, approved by the Board of Directors of PFC, based on the recommendation of Book Running Lead Managers (BRLMs). The issue was oversubscribed by 77.16 times and the issue price was fixed at ₹ 85 per share. On listing, the quoted price was ₹ 113 per share.

Audit observed:

- The prospectus for the IPO permitted subscription by associates of BRLMs and syndicate members. As per Accounting Standard 23 dealing with 'Accounting for investments in consolidated financial statements' notified by the Institute of Chartered Accountants of India, an associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. Audit observed that PFC permitted subsidiaries of BRLMs to subscribe to the issue and allotted them 37.37 lakh shares valuing ₹ 31.76 crore (6.37 *per cent* of QIB portion) in violation of terms of issue as per the IPO prospectus. There was a conflict of interest since the BRLMs were advising PFC about pricing while the subsidiaries might be looking for trading gains. Further, 35 out of 37 subsidiaries of BRLMs, who were allotted shares, divested their shares on the listing day or soon thereafter and made a profit of ₹ 10.93 crore (35.78 *per cent* of their investment).

- PFC floated the issue with a price band of ₹ 73-85 though SEBI guidelines permitted a difference of 20 *per cent* between the upper and lower end of the price band. PFC could have fixed the upper price band as ₹ 87 (instead of ₹ 85) which would have fetched ₹ 23.46 crore more.

Ministry stated (January 2011) that:

- Other CPSUs under the Ministry like NTPC, NHPC and PGCIL had also allowed the associates of BRLMs to subscribe to equity shares in their respective issues.
- The price band of the IPO was recommended by the IPO Pricing Committee of Directors as per the feedback received from the BRLMs based on the market conditions. The price band subsequently approved by the Board of Directors was already higher than the price initially recommended by BRLMs.

The reply was not acceptable since:

- Subsidiaries of BRLMs (not 'Associates') were allotted shares in violation of the terms of issue as per the prospectus thus depriving eligible QIBs/investors from getting the allotment of shares.
- Board of Directors approved a higher price than that quoted by the BRLMs but the fact remained that subjectivity was involved in the process. Audit observed that IPOs of NTPC (₹ 52-₹ 62), PGCIL (₹ 44-₹ 52) and NHPC (₹ 30-₹ 36) took the benefit of 20 *per cent* difference in floor and cap price of the price band.

13.2.7 Asset Liability Management (ALM)

Asset liability management can be broadly defined as the continued rearrangement of both sides of the balance sheet in an attempt to maintain reasonable profitability, to minimize interest rate risk and to provide adequate liquidity. The ALM framework of PFC included periodic analysis of long term liquidity profile of assets, receipts and debt service obligations through liquidity gap statements. Such analysis was made every month in yearly buckets and was being used for Management decisions regarding maturity profile of the borrowings, creation of new assets and mix of assets and liabilities. PFC had an Asset Liability Management Committee (ALCO) which reviewed the ALM position every month. Audit observed that the ALM framework of PFC failed to strengthen the risk management process of PFC as explained below:

13.2.7.1 Widening gap in maturity profiles of assets and liabilities

The weighted average maturity (WAM) of assets and liabilities of PFC, as on 31 March of the last six years was as follows:

Balance sheet date	Weighted Average maturity of Loan assets	Weighted Average maturity of Loan liabilities	Difference in maturity period (years)
31.3.04	4.14	3.37	0.77
31.3.05	4.35	3.49	0.86
31.3.06	4.58	4.23	0.35
31.3.07	4.85	4.09	0.76
31.3.08	5.21	4.02	1.19
31.3.09	5.64	4.15	1.49

The purpose of calculating weighted average maturities of the assets and liabilities was to have an idea of the average time within which such assets would be realized and liabilities would be settled. Widening of gap in maturity period from 0.77 (as on 31 March 2004) to 1.49 (as on 31 March 2009) indicated liquidity problems for the Company and tough borrowing decisions might be required to repay the liabilities.

Ministry stated (January 2011) that weighted average maturity of assets was more than weighted average maturity of liabilities, which was inherent in infrastructure financing particularly power sector financing. It further stated that the calculations for weighted average maturity (done by PFC) did not consider equity capital and reserves which were used to finance loan assets and which were perpetual in nature.

The reply was not acceptable since it was not prudent for a financial institution to consider its equity capital and reserves to manage ALM mismatches. The principle of ALM was to rearrange the assets and liabilities continuously in an attempt to maintain reasonable profitability, to minimize interest rate risk and to provide adequate liquidity. Regarding the claim that PFC had a strong ALM system, the touchstone for checking the efficiency of ALM system of a financial institution was its performance during a financial crisis. During the global financial crisis of 2008, PFC had to take tough borrowing decisions to repay debt obligations of more than ₹ 4000 crore by Management's own admission. The huge outflow during the financial crisis indicated failure of ALM.

13.2.7.2 Failure to monitor short term mismatches through tolerance limits

RBI prescribed (June 2001) ALM guidelines for NBFCs and emphasized the need to monitor short term mismatches and lay down tolerance limits. The methodology prescribed by RBI required the NBFCs to monitor the mismatches in short term buckets i.e. i.e. cash inflows and outflows in the next 1-31 days, 1-3 months, 3-6 months etc. were to be monitored. PFC laid down Integrated Risk Management Policy as per which negative liquidity gap up to 15 *per cent* of the cash outflows for the next 12 months was categorized as low risk, 15-25 *per cent* as medium risk and more than 25 *per cent* as high risk.

Audit observed:

- PFC did not follow RBI guidelines regarding ALM and claimed that the guidelines were not applicable to PFC. However on a reference by Audit, RBI clarified that it had not granted specific exemption to Government NBFCs regarding ALM and stated that non adherence to ALM guidelines prescribed by RBI would increase the risk for the financial institution.

- While RBI guidelines emphasized monitoring of ALM mismatches in short term buckets, and prescribed tolerance limits for the same, PFC analysed the mismatches in yearly buckets i.e. PFC knew the ALM mismatches for the next one year but not the next one month, three months, six months etc.

- These inadequacies adversely impacted PFC during the financial crisis of 2008, as already stated in para 13.2.3.2 PFC raised ₹ 6733 crore through bonds during the volatile period of September 2008 to November 2008, which was 20.60 *per cent* of total funds borrowed through bonds during last five years. Since the bonds had

tenure ranging from three to 10 years and carried fixed interest rates, PFC had to carry higher interest burden of ₹ 217 crore when compared to the average cost of borrowing for the year.

Management stated (February 2010) that:

- RBI guidelines to NBFCs on ALM were not applicable to PFC and the PFC had explained the position to RBI.
- The ALM practices of PFC were studied by M/s KPMG and the Integrated Risk Management policy was laid down as per their recommendation. PFC was managing the risk within the low risk limit laid down in the policy.
- It was to the credit of PFC that it could borrow large amount of funds through bond issues at competitive rates and comparison of the rates with average cost of borrowing for the year is not correct since each borrowing is unique.

Ministry endorsed (*January 2011*) the reply of the Management.

The reply was not acceptable since:

- PFC was sending half yearly returns to RBI earlier and as part of the returns, it was preparing and sending dynamic liquidity statements for short term buckets also. But monitoring in short term buckets was not the regular feature of ALM monitoring by PFC. Thus full facts were not presented to RBI.
- Integrated Risk Management Policy relating to ALM aspect was not in accordance with those prescribed by RBI which was the financial sector regulator. Had PFC laid down tolerance limits for short term buckets, the borrowings during the volatile period could have been curtailed. Further, Audit compared the practice with that of REC and found that the ALM policy of REC provided for short term buckets.
- Borrowing large amount of funds during a financial crisis that too mainly to repay debt obligations by itself proved failure of ALM framework. The argument that the bond issues were made at competitive rates was incorrect since in four out of six bond issues of the volatile period, the rates were higher than AAA rates. PFC incurred higher interest cost of ₹ 54.75 crore in those bond issues when compared to the AAA rates. Thus PFC was able to borrow funds to tide over the liquidity crisis, but it involved a higher cost. Regarding Management's claim that individual borrowing costs should not be compared with average borrowing cost for the year, such comparison were not out of place while assessing efficiency of ALM framework.

Conclusion

PFC was not having a sound system for assessing the requirement of funds resulting in mismatches leading to higher costs. Limited investor base, engagement of arrangers, poor timing of issues and underplaying the issue size were some of the reasons which contributed to higher coupon rates for bonds issued by PFC. Undue favour to arrangers was evident in the fixing of tenure of bonds issued during volatile period. Bank loans were finalised on the basis of indicative rates and some loans were availed at high interest rates without prepayment option. United States Private Placement of senior Notes by the Company coincided with sub-prime crisis and resulted in higher cost. Price band of Initial Public Offering was not fixed prudently and subsidiaries of BRLMs were allotted

shares in violation of terms of issue. Short term asset liability mismatches were not monitored and PFC had to borrow heavily at higher cost to repay debt obligations that came up during global financial crisis of 2008. Audit assessed the total loss on these accounts during the five years from 2004-05 to 2008-09 as ₹ 1485 crore to ₹ 2293 crore.

Recommendations

- ***The mechanism for assessment of requirement of funds needs to be revisited and strengthened.***
- ***PFC should ensure resource mobilization in an economical, efficient and effective manner through judicious fixing of coupon rates for bonds, reducing dependence on arrangers, proper timing, expansion of investor base and prudent fixing of tenure and issue size of bonds.***
- ***Bank loans should be raised in a transparent and efficient manner based on firm quotes, availability of prepayment option etc.***
- ***Before opting for overseas fund mobilization due consideration should be given to exchange risk factors.***
- ***PFC should follow RBI guidelines applicable to NBFCs regarding Assets Liability Management and lay down tolerance limits for short term mismatches.***

13.3 Utilisation of Funds

Introduction

Power Finance Corporation (PFC) was set up in July 1986 as a Financial Institution dedicated to power sector financing and committed to the integrated development of the power and associated sectors. It was notified as a Public Financial Institution under Companies Act, 1956 in 1990 and was registered as a Non-Banking Financial Company (NBFC) by RBI in 1997. PFC was listed (23 February 2007) in the stock exchange after its Initial Public Offering (IPO). PFC is a Government Company within the meaning of Section 617 of the Companies Act as the President of India holds 89.78 *per cent* of the total equity. In June 2007 PFC was conferred 'Nav-Ratna' status. In July 2010, RBI granted the status of 'Infrastructure Finance Company' (a new category under NBFCs) to PFC. The share of PFC in power sector financing during the 11th Five Year Plan (2007-2012) was 11.50 *per cent*.

Operational Framework

The Mission of PFC was to endure as a pivotal Development Financial Institution in the Power Sector committed to the integrated development of power and associated sectors by channeling resources and providing financial, technological and managerial services for ensuring development of economic, reliable and efficient systems and institutions. The Operational Policy Statement (OPS) of the Company stated that PFC's policy framework should be consistent with the policies and regulatory framework of the Government of India. OPS also envisaged that criteria of financial assistance should lay emphasis on financial and operational strength, capability and competence of the promoter and techno-economic viability of projects.

Scope of Audit

The audit covered various activities pertaining to utilization of funds during the period from 2004-05 to 2008-09. Sample of 182 cases (₹ 27941 crore) out of total 1764 cases (₹ 172461 crore) was selected for audit on the basis of monetary value of sanctions and stratified random sampling method.

Audit objectives

Objective of this thematic audit was to assess whether:

- Funds were utilized effectively and efficiently.
- Project appraisal mechanism was proper and internal controls relating to sanction and disbursement of loans were sound.
- Project monitoring mechanism was effective and proper end utilization of funds and timely recovery of dues was ensured.
- Prudence and transparency existed in fixing of lending rates.

Audit criteria

The following criteria were used to assess performance of the Company:

- OPS of PFC
- Disbursement procedure laid down by PFC
- Prudential norms of PFC and RBI
- Best practices followed by the Industry.

Audit Findings

13.3.1 Project Appraisal

As per clause 3.1 of Part II of the OPS of PFC, the Company was required to provide financial assistance to the projects which meet the following criteria:

- The project was techno-economically sound with financial or economic rate of return of not less than 12 *per cent* (as may be applicable);
- Project was feasible and technically sound and provide optimal cost solutions for the selected alternative;
- Project was compatible with integrated power development and expansion plans of the State/Region/Country;

Out of total 182 cases selected, 76 cases pertaining to generation, transmission, distribution and renovation and modernisation, were examined and audit findings were as under:

13.3.1.1 System of assessing reasonableness of project cost was deficient since PFC did not verify independently the cost estimates furnished by borrowers. Further, PFC did not maintain cost data of items being used in power sector utilities as such excess funding could not be ruled out.

Ministry replied (February 2011) that cost of various equipment was on the basis of

recently sanctioned projects across various utilities and schedule of rates of some of the utilities. Further, it was not feasible for PFC to maintain database of current market price of each of the equipment involved in power projects across various areas of generation, transmission and distribution.

The reply was not acceptable as cost estimates should have been verified on the basis of current market prices of various components rather than the last awarded price. Going by the purchase order value also did not ensure reasonableness of cost since there was no check on inflated values considered in a purchase order resulting in adverse cumulative effect on cost estimates.

Further, Audit identified three cases[♣] (out of 14 generation cases in the selected sample), where per mega watt (MW) project cost at the time of sanction was higher than the actual 10th plan per MW cost of around ₹ 4 crore mentioned in the report of Working Group on Power for XI Plan constituted by Ministry of Power. Management contention that it was not feasible to maintain database was not convincing, considering that PFC was exclusively catering to power sector and would have been benefited by maintaining data bank of current market price.

13.3.1.2 Examination of 56 cases of transmission and distribution (T & D) projects revealed that in 15 cases (including four cases with negative FIRR) FIRR was less than that stipulated in OPS i.e.12 *per cent*. This indicated managerial failure to adhere to the criteria stipulated in OPS to ensure financial viability of a project.

Ministry stated (February 2011) that consistent with its developmental role, PFC may also consider financial assistance to public sector utilities having unsatisfactory operational and financial performance provided such utilities committed themselves for improvement in their performance levels. Regarding T & D projects it stated that FIRR of individual T & D projects was often less than 12 *per cent* since the schemes could not be divided into water tight compartments and hence benefit to economy as a whole was considered through EIRR criteria. It further stated that such sanctions would normally incorporate conditionality to ensure improvement of performance of the utilities.

The reply was not acceptable as Electricity Act 2003, emphasised on financial viability of the project i.e. the project revenues should have been sufficient to meet all project costs. This could be achieved by considering financial rate of return. The onus of bringing in the transformation in the power sector was on developmental financial institutions like PFC who were to address this aspect at the appraisal stage itself. Since financial viability of projects was a key factor in sustained development of the power sector, PFC should have focused on the FIRR criteria while conducting project appraisal.

13.3.1.3 PFC sanctioned (October 2008) a loan of ₹ 1770 crore to Sasan Power Limited (Special Purpose Vehicle promoted by Reliance Power Limited) for setting up an Ultra Mega Power Project. While assessing the FIRR, Plant Load Factor (PLF) of 90 *per cent* was assumed instead of 80 *per cent* stipulated in PFC's guidelines based on CERC norms.

[♣] ***(i) Loan NO. 08301004 dated 09-8-2006 - U.P.Rajya Vidyut Utpadan Nigam Limited (UPRVUNL) 2X250 MW-Project cost ₹2356 crore-Cost /MW ₹4.71 crore (ii) Loan NO.08301005 dated 09-8-2006- UPRVUNL)- 2X250 MW - Project cost ₹2605 crore -Cost /MW ₹5.21 crore (iii) Loan NO. 22101002 dated 31-3-2008 -Chhatisgarh State Electricity Board—2X500 MW- Project cost ₹ 4174 crore Cost/MW ₹4.17 crore***

The justification was that the lead financial institution assumed 90 *per cent* PLF and that the Lenders' Independent Engineer (LE) viz. Lehmeyer International (India) Pvt. Limited had stated in his due diligence report that with ' certain measures during execution and best international O & M practices, 90 *per cent* PLF can be achieved'.

Audit observed that 90 *per cent* PLF was an unduly positive presumption since the borrower intended to bring in Chinese equipment for the main plant which had not achieved 90 *per cent* PLF under domestic conditions. Further, at the time of sanction, PFC was having only the sanction letter of the lead financier while as per norms, it should have reviewed the appraisal report of the lead financier before granting sanction for financial assistance. Project FIRR as per PFC's norms was 3.78 *per cent* but considering a newspaper report, stating that the developer was permitted to use surplus coal from the coal block allotted for the project to its other projects, the FIRR was brought, with liberal assumptions, up to the level of 11.72 *per cent* and sanction of financial assistance to the project was justified. Moreover, instead of waiting for the required permission letter of Coal Ministry PFC relied on media reports to justify sanction of loan for the project. Thus necessary documents were not examined and undue haste was shown in sanctioning loan for the project.

Ministry stated (February 2011) that while concerns exist around use of Chinese equipments, the LE was aware of the use of Chinese equipment when the opinion with regard to achievement of a PLF of 90 *per cent* was given. It further stated that the LE had sufficient technical knowledge and expertise to provide its opinion with regard to 90 *per cent* PLF.

The reply was not acceptable since the lender's engineer had given a conditional opinion which stated that 90 *per cent* PLF was achievable provided the best international O & M practices were followed. PFC had little control over the O & M practices to be followed by the borrower after the funds were disbursed and the plant would be commissioned. CERC norms were fixed after considering the PLF trend over the years including competitive bid for Independent Power Projects. It was prudent to rely on regulatory norms rather than to rely on subjective presumptions of the lender's engineer. Further, competitive bidding did not guarantee higher PLF unless the track record of machines proved as desired.

13.3.1.4 It was observed that in 26 cases (out of 76 mentioned above), extensions in date of completion, date of validity of sanction, date of loan closure etc. were accorded without assessing FIRR of the projects at the time of granting such extension.

Ministry stated (February 2011) that request for extension of project completion date was generally received by PFC at a time when more than 50 *per cent* of the loan amount had already been disbursed and at such a stage stopping of funds would not only hinder completion of the project but would also be detrimental to the interests of PFC.
From the reply it was clear that both PFC and the entities were creating a vicious cycle of delays and extensions.

13.3.2 Disbursement – Collateral Security Requirements

13.3.2.1 According to collateral security requirements laid down (March 2007) by PFC for various categories of borrowers, the requirement for Category 'B' borrower was as follows:

- Pledge of shares of atleast 51 *per cent* of project equity till full repayment of PFC loan.
- Debt Services Reserve Account (DSRA) for at least two quarters.
- Personal guarantee of two promoter directors, who were participating in equity contribution.

The policy further provided that in cases where PFC was not the lead financial institution, the collateral security requirements were to be considered on a case to case basis depending upon the securities prescribed by the lead financial institution/bank. Audit observed that in respect of loan of ₹ 1770 crore sanctioned to Sasan Power Limited, collaterals prescribed by the lead financial institution (SBI) were taken, which did not include personal guarantees of two promoter directors.

Ministry replied (February 2011) that as per policy guidelines, in cases where PFC was not the lead financier, collateral security requirements were to be considered on case to case basis, depending upon collateral securities prescribed by the lead financial institution. As the entire equity was to be contributed by Reliance Power Limited and not by any individual, requirement of personal guarantee of promoter directors was not applicable.

The reply was not acceptable as the above policy was open ended as it provided for security requirements to be decided on a case to case basis. Further, the policy did not prescribe corporate guarantee in cases where instead of individuals, promoter companies were required to contribute the equity.

13.3.2.2 Test check of 32 Short Term Loan cases (out of total 284 cases) showed that authenticated utilization certificates from the auditors of the utilities were not obtained as the same was not prescribed in the Procedure for Disbursement.

Ministry stated (February 2011) that utilization certificates were signed by high level officers of the borrowers and in case certificate from the Auditors is insisted, the borrower would have to pay fee to the Statutory Auditors and thus the borrower would prefer to obtain loan from other institutions.

The reply was not acceptable since independent verification by statutory auditors was necessary to ensure proper end utilization of funds.

13.3.3 Project Monitoring

Monitoring of projects was necessary to ensure that funds disbursed were utilized effectively and efficiently. Besides, project monitoring helps to ensure that disbursement of funds was commensurate with the progress of the projects. Review of project monitoring mechanism followed by PFC revealed as under:

13.3.3.1 PFC did not develop an information system to get feedback of utilisation of funds so that proper end utilization of funds could be ensured. Besides, monitoring of projects by the State Coordinators was also not being carried out regularly and periodical returns required to be furnished as per sanction letter of each project were not obtained. On the suggestion (May 2009) of PFC's Risk Management Committee for creation of post sanction unit to strengthen project monitoring, the Company established Project Monitoring Unit in June 2009.

13.3.3.2 Out of 129 projects financed by PFC during 2004-2009, 96 projects were scheduled to be completed by November 2009. It was, however, observed that only 28 projects were commissioned as per schedule, 39 projects were commissioned with delays ranging from two to 28 months and 29 projects were yet to be commissioned (February 2010). Thus, completion of projects as per schedule in 29 *per cent* cases only indicated poor project monitoring and follow-up.

Ministry stated (February 2011) that the quarterly progress reports on PFC formats for most of the major generation projects had since been obtained from the borrowers since 1st April, 2007 onward. Status in terms of major milestones affecting the progress for individual projects were being analysed and put up to the Management as well as posted on the intranet for needful action by the concerned States in-charge.

13.3.4 Prudential norms

Reserve Bank of India (RBI) laid down in 1998 prudential norms to be followed by all NBFCs and exempted (January 2000) Government companies from the ambit of these norms. Subsequently, RBI decided (December 2006) to bring all systemically important NBFCs♦ (including Government NBFCs) under a more comprehensive regulatory purview and sought a roadmap from such NBFCs in the Government sector. PFC being a systematically important NBFC submitted (June 2008) a roadmap for adopting the RBI norms by 2017 but requested that it may be kept out of the prudential norms in view of the requirements of Power sector. Considering the above request the PFC was exempted of adopting the RBI norms till March 2012 and thus it was following its own prudential norms approved by the Administrative Ministry.

Audit observations related to prudential norms were as under:

13.3.4.1 Infrastructure sector NBFCs for housing viz. HUDCO and for power viz. IREDA had already adopted NHB/RBI prudential norms yet PFC was allowed to remain outside the ambit.

Ministry stated (February 2011) that the comparison was not appropriate since the size of projects financed, nature of borrowers etc. were different.

The reply was not acceptable since prudential norms had no relevance to size, nature etc. of the projects.

13.3.4.2 Comparison of provision for non performing assets (NPAs) as per PFC's prudential norms and RBI norms done by the Ministry in September 2005 revealed that the provision for NPAs as per PFC norms was ₹ 36.81 crore as against the provision of ₹ 1859.84 crore as per RBI norms.

Ministry stated (February 2011) that PFC had already apprised the RBI about the existing prudential norms including the norms relating to R/R/R and that RBI allowed exemption from applicability of its prudential exposure norms in respect of lending to State/Central Government entities in power sector till March 2012.

The reply of the Ministry has to be viewed in the light of the limited exemption time available till March 2012 and the very wide gap between the provision required to be made as per PFC and RBI norms.

♦ ***Systematically important NBFCs means*** *NBFCs with an asset size of ` 100 crore or more.*

13.3.5 Lending Rates

As per the Operational Policy Statement (OPS) of the Company, structure of interest rates to be charged by the Company would be as attractive as possible without endangering its own operations or overall objectives. The OPS further stated that the structure would in general be dependent on cost of raising resources and state of financial markets and that the interest rate structure would be reviewed from time to time.

13.3.5.1 Absence of periodical review

Periodical review of interest rates by an NBFC like PFC was essential for effective interest rate risk management. PFC's Standing Committee for Policy reviewed interest rates from time to time but there was no specified period for such review. Interest rates were revised on 15 occasions during the period of five years under review. The Company revised interest rates within 15 days of previous revision on one occasion and within two months of previous revision on four occasions. The interest rates were not revised during the period from 1 March, 2007 to 6 July, 2008, though the market rates varied during this period. Audit noticed that the trigger point for an interest rate review was often a demand for reduction of interest from power utilities citing downward trend in the market. Audit further observed that being a term lending institution, PFC should have reviewed its interest rates every quarter.

Ministry accepted (February 2011) the audit recommendation stating that interest rates were now being reviewed at least once in every quarter.

Conclusion

PFC's criterion for assessing financial viability of projects was not as per their operational policy statement. The Company lowered equity contribution by private sector borrower in contravention of its norms. The Company's monitoring of utilization of funds was not effective when viewed from the number of projects commissioned as per schedule. Prudential norms were liberal when compared to RBI norms.

Recommendations

- ***PFC should focus on financial viability of projects through appropriate parameters and independent evaluation should be made even in consortium lending.***
- ***Utilization of funds should be ensured through effective project monitoring system.***
- ***Prudential norms should be progressively brought at par with RBI norms for effective risk management.***

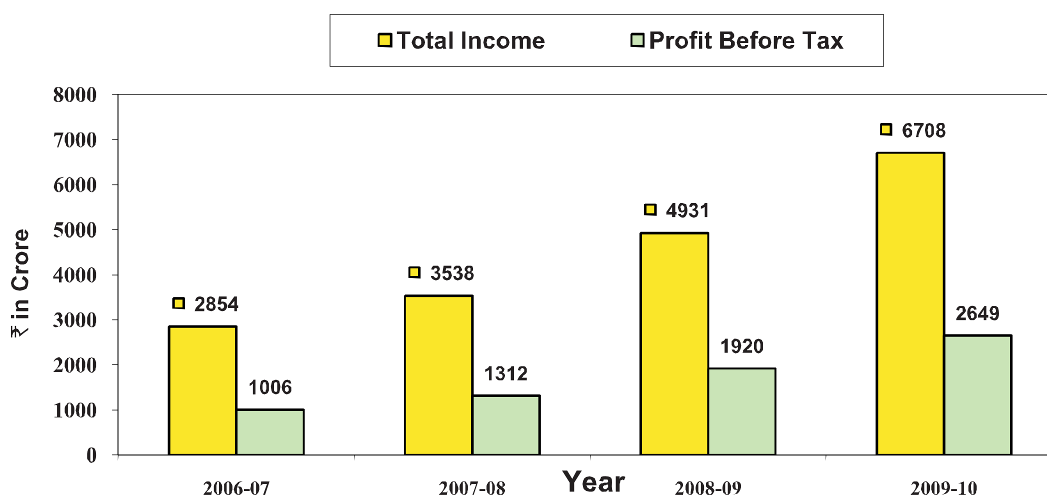
Rural Electrification Corporation Limited

13.4 Mobilisation of Funds

Introduction

Rural Electrification Corporation Limited (Company), a Government of India Public Sector Enterprise, was incorporated on July 25, 1969 under the Companies Act 1956. It

is a key Non-Banking Financial Company (NBFC[♣]) providing finance for development of the Indian Power Sector. It mobilizes funds from various sources including raising of funds from domestic and international agencies and sanctions loans to the State Electricity Boards, Power Utilities, State Government and private power developers. The domestic debt instruments of the Company continued to enjoy 'AAA' rating while its international credit rating from International Credit Rating Agency Moody's was 'Baa3' and from FITCH 'BBB-'. In the year 2008-09, the Company's turnover (total income) and profit before tax were ₹ 4931 crore and ₹ 1920 crore respectively, while in 2009-10 the Company's turnover and profit were ₹ 6707.60 crore and ₹ 2649.19 crore respectively.



Scope of audit

The study covered funds management of the Company including mobilization of funds from various sources and loan management which included assessment of requirement, preparation of cash flows, borrowings from banks/ financial institutions, bonds and external commercial borrowings, disbursal, recovery and repayment of borrowings during the four years ending 2008-09. The study was conducted during January–December 2009 and report was issued to the Management in January 2010. On the basis of replies of the Management of April 2010 the coverage was reduced and modified report on mobilization of funds was issued to the Ministry in August 2010.

Audit objectives

The study was conducted to examine whether:

[♣] A non-banking financial company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.

- funds were raised after proper financial planning and commensurate with business requirements; and
- economy in borrowings was given due consideration.

Audit findings

The total inflow of funds during last four years up to 2009-10 was as tabulated below:

(₹in crore)

Particulars	2006-07	2007-08	2008-09	2009-10
Opening Balance	1,913.64	2,297.27	1,253.04	1886.04
Loan from Banks/Financial institutions	1199.80	2,228.00	2,750.00	3485
Taxable Bonds	314.80	2,568.30	8,930.20	13529.50
Capital Gain Bonds	7,352.88	3,402.74	2,525.23	3057.77
ECB	872.09	166.76	456.65	605.97
Commercial Paper	0	0	1295.00	3150.00
Redemption of Investment	141.48	47.16	141.48	94.32
IPO	0	797.86	0	2627.98
Recovery of loan	4,034.44	5,600.24	5,119.36	5806.54
Operating Profit	1,014.20	1,360.96	1,913.35	2649.77
Total Inflow	**16,843.33**	**18,469.29**	**24384.31**	**36892.89**

Audit observed that overall margin between the cost of borrowing and lending remained at a healthy three *per cent* plus as detailed below.

(Figures in per cent)

Year	Cost of Borrowing	Weighted average lending rates	Margin
2006-07	5.97	9.95	3.98
2007-08	7.52	10.91	3.39
2008-09	9.30	12.46	3.16
2009-10	7.31	11.00	3.69

The Management stated (April 2010) that figures taken by audit were average annualized rates which could not be used for computing borrowing cost, lending rates or margins and that the actual figures relating to the above were as under:

(*Figures in per cent*)

Year	Cost of Borrowing	Yield	Spread	Net Interest margin
2005-06	6.25	9.03	2.78	3.08
2006-07	6.40	9.51	3.11	3.26
2007-08	6.39	9.69	3.30	3.78
2008-09	7.31	10.67	3.36	4.17

Note:

1. ***Yield represents the ratio of interest income to average interest earning assets.***
2. ***Cost of borrowings represents the ratio of interest expense and other charges (including resource mobilization expenses) to average interest bearing liabilities.***
3. ***Spread is the difference between yield and cost of borrowings.***
4. ***Net interest margin is the ratio of net interest in income to average interest earning assets.***

The difference in figures was due to the fact that audit compared the cost of funds raised during the year with the lending rate of that year to assess the performance of the Company during the years covered in audit and observed that there was a healthy margin while the Management referred to the average interest earnings and the average interest earning outstanding assets.

Audit assessed performance of the Company and found that certain system and compliance deficiencies, discussed in succeeding paragraphs, needed to be addressed to ensure robust performance.

System deficiencies:

13.4.1 Assessment of requirement of funds

With a view to ensure effective fund management timely disbursement of funds and minimize the amount of surplus funds at any point of time, the Company implemented Treasury Management Policy w.e.f. August 2006. As per the policy, Generation and Transmission and Distribution (T&D) Divisions were required to assess the requirement of funds and prepare monthly, quarterly and annual assessment of funds and forward it to Resource Division to arrange funds on time and at an economical rate.

Audit observed that Generation and T&D divisions did not provide monthly/quarterly requirements of funds in 2006-07 and 2007-08. In absence of required information from the respective divisions, the Company assessed the requirement of funds based on the interaction with Generation, T&D and project offices of the Company. Subsequently, these divisions prepared annual assessment of funds for 2008-09 and onwards with monthly/quarterly breakups. Audit further observed that in respect of Generation Division while actual disbursement during May 2007, July to September 2007 and October to December 2008 was more than assessment made and ranged between 152 *per cent* and 206 *per cent*, during the remaining period assessment made was higher than the actual disbursement and ranged between 115 *per cent* and 184 *per cent*. Similarly, in respect of T&D Division, actual disbursement during the period from October 2007 to March 2009 was more than the assessment by 113 *per cent* to 266 *per cent* (except during February 2008). This was an indicator of improper assessment of funds leading to deficit/surplus funds.

The Management accepted (April 2010) the audit observation and assured further strengthening of the system of assessment of funds.

13.4.2 Deficient cash flow statements

While preparing monthly cash flow statements during 2006-07 to 2009-10, the opening balance of cash available and tentative funds to be raised through taxable bonds for which the issue had already been launched were not considered by Management to work out the cash deficit. This resulted in frequent drawals from banks at higher rates.

The Management stated (April 2010) that before launching a bond/drawal of funds from banks, cash flow was prepared as realistically as possible to minimize the cost of borrowing and carrying cost and funds were drawn based on the actual requirement to avoid idling of funds or investing for short term at a lower rate of interest. They further added that considering the volatility in the market loans were raised for short term during 2008-09 to minimize the cost of borrowing.

The reply is not acceptable as the Management was silent on not considering the opening balance and funds to be raised through bonds. Further, the Management contention of avoiding short term investment at lower rates was also not correct as the proceeds from the Bonds Series 87 C/ Commercial Paper II raised in November 2008 at the rate of 11.5 *per cent* and in February 2009 at the rate of 6.77 *per cent* respectively were invested in fixed deposits for periods ranging from 24 to 45 days at substantially low rates of interest. Thus, failure of the Company to assess its requirement accurately and retention of unutilized funds during November 2008 to February 2009 resulted in extra cost of ₹ 1.48 crore.

Recommendation

The Company should institute a proper system for assessment of funds on a realistic basis involving accountability to avoid deficit/surplus funds.

13.4.3 Higher cost of borrowing as compared to other PSUs

Table below indicates the average annualized cost of mobilisation of funds to the Company, Power Finance Corporation (PFC) and Indian Rail Finance Corporation (IRFC) for the four years up to 2009-10.

(*Figures in per cent*)

Particulars	2006-07	2007-08	2008-09	2009-10
REC (with Capital Gain Bonds)	5.97	7.65	9.30	7.31
REC (without Capital Gain Bonds)	7.96	9.12	9.95	7.47
PFC	7.44	8.26	8.99	8.80
IRFC	Not available	9.33	8.98	7.70

It would be seen from the above table that the annualized cost of borrowings of the Company without Capital Gain Bonds was higher than that of PFC in all the years except 2009-10. Further, its borrowing cost was higher than that of PFC and IRFC in 2008-09 despite cost advantage of Capital Gain Bonds, which had resulted in reduction of the Company's margin.

The Management replied (April 2010) that audit had taken average annualized rates and if the figures given in prospectus for Follow on Public offer (FPO) were considered, the cost of borrowing of the Company would be lower than PFC and IRFC.

The reply is not tenable because the annualized cost of borrowing of REC as provided by the Company was compared with the annualized cost of borrowing of other PSUs and figures given in FPO were not comparable with the cost of borrowing of other Companies as the figures given in FPO prospectus was ratio of interest expenses and other charges to average interest bearing liabilities.

13.4.4 Non-utilization of opportunity to prepay the costlier loan

The Company raised 23 term loans of ₹ 9662.80 crore from various banks during 2006-07 to 2009-10. Out of these 23 term loans, audit observed that the Company took a short term loan (one year) of ₹ 300 crore in June 2008 at a rate of 9.30 *per cent* from Punjab & Sindh Bank. The Company received (March 2009) an offer from Union Bank for ₹ 300

crore at the rate of 7 *per cent* under repo window, but the opportunity for prepaying the higher cost loan drawn during June 2008 was not availed of despite no penalty for prepayment. This resulted in payment of additional interest of ₹ 1.19 crore.

The Management stated (April 2010) that offer received from Union Bank under repo window was available for only two days.

The reply is not acceptable because the Company could have decided to avail of the opportunity before the validity of the offer of Union Bank expired.

Recommendation

The Company should be more vigilant and avail of opportunities available to prepay higher cost loans.

13.4.5 Non-matching of borrowing and lending as per tenure

Audit observed that the Assets-Liability Committee (ALCO) was not linking its borrowing with disbursement as per the maturity period of respective assets and liabilities. The majority of loans financed by the Company were of long term nature i.e. more than 12 years but the Company was borrowing funds for three years, five years and 10 years period. Thus, the composition was such that over 60 *per cent* market borrowing or 43 *per cent* of total external borrowing was payable within three years. There is, hence, a serious mismatch of funds exposing the Company to liquidity and interest rate risk.

The table below shows the details of repayment of borrowings and recovery of loans outstanding during the period from 2006-07 to 2012-13.

(₹ in crore)

Year	Repayment of borrowings	Recovery of loans outstanding	Mismatch
2006-07	3481.83	4034.44	552.61
2007-08	4273.62	5600.24	1326.62
2008-09	5142.49	5119.36	-23.13
2009-10	12819.83	5806.54	-7013.29
2010-11 (projected)	10119	6810	-3309.00
2011-12 (Projected)	8159	6492	-1667.00
2012-13 (Projected)	10342	6616	-3726.00

The Management stated (April 2010) that the life of a power project was higher whereas the loan period was much lower. The Company was mobilising resources from the market depending upon the requirement, interest rate and Asset, Liabilities Management (ALM).

The reply is not acceptable as the wide gap between the maturity of loan assets and liabilities from 2009-10 and onwards would lead to borrowings at higher cost for repayment of loan liabilities and consequently increase the interest burden unless adequate corrective measures are taken by the Company.

Compliance deficiencies

13.4.6 Asset Liability Management Policy

13.4.6.1 All NBFCs having an asset base of more than ₹ 100 crore were instructed (June 2001) by RBI to implement Asset Liability Management (ALM) system by the year

ending 31 March 2002 as part of their overall system for effective risk management and start reporting/submitting the returns to RBI. ALM provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rate risks of the Company. The Company is exposed to credit risk, interest rate risk, liquidity risk and operational risks and therefore has to put in place systems and internal control mechanisms to manage these risks.

The ALM Policy approved (April 2007) by the Board was to be made fully operational from January 2008 but till date no return has been submitted to RBI. Audit observed that even after 30 months of adoption, the ALM Policy was not properly implemented as it did not address the issues of liquidity risk, interest rate gap analysis and matching of maturity profiles of assets and liabilities.

The Management stated (April 2010) that prudential norms prescribed by RBI were not applicable to Government NBFCs, however, the Company had developed ALM system which was being reviewed by Asset Liability Management Committee (ALCO). They further added that ALCO meets on quarterly basis and reviews the liquidity risk, matching of maturity profiles of assets and liabilities and interest gap analysis etc.

The Management reply is not relevant regarding applicability of prudential norms of RBI. Though, ALCO has started analyzing risks from September 2009 no return was filed (July 2010) with the RBI as prescribed for NBFCs.

13.4.6.2 Absence of interest gap analysis

For interest rate gap analysis, the asset/liability in respect of which the interest rate reset/repricing has to take place contractually during the interval (in different time buckets) is to be considered as rate sensitive. Data regarding interest due for reset on different loans in different time buckets is crucial for preparation of Interest Rate Sensitivity Statement. Audit observed that the ALCO was not preparing the Interest Rate Sensitivity Statement, and had prepared the first statement in July 2009 only. Further, the statement prepared in July 2009 contained data pertaining to one year only, which would not serve the desired purpose of long term liquidity analysis.

The Management stated that the ALM section had started preparing interest rate sensitivity statement from September 2009 and with the support of proposed ALM software, the ALM statement would be readily available in future.

Conclusion

The Company mobilized funds aggregating ₹ 9662.80 crore, ₹ 2101.47 crore and ₹ 46126.42 crore through loans from banks/financial institutions, External Commercial Borrowings (ECB), Bonds and Commercial Papers during 2006-07 to 2009-10 respectively. Though, the Company had a healthy margin between cost of borrowing and lending, still there was ample scope for improvement. However, the cost of borrowing of the Company was comparatively higher when compared with other similar PSEs.

System of assessment of requirement of funds and preparation of cash flow statement was deficient in the Company which led to surplus/deficit funds on many occasions. Excess funds mobilized through bonds remained unutilized during November 2008 to February 2009 resulting in extra cost of ₹ 1.48 crore. The Company also failed to avail the opportunity to repay the short term loans of ₹ 300 crore taken at a higher rate of

interest which resulted in an additional burden of ₹ 1.19 crore. Further, lack of linking its borrowings with maturity period of its assets and liabilities, non implementation of ALM policy, pointed to serious mismatch of funds exposing the Company to liquidity and interest rate risk.

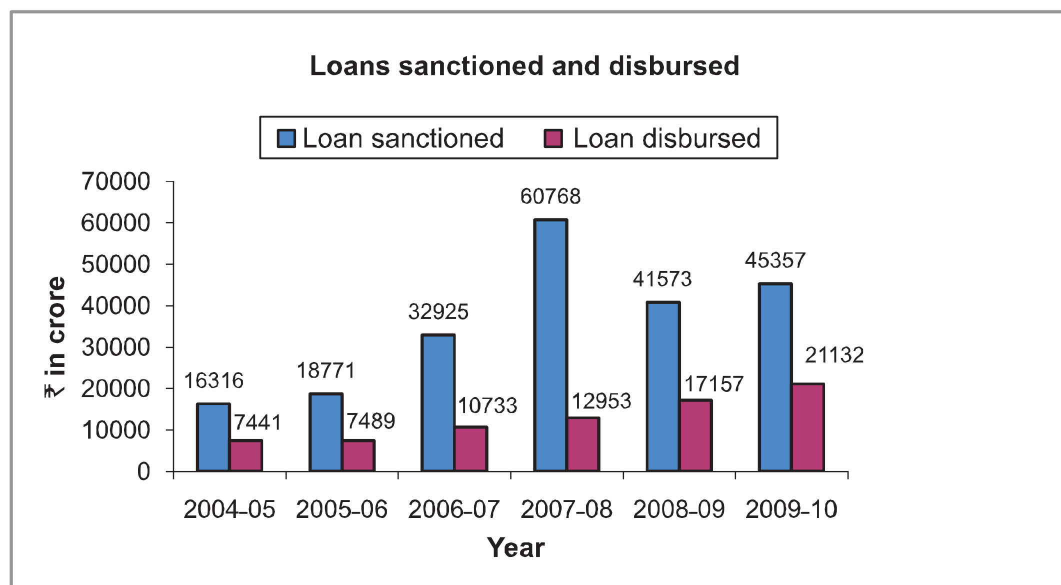
Thus, it is essential for the Company to thoroughly review and improve its existing systems, in the light of audit observations to maintain sound financial health.

The matter was reported to Ministry in August 2010; reply was awaited (February 2011).

13.5 Loan Management

Introduction

Rural Electrification Corporation Limited (Company), a Government of India Public Sector Enterprise, was incorporated on July 25, 1969. It was a key Non-Banking Financial Company (NBFC[♣]) providing finance for development of the Indian Power Sector. It mobilizes funds from various sources including raising of funds from domestic and international agencies and sanctions loans to State Electricity Boards, Power Utilities, State Government and private power developers. The domestic debt instruments of the Company had 'AAA' rating while its international credit rating from International Credit Rating Agency Moody's was 'Baa3' and from FITCH 'BBB-' The Company's turnover (total income) and profit were ₹ 6707.60 crore and ₹ 2649.19 crore respectively during 2009-10. The Company sanctioned loans aggregating to ₹ 215,203.23 crore and disbursed ₹ 76,905.41 crore during 2004-05 to 2009-10. Year wise position of loans sanctioned and disbursed is given below:



[♣] *A non-banking financial company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.*

Audit Objectives

The study was conducted to examine whether controls relating to appraisal of applications, sanction and disbursement of loans were sound, effective and adequate to cover the risks of lending.

Scope of Audit

The study covered funds management of the Company i.e., mobilization of funds and loan management which included preparation of cash flows, assessment of requirement, raising funds from banks/ financial institutions, through bonds and external commercial borrowings, disbursal, recovery and repayment of borrowings. The study was conducted during January 2009 to December 2009 and report was issued to the Management in January 2010. On the basis of the Management's reply (April 2010) the coverage was reduced and modified thematic report on loan management was issued to the Ministry in August 2010.

The loans disbursed to power projects have a moratorium period of two to three years. Therefore, this study on loan management covers a period of six years from 2004-05 to 2009-10. Sample size taken for Generation Projects was 25 *per cent*, 50 *per cent*, 75 *per cent* and 100 *per cent* in cases where disbursement of loan was in the range of up to ₹ 50 crore, ₹ 50 to ₹ 100 crore, ₹ 100 to ₹ 300 crore and exceeding ₹ 300 crore respectively based on stratified sampling method. Audit test checked the records relating to sanction of loans for 12 generation projects (Private Sector: five and State Sector: seven) out of 19 projects. For Transmission & Distribution projects Audit test checked 77 out of 111 completed/identified for closure projects in Project office, Jaipur on random sampling basis.

Audit findings

The Company's Non-performing Assets (NPAs) came down from 10.63 *per cent* in 2003-04 to 0.03 *per cent* in 2009-10. Prior to 2003-04, the State Electricity Boards (SEBs) were the only borrowers of the Company and the NPA percentage was high due to the poor financial health and Aggregate Technical & Commercial (AT&C) losses (earlier called Transmission and Distribution losses) of its borrowers. The Company rescheduled loans of four SEBs during the period from 2004-05 to 2007-08, which also helped to improve the recovery rate to 99.97 *per cent*. However, Audit observed that performance of the Company could improve by strengthening the guidelines for appraisal of projects and standardising the loan agreements as discussed in subsequent paragraphs.

13.5.1 Project Appraisal - Generation Projects

13.5.1.1 Deficiency in Guidelines: The Company followed CRISIL guidelines for appraisal of generation projects up to December 2007 and thereafter, its own guidelines approved (January 2008) by the Board of Directors. Audit observed that the Company's guidelines were silent on discounting rate to be considered for calculating levellised tariff[♥] and interest on working capital and on standardization of parameters for assigning marks in respect of industry analysis, Management analysis, consultant for Detailed Project Report, promoter's experience etc.

♥ Levellised Tariff refers to the average fixed and variable tariff over the entire term of the Power Purchase Agreement adjusted for inflation.

The Ministry assured (January 2011) that the Company would take necessary action to review and revise guidelines so as to follow best practices in the industry.

13.5.1.2 Deficiencies in appraisal: Scrutiny of records of 12 generation projects test checked revealed the following deficiencies in appraisal of projects:

- Policy circular of the Company (September 2004) stipulated that interest rate of eight *per cent* was applicable in respect of mega generation projects of private sector borrowers i.e where the disbursement amount was above ₹ 500 crore and 8.75 *per cent* in respect of large generation projects of private sector borrowers i.e. where the disbursement amount was ₹ 300 crore to ₹ 500 crore. In Pathadi Thermal Power project, the Company sanctioned (March 2005) a loan of ₹ 516.57 crore and charged interest at the rate of 8 *per cent* i.e. 0.75 *per cent* below the normal rate of interest (applicable to a loan over ₹ 500 crore) though the borrower drew only ₹ 375.53 crore.

- A project appraisal of Anpara Thermal Power was done based on the project cost provided by the borrower wherein there was an increase in cost of land by 20 *per cent* without any basis. The borrower while furnishing the cost of project to the lender's engineer, increased the cost of non-engineering procurement and construction (Non-EPC) contract from ₹ 138.40 crore to ₹ 265 crore without making any change in the overall project cost.

The Ministry stated (January 2011) that the cost of land was not seen in isolation when the capacity of the project changed from 1000 MW to 1200 MW as it was coupled with site development activities also. Further, the changes in EPC/Non-EPC costs were made subsequent to the actual award of contracts.

The Ministry's reply was not convincing as increase in cost of land was without any basis and fluctuation of more than 90 *per cent* in the cost of Non-EPC contract indicated inaccuracies in estimation of project cost.

- As per the entity appraisal guidelines, entities having average score of 2.5 to 3.00 should be categorised as Grade III and accordingly loan should be sanctioned in the debt equity ratio of 70:30. RKM Power Generation Company was categorized as Grade III as per the guidelines but sanctioned a loan of ₹ 270 crore with debt equity ratio of 80:20 as against the admissible ratio of 70:30, and loan was disbursed on the basis of self certification given by the borrower (without ensuring compliance of pre-disbursement conditions such as creation of securities, execution of power transmission agreement, signing of power purchase agreement etc.).

The Ministry stated (January 2011) that the Company sanctioned the loan in line with the approval of lead financial institution i.e. PFC, and further PFC had confirmed compliance of pre-disbursement conditions and that in the present case, the Company had checked the pre disbursement conditions at their end.

This reply was not acceptable because the Company violated its own appraisal policy.

- In Teesta Hydro Electric Project, depreciation of ₹ 3571.69 crore was considered against the depreciable project cost of ₹ 2700 crore which resulted in incorrect

Internal Rate of Return (IRR), an important basis for determining viability of the project.

The Ministry admitted (January 2011) that the mistake was due to oversight.

- As per the loan policy circular of the Company, the exposure limit for 'A' category company was 75 *per cent* of the company's networth. Accordingly, admissible exposure limit of Maharashtra Generation Company for Bhusawal project was ₹ 3148 crore but the Company sanctioned a loan ₹ 3693 crore.

The Ministry stated (January 2011) that higher loan was sanctioned considering the projected net worth but disbursement was linked to actual net worth, thus, restricting to admissible exposure.

The Ministry's reply was not convincing as the amount to be sanctioned should be strictly based on the present net worth as per the Company's policy.

- Debt Refinancing: The Company sanctioned (October 2005) debt refinancing and long term loan of ₹ 1527.43 crore and ₹ 332.57 crore respectively to Tehri Hydro Development Corporation (THDC) for implementation of Tehri Hydro Electric Project (Stage I). THDC anticipated that the project would be completed by March 2006. Audit observed that while seeking ex-post facto approval of Board of Directors, it was informed that THDC had applied for a term loan of ₹ 1460 crore for project financing including interest during construction period and ₹ 400 crore for refinance of outstanding amount under supplier's credit which was factually incorrect as THDC applied for a loan of ₹ 332.57 crore only for project financing. In case of debt refinancing, repayment period should have been restricted to remaining loan repayment period but the Company in violation of the policy treated entire amount of loan as a fresh loan for project execution. Further, THDC was given option to pay upfront fee of 0.1 *per cent* or commitment charges at the rate of 0.25 *per cent per annum* on undrawn amount of the committed loan. The Company should have insisted for upfront fee of 0.1 *per cent* of loan amount of ₹ 1860 crore, as the major portion of loan was for repayment of loan raised by THDC. This resulted in loss of revenue of ₹ 1.86 crore as the borrower opted to pay commitment charges.

Recommendation

The Company should devise internal control system to ensure compliance of its policy and proper reporting to Board.

13.5.2 Project appraisal - Transmission and distribution projects

13.5.2.1 Deficiency in guidelines:

Prior to approval of guidelines by the Board in June, 2007 the appraisal of T and D projects was governed by circulars issued from time to time. Review of guidelines revealed that operational guidelines for system improvement schemes provided that the scheme would be considered viable if it yielded internal rate of return of at least 12 *per cent* on investments made under the scheme. The guidelines exempted the schemes for introduction of innovative technology or transmission schemes sent for approval of regulatory commission from calculation of IRR. Accordingly, the Company did not

calculate IRR of T and D schemes sent for approval to the State Electricity Regulatory Commissions (SERC) to ensure viability of the projects.

The Ministry stated (January 2011) that most of the borrowers of T and D schemes were state sector utilities and SERC generally took considerable time to approve the schemes and if the sanction was delayed till SERC approval, the Company had the risk of losing its business to other financial institutions. It further stated that a new clause was incorporated in the standard sanction letter issued to borrowers which stipulated that in case scheme cost approved by the Regulator was less than the scheme cost as envisaged at the time of sanction of loan, the loan would be reduced accordingly and in case scheme cost approved by Regulator was more, decision would be taken at that time depending upon the merits of the case. The reply further added that, T and D guidelines stipulated technical and financial viability of the projects only, which was ensured during detailed appraisal.

The Ministry's reply was not acceptable because detailed appraisal was based on the T and D guidelines and deficiency in the guideline may result in sanction of loan to unviable schemes.

13.5.2.2 Disbursement of loan without adequate security

The Company sanctioned (October 2004) term loan of ₹ 1285 crore to NTPC-SAIL Power Company Private Limited (NSPCL), erstwhile Bhilai Electric Supply Company Limited. Out of this, the Company disbursed ₹ 1185 crore to NSPCL. As per loan agreement, the borrower was required to secure the principal, interest and other charges payable by way of creation of mortgage of immovable assets and hypothecation of all movable assets of the project in favour of the Company. Audit observed that the borrower did not create mortgage of land in favour of the Company so far (December 2010). Further, there was no escrow cover on main revenue account.

The Ministry stated (January 2011) that the Company was in the process of creating security as land mutation was taking time with the state government and that the Company had started charging one *per cent* additional interest for not creating security as per policy.

This reply was not acceptable because increase in the rate of interest would not secure the loan amount.

13.5.3 Deficiencies in Loan Agreements

13.5.3.1 Deficiency in Loan Agreements of Generation Projects

Audit noticed in the 12 Generation projects test checked, that largely loan agreements were not standardized and were deficient in the following aspects.

- Loan agreements with private sector borrowers did not have a clause for commitment charges;
- Agreements with Punjab State Electricity Board, Jaypee Industries Limited and GSPC Pipavav Power Company Limited did not have clause for draw-down schedule;
- Agreements with THDC, MSPGCL, PSEB and GSPC Pipavav Power Company Limited did not have a clause for insurance of assets;
- Interest reset clause was not available in agreements with MSPGCL and PSEB;

- Mortgage of land and building and hypothecation of immovable assets of the projects were not made a pre-disbursement condition in agreements with THDC, Bhilai Power Supply Company, PSEB, MSPGCL and GSPC Pipavav Power Company Limited;
- Clause for opening escrow account, tripartite agreements between borrower, banker and lenders for creating charge on receivables of borrowers for each loan was not available in loan agreement with Bhilai Power Supply Company;
- The loan agreements with Bhilai Power Supply Company and Punjab State Electricity Board did not authorize the Company to have first charge on escrow account of borrower.
- Loan agreement provided for reset of the rate of interest at the end of every third year beginning with the date of first disbursement whereas the Company was resetting the interest rate for each disbursement every third year resulting in different interest rates for each disbursement, which may lead to legal problems in future due to different provisions in the sanction letter and loan agreement.

The Ministry stated (January 2011) that provision of commitment charges was not there in some of the private sector project as upfront fee was charged from them as per Industry practice; draw down schedule was obtained from state sector borrowers who had opted for commitment charges; interest rates were charged on the basis of REC Loan policy circular and accordingly reset clause was applicable and that it would be ensured in future that interest reset clause was included in the agreement; that disbursements were made on creation of necessary security/approval of competent authority; clause for opening escrow account was not insisted in case of Bhilai Power Supply Company in view of the business potential available with them; and assured that in future insurance of security would be included in loan agreements.

The Ministry's reply was not acceptable because for proper assessment of requirement of funds, draw down schedule was essential; financial interest was not safeguarded in the absence of security as a pre disbursement condition.

13.5.3.2 Deficiency in Loan Agreements of T & D Projects

In case of loan agreements of T&D Projects, it was noticed that the Company was disbursing loans on three year interest reset basis and 10 year interest reset basis, but the loan agreements and sanction letters were silent about the interest reset period.

The Ministry stated (January 2011) that a "Standard Sanction Letter' was being followed uniformly since July 2009 and loan agreement format was also standardized.

13.5.4 Borrower's Profile

Audit observed that the Company did not maintain borrowers' profile relating to AT & C losses, return on capital employed and financial performance of state sector borrowers. The exposure limits fixed by the Company for borrowers were based on PFC's exposure limits or the Company's prudential exposure limits, whichever was higher in respect of 'A' category borrowers and as per PFC's exposure limit in respect of other category of borrowers. The exposure limits fixed by the Company, ranged from 50 *per cent* to 250 *per cent* of the Company's owned funds and were not based on either the financial health

of the borrower or reduction in AT&C losses. Default by these SEBs/State utilities may have serious consequences.

The Ministry stated (January 2011) that the Company was following the PFC's grading and exposure limits who took into account important factors like financial health, AT&C losses default status etc. and during entity appraisal all the factors were again analysed for Generation projects and necessary checks and conditions stipulated in the sanction letter.

The reply was not acceptable because the Company had fixed the exposure limit as fixed by PFC or REC Prudential norms and had taken further exposures even in cases where the profit and return on capital employed were negative and AT&C losses had recorded an increasing trend.

Recommendation

The Company should put in place a system of its own for fixing exposure limits considering the financial health, reduction in T&D losses, etc. of the borrowers.

Conclusion

The Company's guidelines for appraisal of the projects were deficient on many aspects as discussed in the preceding paras.

Test check of records relating to 12 generation projects revealed deficiencies in the system of appraisal of projects. Further, the Company could not evolve its own system of fixing exposure limits for state sector borrowers considering their financial health, reduction in T & D losses, defaults etc. The Company did not have standardized loan agreements with the borrowers for generation projects resulting in non inclusion of some of the terms and conditions necessary to protect its interest. It was also noticed that Company deviated from its own policy regarding repayment period in case of debt refinancing.