

## CHAPTER II: MINISTRY OF DEFENCE

### 2.1 Management of Defence Offsets

#### 2.1.1 Introduction

An offset is a mechanism to partially compensate for the significant outflow of a purchasing country's resources in large purchases of foreign goods and services by making it mandatory on the foreign supplier to either reverse purchase, execute export orders, invest in industry or in research and development (R&D) in the buyer country.

For capital acquisitions in excess of ₹300 crore, the Defence Procurement Procedure (DPP) 2005 (effective from 1 July 2005), prescribed an offset at 30 *per cent* of the indicative cost of the acquisition in 'Buy Global' category and 30 *per cent* of foreign exchange component in 'Buy and Make' category. The offset obligation was to form a part of every Request for Proposal (RFP) and eventually of the main contract.

Different DPPs promulgated between 2005 and 2011, *inter alia*, allowed foreign vendors to earn offset credit through a combination of the following methods to fulfill their offset obligation:

- Direct purchase of, or executing export orders for eligible products/components manufactured by or services provided by Indian industries, Defence Public Sector Undertakings (DPSUs), the Ordnance Factory Board (OFB) and private Indian industry.
- Direct foreign investment (DFI) in Indian industry for industrial infrastructure for services, co-development, joint ventures and co-production of eligible products/components.

- DFI in Indian organizations engaged in defence R&D as certified by Defence Offset Facilitation Agency (DOFA<sup>1</sup>).

## **2.1.2 Scope of Audit**

Since 2005, the Ministry of Defence (MoD) concluded 16 offset contracts with various vendors for ₹18,444.56 crore of which offset up to the value of ₹5543.33 crore should have been achieved as of May 2012. We examined (October 2011 to February 2012) all the 16 contracts with a view to ascertain that the DPP provisions were adhered to and a proper mechanism was in place to monitor the implementation of offset contracts.

## **2.1.3 Our Findings**

### **2.1.3.1 Direct Foreign Investment**

Though DPPs 2006, 2008 and 2011 allowed fulfillment of offset obligations through Direct DFI in specified Indian industry, there was lack of clarity as regards the type of foreign investment which would be eligible and in the interpretation of various provisions and terms in the DPPs relating to offset contracts. In view of this, the Ministry in November 2010 issued a guidance note for clarification so as to resolve the problem of vendors offering ineligible offset projects. As per the said guidance note, the term 'direct' in DFI in the DPP defines the nature of transaction between the Original Equipment Manufacturer (OEM) and the Indian Offset Partner (IOP) whereby foreign investments can be made by the foreign vendor only in the form of Foreign Direct Investment (FDI). Thus, foreign OEMs can discharge their offset obligations only in the form of FDI in IOPs. As a corollary to that, the Ministry also held that DFIs in kind were not eligible offsets as per DPP 2006 which stipulated that for products with imported components only the value addition in India would count towards offset obligation. The Defence Acquisition Council (DAC) in February 2011 also reiterated that investment in kind through non equity route was not a permissible DFI.

We observed that in five offset contracts, equipment involving ₹3,410.49 crore was being directly provided by the foreign vendor as DFI in kind without any

---

<sup>1</sup> DOFA functions under the Department of Defence Production and acts as a single window agency to facilitate implementation of the offset policy.

value addition through the IOPs. This assumes added significance since procurement contracts with an offset obligation invariably involve loading of extra cost element on that account. These cases are discussed below:

**2.1.3.2 Contract with M/s Boeing, USA (C-17 Globemaster aircraft) with TWT test facilities as offset**

The offset contract for USD 195.00 million (₹874.22 crore) concluded (June 2011) with M/s Boeing, USA, in connection with procurement of C-17 Globemaster aircraft, catered for establishment of a Transonic Wind Tunnel (TWT) test facility at the Defence Research and Development Organisation (DRDO) in the form of DFI. Of this, offset credit amounting to 90 *per cent* was for the initial setting up of above facility and 10 *per cent* for subsequent purchase of testing services from the IOP.

As the TWT test facility was a DFI in kind, the offset was allowed by the DAC even as it was not an eligible offset, though this was done on the basis of Technical Offset Evaluation Committee (TOEC) recommendation, the decision was taken without the mandatory certification by DOFA.

The Ministry stated (April 2012) that offset credit for investment by Boeing in setting up the facility was accepted by the DAC in its meeting on 21 February 2011 and that approval in principle for setting up of the facility at DRDO had also been accorded by the Cabinet Committee on Security (CCS).

The reply is silent on whether specific waiver of the Raksha Mantri (RM) was sought for the breach of the DPP provisions. It is also not acceptable because the DAC in the same meeting had maintained that investment in kind through non equity route was not permissible for offset and only purchase of goods and services by OEM from IOP would so qualify.

**2.1.3.3 Offset with M/s Boeing, USA (P-8(I) aircraft)**

Against the offset contract concluded (January 2009) with M/s Boeing, USA for procurement of P-8(I) aircraft for the Indian Navy, the vendor agreed to provide DFI worth USD 153.90 million (₹750 crore) in the form of safety, reliability and air worthiness seminars; establishment of fire finder classrooms; transfer of metallurgy and hydraulic lab facilities, composite manufacturing

assembly/tooling, mobile broadband, friction stir welding and aero structures tools and processes.

The DFI proposals relating to safety, reliability and airworthiness seminars and establishment of fire finder class rooms were not valid offset as there was no value addition through the IOP. The remaining proposals relating to transfer of metallurgy/hydraulic lab facilities, composite manufacturing assembly/tooling etc. were also a kind of direct import without any value addition through the IOP.

The Ministry while admitting the facts stated (April 2012) that these DFI proposals do not qualify for offsets and the same has been conveyed to M/s Boeing. It was further stated that the vendor had not claimed offset credit so far. The reply, however, does not reckon the fact that the elements of offset once included in the contract are liable to be claimed by the vendor. Moreover, even if a claim by the vendor is not admitted by the Ministry, offset deficit of USD 153.90 million (₹750 crore) would still remain.

#### **2.1.3.4 Cases of Training Simulators as offset**

A decision was taken (November 2010) in a meeting between Defence Secretary and the Secretary (Defence Production) that purchase of services by OEM from IOP for sale to MoD/Armed forces would not count for offset credit and that only purchase of services by the vendor for sale to third parties would be admissible as offset. These decisions amplified and reinforced the provisions contained in Paragraph 2.1 of Annexure D of DPP 2006 which stipulated the manner in which offset obligation would be discharged by foreign vendors through DFI in specified Indian industries. Consequently, the DAC in December 2010 held, that investment in simulator for P 8(I) aircraft would not be recognized for offset credits and hence only purchases of simulator services by the vendor from the IOP would be eligible. This was reiterated by the DAC in February 2011.

However, in violation of the above provisions of DPP and decisions taken in the DAC, in the following cases, vendors are still claiming DFI in kind through supply of ready built training simulator provided to IOPs towards discharge of their offset obligation.

*Report No. 17 of 2012-13 (Air Force and Navy)*

Details of Offset Contracts		
Vendor and Date of contract	Name of equipment offered as a DFI	Value of equipment offered as Offset
M/s Boeing, USA for C-17 Globemaster aircraft *** (14-06-2009)	C-17 Maintenance training simulator C-17 Flying training simulator	USD 38.21 million (₹171.34 crore) USD 96.87 million (₹434.40 crore)
M/s Lockheed Martin Corpn., USA for C-130J Hercules aircraft (06-03-2009)	Weapon training simulator	USD 121 million (₹ 619.59 crore)
M/s Rosoboronexport, Russia for Medium Lift Helicopters (05-12-2008)	Two mission based training simulators	USD 95 million (₹460.56 crore)
M/s RAC MiG Corpn, Russia for upgrade of MiG 29 aircraft (07-03-2008)	Simulator centre	USD 25 million (₹100.38 crore)

\*\*\* Part of contract discussed in para 2.1.3.2

The Ministry in its reply, *inter alia*, stated (April 2012) that:

- Department of Defence Production (DDP) had accepted training simulator as a valid DFI and subsequently DAC had also clarified in its meeting on 14 December 2010 that training may include training services and training equipment such as simulator.
- No offset credit had been admitted either for the maintenance or the flying training simulator and that offset credit will be assigned only after examining the terms of the contract between the IOPs and the foreign vendors.

The reply is not acceptable as the DAC had clearly held in December 2010, and again in February 2011, that only purchases of simulator services by the vendor from the IOP would be eligible to the extent of value addition in India and investment in simulator itself would not be recognized for offset credits. Further, the reply while stating that ‘no offset credit had been admitted either for the maintenance or the flying training simulator’ does not clarify how the deficit in discharge of offsets would be met in case the claims are not admitted. The Ministry’s reply is ambivalent as on the one hand it contends that provision of training simulators are a valid DFI and on the other hand it states that the offset credit for USD 95 million would be assigned only after

examining terms of the contract between the IOP and the foreign vendor which raises a question mark about the acceptability of DFI in kind as a valid offset.

#### **2.1.4 Selection of invalid Indian offset partners**

As per DDP clarifications, the IOP is required to comply with the guidelines/licensing requirements for the defence industry issued by the Department of Industrial Policy and Promotion (DIPP). Further, Government has allowed 100 *per cent* participation of private sector in the defence sector with FDI permissible up to 26 *per cent*.

We however, noticed that some companies having more than 26 *per cent* of foreign holding were also accepted by the Ministry as IOPs. Significant deviations from prescribed selection criteria were noticed and are discussed in the succeeding paragraphs.

##### **2.1.4.1 Contract for upgrade of MiG 29 aircraft**

In the offset contract (March 2008) for upgrade of MiG 29 aircraft, M/s Prescient Systems and Technologies Private Limited was approved as IOP. The firm is a foreign company and was not eligible as IOP as per DPP 2006.

The Ministry stated (April 2012) that the firm is a sub vendor of RAC MiG and is not an IOP. As the firm stands included in the list of IOPs in the offset contract the Ministry's reply is not tenable.

##### **2.1.4.2 Procurement of Low Level Transportable Radar**

In the offset contract (July 2009) for procurement of Low Level Transportable Radar (LLTR), M/s Thales International India (TII) was approved as IOP. The company is a 100 *per cent* subsidiary of M/s Thales, Singapore and M/s Thales, Hong Kong and was, therefore, not eligible to be selected as IOP.

Accepting the facts, the Ministry stated (April 2012) that the issue of eligibility of M/s Thales India as an IOP was taken up with M/s Thales and the firm agreed to remove M/s TII as an IOP.

### **2.1.4.3 Procurement of fleet tanker**

In the offset contract (April 2008) for procurement of fleet tankers for the Indian Navy, M/s Wartsila India Ltd. and M/s Johnson Pumps Ltd. were approved as IOPs. M/s Wartsila is a subsidiary of M/s Wartsila Global which holds 96 *per cent* of its stock. Similarly, M/s Johnson Pumps is a subsidiary of a foreign company *viz.* M/s SPX Flow Technologies, Sweden. Therefore, both these firms were ineligible for being enlisted as IOPs.

The Ministry stated (April 2012) that the vendor had removed M/s Wartsila India Ltd. from the list of IOPs, M/s Johnson Pumps has been retained on the premise that it is a company registered under the Indian Companies Act even though it is a subsidiary of M/s SPX Flow Technologies, Sweden. The Ministry's contention is not acceptable in the case of M/s Johnson Pumps since the company is a subsidiary of a foreign company.

### **2.1.5 Monitoring Mechanism**

#### **2.1.5.1 Deficiencies in monitoring mechanism**

As per DPP, vendors are required to submit quarterly reports on implementation of offset to the Acquisition Manager concerned in the MoD. For monitoring of offset obligations MoD had set up an offset monitoring cell (OMC) in 2010 to assist the concerned Acquisition Manager in the Ministry.

We reviewed the work done by the OMCs and noticed the following deficiencies:

- Due to lack of manpower and established procedures, the OMC was not able to effectively monitor the offset obligations. The OMC had at one stage conveyed to the Ministry that it was not clear about the type of assistance required to be rendered by it to the Acquisition Wing.
- The scrutiny of the quarterly reports by OMC was based primarily predicated on the facts and figures submitted by the vendors and it had no mechanism in place for independent verification of these statements.

The provision in DPP relating to audit of actual execution of contracted offsets by a nominated official/agency had never been invoked.

The Ministry in its reply (April 2012) stated that in the offset contract for C-130J Hercules aircraft, an audit as envisaged in the DPP had been conducted. The Ministry at the same time admitted that despite repeated requests, the foreign vendor did not provide the copies of offset contracts to the OMC and also did not submit the required quarterly reports. The Ministry also admitted that monitoring of offset needs to be strengthened and the matter regarding setting up of a dedicated team for this work was under consideration with the DAC.

### **2.1.5.2 Non recovery of penal charges**

As per the DPP, a penalty @ 5 per cent of the value of unfulfilled annual offset obligation is to be levied on the vendor and the unfulfilled offset value is to be carried forward to the subsequent year.

We observed that while in 13 of the 16 contracts reviewed in audit the circumstances or stage for levy of such a penalty had not been reached, at least in two contracts, penalty charges of ₹3.06 crore leviable on vendors on account of unfulfilled offset obligation had not been recovered from the defaulting vendors, as indicated below:

<b>₹in crore</b>		
<b>Subject Contract</b>	<b>Vendor</b>	<b>Penalty due</b>
Harop system	M/s IAI, Israel	2.04
C-130J Hercules aircraft	M/s Lockheed Martin Corporation, USA	1.02

In the third offset contract with M/s Fincanteri, Italy for procurement of fleet tankers, the work was held up after achieving 52 per cent progress, no penalty charges could be imposed on the vendor due to non-inclusion of year-wise schedule of implementation in the contract.



In respect of offset contract for Harop system, the Ministry stated (April 2012) that the offset obligation unfulfilled during second and third year would be assessed with reference to the revised commercial offset schedule and penalties, if any, would be levied on the vendor. In respect of C-130J, the Ministry stated that due to inability of the vendor to fulfill offset, the vendor was proposing an alternate project and hence question of penalty at this stage did not arise. The reply in both these cases fails to reckon that change of offset component and value after conclusion of the contract was not permissible under the DPP. The Ministry's reply is also silent on non-inclusion of year wise schedule in the offset contract for fleet tankers.

### **2.1.6 Conclusion**

A committee was set up by the Government under the chairmanship of Dr Vijay Kelkar to examine and recommend changes to strengthen self-reliance in defence preparedness. In its report (April 2005), the committee placed a thrust on pursuing an offset policy to bring in technology and investment and an offset provision was first incorporated in the DPP 2005 on this basis.

However, despite India being one of the largest importers of defence hardware, the benefits of offsets could not be reaped to the extent envisaged due to lack of uniformity in interpretation of the extant offset provisions. Acceptance of DFIs in kind with no value addition through the IOPs was also not in consonance with the offset provisions as prescribed in the DPPs.

There were also instances of selection of ineligible IOPs. The overall monitoring mechanism for directing offset activity towards desired objectives was ineffective as it was created without a clear definition of its objectives and role. It thus remained only a paper exercise.

MoD needs to ensure clarity in the offset provision and procedures so as to leave little room for ambiguity in its interpretation. The monitoring mechanism also needs to be reviewed to ensure effective implementation of the offset contracts.

## **2.2 Inordinate delay in procurement and integration of a Radar Warning Receiver system**

**Out of 336 Radar Warning Receivers (RWRs), only 73 (22 per cent) could be integrated on the aircraft even after seven years of their procurement. Performance of the RWRs integrated was found largely unsatisfactory. As a result, most of these systems could either not be integrated or are to be integrated only as an interim measure. Thus, IAF failed to derive intended benefits from an investment of ₹521 crore.**

A Radar Warning Receiver (RWR) alerts pilots of the various types of hostile emitters employed by other countries and enables pilots to initiate suitable action to minimize attrition. Thus availability of suitable, reliable and proven system with state of the art technology is crucial for the success of missions and survival of aircraft deployed for such missions.

In order to have commonality of RWR across its fleet, IAF planned (2002) to procure and integrate the indigenously developed RWR system as a standard RWR on most of its fleet. Accordingly, the Ministry of Defence (MoD) in September 2005, awarded a contract to M/s. Bharat Electronics Limited (BEL) for supply of 336 RWRs at a total cost of ₹521 crore. The RWRs, scheduled to be delivered by September 2010 were to be integrated on ten types of aircraft.

The work of integration of the RWRs on six types of aircraft was contracted (March 2008) by the MoD, after a 30 month delay, to M/s. Hindustan Aeronautics Limited (HAL) at a total cost of ₹36.04 crore. The integration on the remaining four types of aircraft was to be taken up separately under the upgradation programme of those aircraft by HAL.

We observed that though BEL was to make staggered deliveries till September 2010 of the 336 RWRs, it supplied 316 of these (*i.e* 94 per cent) to the Air Force by July 2007 itself. Early acceptance of deliveries, coupled with the

*Report No. 17 of 2012-13 (Air Force and Navy)*

30 months delay in the integration contract (March 2008) resulted in expiry of warranty of RWRs even before these were integrated with the aircraft.

As of April 2012, the position of integration of the RWRs was as follows:

<b>Sl. No.</b>	<b>Platform</b>	<b>No. of system Procured</b>	<b>No. of system integrated</b>	<b>Balance</b>
1	Aircraft 'A'	54	Nil	54
2	Aircraft 'B'	28	Nil	28
3	Aircraft 'C'	16	04 <sup>2</sup>	12
4	Aircraft 'D'	38	Nil	38
5	Aircraft 'E'	16	Nil	16
6	Aircraft 'F'	11	Nil	11
	Depot level set up	01		
7	Aircraft 'G'	28	20	8
8	Aircraft 'H'	30	Nil	30
9	Aircraft 'I'	43	43	-
10	Aircraft 'J'	71	6 <sup>3</sup>	65
	<b>Total</b>	<b>336</b>	<b>73</b>	<b>263</b>

We observed that out of the 73 RWRs that were integrated by April 2012 the performance of as many as 69 of these integrated on 43 aircraft 'I', 20 aircraft 'G' and 6 aircraft 'J' aircraft was found to be unreliable/ unsatisfactory. Due to this and other reasons mentioned below, the objectives in making the investment in procuring and integrating the RWRs on the whole remained unfulfilled:

- the Air Force decided to integrate another set of 103 RWRs on the aforementioned aircraft as also on aircraft 'H' only on an interim basis pending development of a replacement/advanced system.

<sup>2</sup> The performance status of the four RWRs installed on aircraft 'C' is not known.

<sup>3</sup> Six RWRs have been integrated so far on aircraft 'J' as an interim measure. The aircraft is to be fitted with an advanced system during its upgrade.

- IAF also decided not to integrate 54 RWRs valuing ₹55.72 crore on aircraft 'A' due to limited residual life left of the aircraft.
- the fitment of 65 RWRs on aircraft 'D', 'E' and 'F' was awaiting ratification (April 2012) by Regional Centre for Military Airworthiness (RCMA).
- integration of 28 RWRs on aircraft 'B' had not commenced (April 2012) even as their fitment was ratified by RCMA as early as in June 2010.
- integration of 12 RWRs on aircraft 'C' would be taken up at a later stage.

The Ministry replied (April 2012) that RWR is a proven system and totally reliable and that its average serviceability exceeded 80 *per cent*. It also stated that RWRs rendered surplus after incorporation of the advanced system would be utilized on aircraft 'K' to cater for operational requirement during hostilities.

We do not agree with the Ministry's reply because performance of 69 out of 73 RWRs integrated so far has been found unsatisfactory and no evidence of average serviceability exceeding 80 *per cent* was provided by the Ministry. Further, integration of the system on aircraft 'K', a trainer aircraft, would not further the intended objectives for which approval for procurement of RWR was originally obtained. As even the feasibility of integration of RWR on aircraft 'K' was yet to be ascertained (April 2012) the Ministry's reply is evidently an afterthought and does not alter the fact that IAF could not put in place an effective RWR system desired by them even after an expenditure of ₹521 crore.

### **2.3 Inordinate delay in induction of a system**

**Abnormal delays in commissioning and validation of the system 'A' onboard a particular class of submarines adversely impacted their availability for operations. Besides, no benefits could be derived for over a decade from an investment of ₹167.64 crore.**

System 'A' is critical equipment without which a submarine cannot go to sea. The installation of system 'A' is a long process as it involves a significant amount of underwater works including cabling.

The Ministry of Defence (MoD) concluded a contract (March 2001) with Bharat Electronics Limited (BEL) at a total cost of ₹167.64 crore for supply, assistance in installation and commissioning of indigenously developed system 'A' onboard of four submarines of a particular class. The contract was on concurrent engineering basis as the transfer of technology to BEL from the Defence Research and Development Organisation lab, which had developed the system, was in progress (March 2001). The delivery was scheduled between March 2003 and March 2007. We noticed that the position of installation and commissioning of the four contracted system 'A' was as tabulated below:

<b>Sl. No.</b>	<b>System 'A' number</b>	<b>System Commissioned in</b>	<b>Completion of Sea Acceptance Trials</b>
1.	I	March 2005	January 2011
2.	II	October 2005	Yet to be carried out as of May 2012
3.	III	Yet to be installed as of May 2012	N.A
4.	IV	August 2008	December 2011

In the absence of Sea Acceptance Trials (SATs), the system 'A' installed in one of the three submarines remains unreliable whereas, the system 'A' is yet to be installed on the fourth submarine. Since these systems are critical for operation of the submarines, the operational availability of these submarines was severely impacted. Moreover, no tangible benefits could be derived by the Navy from an investment of ₹167.64 crore made on the system 'A' for the last eleven years because much of the technical life of system 'A' has already expired.

The Ministry of Defence stated (May 2012) that though the contract for system 'A' was signed in 2001, only 30 per cent of the contract value was paid as advance, the remaining amount was being paid as stage payments linked to delivery/installation. The Ministry also contented that the decision to fit the system 'A' was to provide a thrust to indigenisation and self-reliance and the initial teething problems were expected. It was further stated that the

successful completion of SATs on board the two submarines had greatly increased their confidence in the indigenisation effort.

The Ministry's reply does not reckon the fact that the system 'A' was developed (April 2000) and adjudged suitable by the Navy and BEL for outright production. Inordinate delays in installation/SATs adversely affected the operational preparedness of the Navy as even the two submarines on which the system 'A' has been installed could not go to sea due to its acceptability tests being carried out as late as 2011 and the same system 'A' on the other two submarines being still untested. Thus, the Navy could not derive any benefit for more than a decade from an investment of ₹167.64 crore.

#### **2.4 Avoidable extra expenditure in procurement of Electro Optic Devices for Dorniers**

**Procedural delays in the Ministry of Defence while processing award of contract for supply and installation of 15 Electro Optic Device systems with HAL resulted in avoidable extra expenditure of ₹10.95 crore. The delays in procurement also deprived the Indian Navy of equipment of operational nature for a considerable period of time.**

After procuring 10 Electro Optic Devices (EOD) from a foreign vendor 'X' based on a contract executed with the firm in December 2003 the Indian Navy moved a proposal for procurement of 15 additional EODs to be used as Passive Sensors for detection and identification of enemy presence without resorting to active transmission that results in loss of tactical advantage as the enemy becomes aware of the aircraft presence. The proposal involved placement of a repeat order on vendor 'X' using an option clause in the December 2003 contract which enabled the Ministry of Defence (MoD) to place additional orders upto one year from the date of contract i.e. 17 December 2004 without any variation in price. The vendor agreed (March 2005) to supply 15 EOD systems at the prices concluded in the contract of December 2003 with 4 *per cent* escalation upto June 2005. The proposal to place a repeat order in this manner was fully covered by Defence Procurement Procedure (DPP) – 2003.

After receiving the acceptance of necessity from the MoD on 03 December 2004 the proposal was recommended to Integrated Headquarters (IHQ), MoD (Navy) in January 2005. Though at that stage there were clearly five months available for securing the formal commercial offer from the vendor and for placement of orders, the IHQ MoD (Navy) surprisingly decided to process the case as per Defence Procurement Procedure, 2005 which was to come into effect on 01 July 2005.

Thus, the proposal remained in process by the time the validity of the vendor's offer for additional supplies at December 2003 prices expired. Consequently, the MoD decided to place the order to procure the same equipment from HAL which had already installed four EOD systems on aircrafts manufactured by it and supplied to Indian Coast Guard as sub-contractor of vendor 'X' in fulfilment of latter's contract of December 2003. Since a direct order on HAL could be placed only if the procurement was categorised 'Buy Indian', whereas the indigenous content of EOD to be procured from HAL was less than the mandatory 30 *per cent*, a case was moved for securing approval of Raksha Mantri, the competent authority, to deviate from the norm of 'Buy Indian' as laid down in DPP-2006. The entire process took five years and the contract with HAL could not be signed before 21 January 2010. This not only delayed the equipment by almost five years but also resulted in extra expenditure of ₹10.95 crore as the price paid to HAL was higher than that at which vendor 'X' was ready to supply it way back in 2005.

The matter was referred to the Ministry (January 2012); their reply is awaited (September 2012).

## **2.5 Non-exercise of option clause resulting in extra expenditure in procurement of fuel barges**

**Failure of the Indian Navy to acquire one fuel barge under option clause of an existing contract resulted in extra expenditure of ₹2.94 crore.**

A contract was concluded by the Indian Navy (IN) with M/s Shalimar Works Ltd, Kolkata in November 2007 for procurement of two fuel barges at a unit rate of ₹16.04 crore. The contract carried an option clause which gave the

purchaser a right to place a separate order on the same builder for one more barge on repeat order basis at the same terms and conditions within one year from the effective date of contract i.e upto November 2008. Our examination (December 2011) revealed that a Request for Proposal (RFP) for procurement of five fuel barges was issued to 14 indigenous shipyards in June 2008 i.e. well before November 2008 deadline for exercising the repeat order option in the November 2007 contract. A contract with L1 vendor M/s Modest Infrastructure was concluded (November 2009) at a cost of ₹94.88 crore (exclusive of the costs of modifications and project monitoring), each barge costing ₹18.98 crore a piece. Had option clause of the previous contract been exercised, IN could have purchased at least one barge at the price of ₹16.04 crore and reduced the number of barges under the fresh RFP to four. Failure to exercise the option clause in the contract concluded in November 2007, resulted in an avoidable extra expenditure of ₹2.94 crore in procurement of one barge.

Incidentally, the instant case is not a one off case as a loss of ₹68.95 lakh due to non-exercise of option clause in procurement of naval stores was reported earlier in Paragraph 2.6 of Report No.20 of 2011-12 (Air Force and Navy). MoD may reiterate to the procurement authorities to ensure that “option clauses” are exercised effectively and are not allowed to lapse in a routine manner.

We took up the matter with Integrated Headquarters, Ministry of Defence (Navy) initially in June 2011 and subsequently in September 2011. The IHQ MoD (Navy) accepted (November 2011) that failure to exercise the option resulted in a loss of ₹2.94 crore.

The matter was referred to the Ministry (December 2011); their reply was awaited (September 2012).



## **2.6 Recovery of accrued interest on advance payments**

**A recovery of ₹28.78 crore on account of accrual of interest, on unspent advances made to Cochin Shipyard Limited, was made after we pointed it out.**

The Ministry of Defence accorded (June 1999) sanction, for acquisition of an indigenously designed and constructed Air Defence Ship (ADS) for the Indian Navy at an estimated cost of ₹1,551.64 crore from Cochin Shipyard Limited (CSL). The sanctioned cost was revised (March 2003) to ₹3,261.00 crore.

Though CSL had only incurred an actual expenditure of ₹127.22 crore (March 2005) on the ADS project, the Indian Navy between December 1999 and March 2004, made advance payments totalling ₹271.26 crore to CSL based on the sanctions issued by the Ministry. The Ministry had directed (November 2005) CSL to keep the advances received in a 'separate account' and to credit any interest earned to the project. For this purpose CSL opened (August 2006) a 'separate account' with the Union Bank of India.

We pointed out (November 2008, January 2009 and July 2010) failure of CSL in crediting interest to the Government on the unspent advance held by CSL for the period from January 2000 to March 2010. The CSL credited (April 2010) ₹13.25 crore to the 'separate account' as interest, for the period, on the unspent advances. In the same month, CSL also remitted ₹38.95 lakh to the 'separate account' from the advances held with them as on 31 March 2010. An amount of ₹15.53 crore was further recovered in April 2011.

The Ministry accepted (March 2012) that recovery of ₹28.78 crore was made from CSL on account of accrued interest on unspent advances at the instance of audit.

**2.7 Avoidable expenditure in construction of a swimming pool**

**Failure to take timely action by the Chief Engineer in construction of a swimming pool at a Military Station resulted in an avoidable expenditure of ₹1.32 crore.**

The Defence Works Procedure stipulates that if the tendered cost for a work exceeds its corresponding administrative approval (A/A) amount by more than 10 *per cent*, the case will be taken up for grant of financial concurrence (FC) of the competent financial authority (CFA) to enable the Engineer authority to conclude the contract.

The Headquarters (HQ), Andaman and Nicobar Command (ANC) accorded (March 2005) A/A, for provision of a swimming pool at a Military Station at an estimated cost of ₹2.80 crore. As no offers were received in the first call, the Chief Engineer, Port Blair (CE) issued (November 2006 and March 2007) tenders and the lowest offer (L1) at ₹3.13 crore received (April 2007) in the second call was valid till 24 July 2007. Due to insufficiency of amount in the A/A, the CE solicited (June 2007) a corrigendum to A/A for an amount of ₹3.24 crore. The revised A/A was accorded on 10 September 2007 i.e after lapse of the offer.

Meanwhile, following expiry of the offer the CE in the third call (August 2007) obtained (September 2007) another L1 offer at ₹3.55 crore which was not accepted by the CE citing insufficiency of funds. Offers received in the fourth and fifth call were also not accepted citing abnormally high rates and without assigning any reason, respectively. The contract was ultimately concluded (July 2009) with L1 vendor in the sixth call at a cost of ₹4.45 crore, after another revision (June 2009) in A/A at ₹4.65 crore. The work was completed in December 2011 at ₹4.87 crore inclusive of ₹0.65 crore on account of escalation paid to the contractor.

Our scrutiny (August 2011) revealed that:

- The lowest offer in second call was determined in April 2007 with validity upto 24 July 2007. However, revised Approximate Estimates (AEs) for HQ, ANC approval to enable acceptance of the tender were forwarded by the CE, in June 2007. The delay led to lapse of the contractor's offer.
- Even though the L1 offer at ₹3.55 crore in third call was within tolerance limit (8.73 *per cent*) of the revised A/A amount of ₹3.24 crore, yet the contract was not concluded by CE on the ground of insufficient funds sanctioned in the A/A.
- The contractor who was awarded the contract in the sixth call, namely M/s Ober Construction, had unsuccessfully bid in the preceding four calls, the L1 offer in each of which was allowed to lapse on frivolous grounds.

The Ministry stated (July 2012) that there was no ground for CE to exercise his financial powers judiciously to accept the tender as statutory audit had raised observation on the very sanction of swimming pool itself. The Ministry's contention is erroneous at the preliminary audit comment itself was made (December 2007) only after the fourth call. In any case the offer of M/s Ober Construction against which the work was awarded, was accepted during currency of the audit observation. As such, specific failure of the Engineer authority is being attempted to be explained away as inaction in response to audit observation.

Thus, failure of the CE to act in time led to an avoidable expenditure of ₹1.32 crore.