

# **Contract management issues**

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# Devil hides in the fine print and between the lines

- Remember Shylock asking for his 'pound of flesh' and being told to take it without taking a drop of blood. This is a lesson in contract management.
- The standards of financial propriety mandate that officers are expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money (Rule 21, GFRs 2005).
- But we see everyday 'persons of ordinary prudence' being outsmarted, whether doing shopping for home or for office! We need to raise the bar. As an ALERT CUSTOMER we must scan the fine print and what is hidden from view. Officers must choose telescope or microscope carefully. Please pay attention to vetting of RFP and contracts, not just on price and deliverables.
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## Contract Management in Defence Acquisitions - Elusive search for a perfect bride / groom under a monogamy system

- A finicky customer in a Sellers' market means no deal! Pragmatic approach to speed up acquisition programme. Expecting best features drawn from a variety of different contexts may mean QRs contrary to the laws of physics or business. Trade offs between weight, speed, dimensions, maneuverability, performance, agility, endurance, maintainability, cost, time schedules for induction, performance under extreme conditions and maintainability. Best gadgets with uncertain life cycle support or next best products with assured support? Military grade specifications or Commercially Off The Shelf (COTS) technologies?
- BEST would not often be ON SALE or the cost would be simply unaffordable for one-for-one replacement of ageing stock as diverse features are compacted into single weapon system
- Capabilities of weapon systems should be assessed not in isolation but in the context of Tri-Service combination of alternatives to arrive at pragmatic requirement setting.

# Improved documentation with safeguards can help

- We need a more elaborate, inclusive and well-documented process for formulation of Requirements, Specifications and Project Goals. These must be formulated *and changed in individual cases* by a high powered expert body.
- Guiding considerations behind categorization of a military acquisition as also the formulation/ approval/ change of requirements must be based on professionally-documented studies or on well-documented reasons.
- Evolve separate legal norms/procedures for their disclosure to Judiciary, Parliamentary Committees, Audit, CVC etc

# Problem areas in Works Contracts

- Site selection based on judgment without comprehensive analysis of alternatives; Inadequate mechanism to ensure optimum utilization of available land holding
- Premature award of contract without full preparation (designs/drawings, soil tests, Land acquisition, environmental/municipal etc regulatory clearances, ) resulting additional claims of price variation or compensation and idle resources / blocked funds or even abandonment
- Frequent user-driven changes in scope of work or other uncertainties make Turnkey contracts difficult.
- Contractor's default and litigation due to excessive use Standard Form Item Rate contracts.
- Weaknesses in the Departmental Designing wings -dependence on consultants, lack of site specific designs
- Inadequate use of IT in designing and project management - Rigorous, professional approach missing
- Lack of due diligence in risk and cost contracts, difficult recoveries

# UNCERTAINTY is the root cause

- Uncertainty intrinsic to the subject matter (in R&D) or vendor's/ adversary's true capabilities: genuine ignorance or lack of due diligence
- Uncertainty of budget leads to unnecessary fragmentation and sub-optimal costs
- Changes in priorities, changes in Site of construction and almost continuous changes in scope of work lead to brakes and accelerators
- Uncertainty about continuity of engagement in the project team leads to loss of motivation.

# Impact of concerns about corruption

- Involving more persons in decision making is a systemic response against misuse of discretion by single or fewer individuals
- It leads to a heavy-duty appraisal mechanism, delays, diffusion of responsibility and worse, a process-centric decision avoidance syndrome
- Trade off between fighting corruption and decision atrophy
- Problems are pretty well-known and systemic in nature and that is the problem: Everybody's problem is Nobody's problem.

# It sounds so cliché but must be said

- Decisions are always taken based on available information in an imperfect environment. The Executive has a duty and responsibility to act and decide. We need to build a climate of trust, tolerance and transparency so that the officers are empowered / facilitated to take decisions and approve changes from standard rules and procedures for good reasons to be placed on record. Procedures are not an end by themselves. Best is the enemy of good and timely, albeit imperfect decisions need be valued.

# It sounds so cliché but must be said

- Bridging the communication gap and trust deficit amongst stakeholders is the key to the success of any endeavour. Excellent players in a losing team imply one-upmanship and mistrust.
- There is **ASOLUTELY NOTHING** that cannot be understood between intelligent people if there is patience and willingness to explain and listen.
- Rules and processes can never be perfect. They are generally based on average foresight and unlikely to cover the strangest things that can happen.

# **FUNDAMENTALS OF THE LAW OF CONTRACTS (INDIAN CONTRACT ACT 1872)**

- **A CONTRACT IS AN AGREEMENT ENFORCEABLE BY LAW**
- **THE CONTRACT ACT ALLOWS ORAL AGREEMENTS ALSO TO BE ENFORCED BUT ARTICLE 299 OF THE CONSTITUTION MANDATES THAT ONLY A WRITTEN CONTRACT CONCLUDED BY AUTHORITIES SPECIFICALLY EMPOWERED TO ENTER INTO CONTRACT ON BEHALF OF THE PRESIDENT OR THE GOVERNOR CAN BIND THEM.**
- **AN AGREEMENT ARISES WHEN THERE IS AN OFFER TO DO OR NOT TO DO SOMETHING IN RETURN OF SOMETHING BY ONE AND THE ACCEPTANCE OF THE OFFER BY THE PERSON TO WHOM THE OFFER IS MADE**
- **COMMUNICATION OF AN OFFER IS COMPLETE WHEN IT REACHES THE PARTY TO WHOM IT IS MADE. COMMUNICATION OF ACCEPTANCE IS LEGALLY DEEMED TO BE COMPLETE AS SOON AS THE ACCEPTANCE GOES OUT OF THE HANDS OF THE ACCEPTOR.**
- **`OFFER' IS DISTINCT FROM `INVITATION TO OFFER'. A CONDITIONAL ACCEPTANCE IS NOT AN ACCEPTANCE. IT IS A COUNTER OFFER.**

# **FUNDAMENTALS OF THE LAW OF CONTRACTS**

- **AN AGREEMENT WITHOUT BILATERAL EXCHANGE OF `CONSIDERATION' IS NORMALLY VOID. COURTS DO NOT LOOK INTO THE ADEQUACY OF `CONSIDERATION' .**
- **PARTIES TO THE AGREEMENT MUST BE LEGALLY COMPETENT TO CONTRACT**
- **PARTIES' CONSENT MUST BE FREE, NOT VITIATED BY COERCION, MISTAKE, MIS-REPRESENTATION, FRAUD OR UNDUE INFLUENCE**
- **OBJECT OF THE AGREEMENT MUST BE LAWFUL. IT SHOULD BE FRAUDULENT, INJURIOUS TO THIRD PARTIES, IMMORAL OR OTHERWISE OPPOSED TO PUBLIC POLICY OR VIOLATIVE OR DEFEATING THE LAW OF THE LAND**
- **`CONSIDERATION' EXCHANGED BETWEEN THE PARTIES MUST BE LAWFUL**
- **CONTRACTUAL OBLIGATIONS CAN BE MODIFIED OR EXTINGUISHED BY A FRESH CONTRACT OR BY LAW IN CASE THE PERFORMANCE OF CONTRACT BECOMES IMPOSSIBLE**

# FUNDAMENTALS OF THE LAW OF CONTRACTS

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- **THE PERFORMANCE SHOULD BE TENDERED AT AGREED PLACE AND TIME OR A REASONABLE PLACE AND TIME**
- **COMPENSATION FOR BREACH OF CONTRACT CAN BE PREDETERMINED AS PART OF THE ORIGINAL AGREEMENT (LIQUIDATED DAMAGES) OR IT CAN BE DETERMINED BY COURTS AS THE LOSS THAT CAN NATURALLY AND DIRECTLY BE ATTRIBUTED TO THE BREACH.**
- **COMPENSATION CANNOT BE ALLOWED FOR REMOTE/INDIRECT LOSSES OR FOR LOSSES NOT CONTEMPLATED BY THE PARTIES AT THE TIME OF ENTERING INTO THE CONTRACT.**
- **THE AGGRIEVED PARTY IS EXPECTED TO TAKE ALL REASONABLE STEPS TO MINIMIZE THE COMPENSATION PAYABLE BY THE PARTY COMMITTING THE BREACH. EXPEDITIOUS FINALIZATION OF THE 'RISK AND COST' CONTRACTS IS A MUST TO ENFORCE RECOVERY**

# **STANDARD FORM CONTRACTS**

- **CONTRACTS BY DOMINANT PARTY 'IMPOSED' WITH NUMEROUS FINE-PRINT CONDITIONS- TAKE IT OR LEAVE IT IN TOTO-- GRUDGING CONSENT FACED WITH NO ALTERNATIVE SITUATION**
- **COURTS HAVE EVOLVED CERTAIN PRINCIPLES TO PROVIDE RELIEF TO THE PARTY WHO RELUCTANTLY ACCEPTS A STANDARD FORM CONTRACT**
- **STRICT INTERPRETATION OF CONTRACT CONDITIONS-- INTERPRETATION FAVOURING THE 'WEAKER PARTY' ADOPTED IN CASE MULTIPLE INTERPRETATIONS POSSIBLE**
- **COURTS EXPECT THAT THE 'DOMINANT PARTY' WILL TAKE REASONABLE CARE TO HIGHLIGHT THE IMPORTANT CLAUSES ADVERSELY AFFECT THE INTERESTS OF THE WEAKER PARTY TO HIS NOTICE**
- **BENEFIT OF CONTRACT CONDITIONS CAN'T BE ALLOWED TO THIRD PARTIES**

# **INTERPRETATION OF CONTRACT PROVISIONS--GUIDING PRINCIPLES**

- **PARTIES TO A CONTRACT `LEGISLATE' FOR THEMSELVES WITHIN THE RESTRICTIONS PLACED BY LAW. HENCE, THE INTENTION OF THE PARTIES IS OF UTMOST IMPORTANCE**
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- **IF THE INTENTION OF THE PARTIES IS NOT CLEAR OR NOT PROVED TO THE SATISFACTION OF COURTS, RECOURSE TO WHAT IS THE MEANING ASSIGNED IN COMMON BUSINESS PARLANCE AND FINALLY TO WHAT THE COURTS REGARD AS A `REASONABLE' MEANING**

# General Guidelines for Government Contracts

- The terms of contract must be precise and definite and there must be no room for ambiguity or misconstruction therein.
- As far as possible legal and financial advice should be taken in the drafting of contracts and before they are finally entered into.  
(especially where standard forms of contract are not used)
- Standard forms of contracts should be adopted wherever possible, the terms to be subject to adequate prior scrutiny.
- The terms of a contract once entered into should not be materially varied without the previous consent of the authority competent to enter into contract as so varied.
- No contract involving an uncertain or indefinite liability or any condition of an unusual character should be entered into without the previous consent of the competent financial authority.

## **General Guidelines for Government Contracts**

Whenever practicable and advantageous, contract should be placed only after tenders have been openly invited and in case where the lowest tender is not accepted reasons should be recorded.

In selecting the tender to be accepted the financial status of the individual and firms tendering must be taken into consideration in addition to all other relevant factors. Even in cases where a formal written contract is not made, no order for supplies etc. should be placed without at least a written agreement as to price.

Provision must be made in contract for safeguarding government property entrusted to a contractor.

No relaxation of specifications agreed upon in a contract or relaxation of the terms of an agreement entered into by the Government should be made without proper examination of the financial effect involved in such relaxation.

# General Guidelines for Government Contracts

- Any extension of contract date should be done with a total review of all contract provisions to see if they need modification.
- All contracts should normally have a provision for recovery of liquidated damages for defaults and warranty/guarantee clause and termination clause upon due notice with or without reasons.
- Who has to pay what applicable taxes/duties/charges/other statutory levies; basis for the calculation of escalation in respect of materials and labour; freight insurance, handling, installation etc should be settled clearly beyond any doubt.
- A schedule of quantities with the issue rate of such materials which are supplied departmentally, to be used in the contracted work, should form part of the contract. It should also contain an escalation clause pertaining to rates of such materials, the prices of which are controlled by Government and which the Contractor arranges himself, so that the Government may get the benefit of any saving in the quantities of the material actually used in execution.

## Sundry Case Studies in Contract Audit

- Anything that can go wrong actually goes wrong somewhere. If rear view wiper is not listed as accessory, you may get a car without one. If contract says 'Deck to be painted', contractor would not paint 'Decks'.
- Oil and Natural Gas Corporation Limited incurs extra expenditure of Rs.51 crore due to incorrect cost estimation and consequent decision to go in for re-tendering in two cases.
- Objectionable payment of escalation on upfront mobilisation advance as a result of wrong definition of "Gross value of work done" on which escalation was payable under the contract.
- Power Grid Corporation of India Limited: Transparency of the bidding process was compromised by the Company/Ministry by changing bid conditions from Build Own Operate Transfer (BOOT) to Build Own Operate (BOO) in two projects after opening of bids. The change affected the ownership status of assets.
- Food Corporation of India released security deposit to tenderers without ensuring fulfillment of the terms and conditions of tender resulting in undue favour of Rs.7.01 crore to tenderers.

## Sundry Case Studies in Contract Audit

- BEML Limited amended the currency of payment from US Dollar to Euro at vendor's insistence and incurred an extra expenditure of Rs.26.62 crore.
- Airline Allied Services Limited incurred avoidable expenditure of Rs.2.50 crore on payment of lease rent before commencement of commercial operation of the leased aircraft due to delay in painting. [premature commencement of lease]
- Airports Authority of India incurred revenue loss of Rs.5.39 crore on failure of the Authority to finalise exclusive advertisement contracts at various airports within the stipulated period.
- Airports Authority of India incurred a loss of Rs.4.27 crore on import of Airfield Fire Fighting and Rescue Vehicles due to non-availment of customs concession under Export Promotion of Capital Goods scheme.
- The Airports Authority of India incurred wasteful expenditure of Rs.3.24 crore on construction of civil and electrical works in spite of being aware that Begumpet airport would cease for all civil aviation operations after the commissioning of the new Airport at Shamshabad, Hyderabad.

## Sundry Case Studies in Contract Audit

- Neyveli Lignite Corporation Limited was deprived of additional revenue of Rs.8.14 crore due to non-adherence to price clause in sale of lignite under fuel supply agreement (FSA) with ST-CMS Electric Company Limited (buyer), engaged in generation and supply of electricity to Tamil Nadu State Electricity Board.
- Northern Coalfields Limited issued contracts for removal of overburden and paid service tax of Rs.16.95 crore on the cost of explosives though no service in the form of blasting was provided by the contractor. The Company took decision in April 2006 that explosives would be supplied by the Company on chargeable basis. But the contract was issued including cost of explosives required for blasting though they would be supplied by the Company free of cost. Blasting job would also be done by the shot firer/blaster of the Company, being a statutory requirement.
- Export Credit Guarantee Corporation of India Limited paid inadmissible claim for Rs.2.20 crore, ignoring the lapses committed by the bank officials, in contract execution.

## Sundry Case Studies in Contract Audit

- Hindustan Aeronautics Limited suffered locking up of Rs.95.26 crore and consequent loss of interest of Rs.16.62 crore on acceptance of an unviable delivery schedule coupled with delay in submission of change order.
- Air India lost interest of Rs.9.83 crore on failure to raise invoices in time for the ground handling services rendered to the customer airlines and non levy of penal interest for the delay in receipt of payment as per contractual provisions.
- HMT Machine Tools Limited committed gross irregularities in the process of sale of property belonging to Praga Tools Limited. **Audit observed that the financial figures i.e., both the land value and the total bid value were completely altered by striking off earlier figures in the bid documents and the original signatory of the bid did not authenticate the corrections which were in violation of the tender conditions. As the corrected bid amount of Rs.82.30 crore was close to the reserve price fixed by the Company i.e., Rs.80.96 crore, it creates suspicion about the amount which was originally mentioned in the bid.**

## Sundry Case Studies in Contract Audit

- For the procurement of the fleet tankers worth Rs 936 crore, Indian Navy awarded a contract for acquisition of a fleet tanker to a foreign shipyard even though the steel to be used by the shipyard in construction did not meet Indian Navy technical specifications. Excess provisioning of spares of Rs 30.44 crore and under-realisation of offset benefit to Indian industry were also noticed.
- Railway Board instructions provide that the contracts for works should not be awarded without completion of prerequisites such as obtaining clear possession of land, site clearance, soil tests and preparation of all plans, drawings and in case such an action was warranted for expeditious completion of the work, the requisite works should be completed in time to hand over the same to contractor immediately so that the progress of work was not hampered. These were violated in several cases.
- Several cases of loss due to delayed finalization of risk and cost tenders and failure to ensure timely availability of approved drawing and design of works and supply of requisite items of material resulted in avoidable expenditure

## ***CAG Audit Report No. PA 17 of 2008 on DELHI METRO***

- Audit reviewed the process of appointment of the GC and 27 contracts valuing Rs. 6540.03 crore out of 100 high value contracts (> Rs.5 cr) amounting to Rs. 8900.57 crore. Out of 27 contracts, 13 were lump sum price contracts in the nature of 'design and construct' wherein the designs were developed by the contractors. The remaining 14 contracts reviewed were based on bill of quantities.
- ***Audit Recommendation: The good practices adopted by the company for traffic management, safety and environment should be documented to enable their sharing and adoption by other or similar construction projects.***
- **The company followed donor's guidelines in case of donor funded contracts. The company has, however, not documented guidelines, policy and procedures for domestically funded contracts. *The company should formulate and manualise the procurement guidelines for each stage relating to pre-qualification, short listing of vendors, estimation, bids evaluation, award and execution of contracts.***

## ***Appointment of general consultant by Delhi Metro***

- Donor guidelines for the appointment of the GC provided for financial negotiations only with the first ranked technical bidder. So, the selection of the GC was not based on a system where the best bid was selected on the basis of technical quality cum cost basis.
- Financial bid of the highest ranked technical bidder *viz.*, PCI led consortium of Rs. 347.38 crore (exclusive of taxes, duties, levies and escalation) was opened and after negotiations, the contract was awarded at a price of Rs. 208.15 crore.
- ***Audit Recommendation: In case it is possible to give a clear definition of inputs required from the consultants, their appointment should be based on a system where the best bid is selected on the basis of both technical quality as well as financial cost.***

## ***CAG Audit Report No. PA 17 of 2008 on DELHI METRO***

- Finalisation of the cost estimates before the receipt/opening of financial bids is an established best practice. Out of 13 'design and construct' contracts reviewed, in 7 cases (award value Rs. 3314.50 crore), the estimates were revised or approved after opening of financial bids. Thus, tenders were invited without benchmark estimates, in the absence of which efforts undertaken to optimise costs could not be ascertained. Further, out of these seven cases, in three cases (award value Rs. 3097.89 crore), even financial concurrence was not obtained.
- The company paid Rs. 6.92 crore against contractors' claims in eight contracts which were not admissible as per the contract agreement
- In six cases, advances amounting to Rs. 38.72 crore not contemplated in the agreements were sanctioned to the contractors
- ***To enforce utilisation of indigenous material by a contractor, explicit penalty clause should be incorporated in the contract agreement***
- ***Audit found procedural deficiencies in the system of opening of bids  
The company needs to further strengthen its system of processing of bids to bring in more accountability, transparency and fairness.***
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## **Oil and Natural Gas Corporation Limited loses Rs.853.09 crore in decision to buy condensate produced by the Tapti Joint Venture at crude oil price instead of gas price**

- The decision of the Company to purchase condensate at crude oil price was inconsistent with the directives (May 1998) of Ministry of Petroleum and Natural Gas (MOPNG) to treat the condensate as gas.
- The Company was valuing the condensate generated from its own Bassein gas field<sup>4</sup> at gas price and paying royalty<sup>1</sup> as applicable to gas.
- The net gain of Rs.131 crore appraised to the Board was in fact loss of Rs.202 crore (US\$45 million) as the Company had not considered the subsidy element on domestic LPG and SKO which it was bearing as per the Government directives.
- As per the PSC, the JV was a 'contractor' and GOI is the owner of JV field. The GOI had only given the mining lease to the contractor to explore and exploit hydrocarbon resources on certain terms and conditions. The JV which is the seller and the Company which is the buyer cannot independently decide the pricing of the hydrocarbon resources, including that of condensate.

## **Spices Trading Corporation Limited (wholly owned subsidiary of STC) suffers loss of Rs.1167.48 crore**

- The Company entered into new line of business activity of third country exports of metal scrap in 2004-05. While the Company established LC on the foreign sellers for the purchase of metal scrap, it accepted the offer of getting sales proceeds through 'swift payment' from the overseas buyers without insisting for back-to-back LC. Reasons/compulsions for accepting such unfavorable payment terms were not on record. The Company's action of exposing itself for Rs.2525 crore (2008-09) for a meager margin of 1.26 *per cent* (Rs.32.13 crore) without insisting for LC from buyers was fraught with the risk of default. 134 LCs valuing Rs.1320 crore devolved due to non remittances by overseas buyers. The reasons for accepting cheques as security without verifying the financial credentials of the BA were not on record.
- Deals struck with newly formed companies with no credentials. The failures of the Company to read the nexus between its Business Associate and sellers/buyers were fully exploited by the BA. Inspection agencies were appointed by the overseas sellers, there was no control on the inspection agencies by the Company. **Metal scarp containers had iron scrap rather than nickel or copper scrap as expected.**

## MTNL skips indigenization clause, pos contract

- **MTNL failed to implement the policy formulated by Prime Minister's office for promoting indigenous manufacturing of telecom equipment. Further, the Company extended undue benefit of Rs.16.18 crore to the vendor by waiving penalty in contravention of terms and conditions of the tender**
- The terms and conditions of the tender provided that:
  - The bidder should either be an Original Equipment Manufacturer (OEM) of IPDSLAM or its Indian subsidiary if the OEM is a foreign company or be a registered Indian company having Transfer of Technology (TOT) agreement with OEM of IP-DSLAM.
  - The vendor should supply IP-DSLAM equipment having indigenous component of manufacturing in India with minimum value addition of 30 *per cent*.

**Indian Railway Catering and Tourism Corporation Limited would lose revenue of Rs.7.63 crore *due to deficiency in agreement:***

**IRCTC would lose revenue of Rs.7.63 crore due to non-inclusion of clause in the agreements for proportionate increase in concession fee with the increase in the passenger carrying capacity of trains as a result of increase in number of coaches.**

The bidders are required to offer lump sum concession fee to IRCTC for the tenure of licence. This concession fee is based on the passenger carrying capacity of trains. The capacity can increase due to:

- Increase in the frequency of trains, and
- Increase in the number of coaches in the trains.

Logically, the lump sum concession fee receivable by IRCTC should increase with the increase in passenger carrying capacity. Therefore, the agreements between IRCTC and caterers provide for *pro-rata* increase in the concession fee on account of increase in the frequency of trains. However, the agreements do not provide for such a hike in case of increase in the number of coaches in the trains.

THANK YOU