The Birth and untimely Death of 3 High Value Cranes in Chennai

[*Importance of providing appropriate Payment, Inspection and Rejection terms in High Value M & P Contracts*]

A. CONCEPT NOTE

1.1 Procurement and Non-utilization of 3 High Value Cranes in ChPT

In the year 1996, Chennai Port Trust (ChPT) initiated a proposal to procure three high-value Rail Mounted electric Gantry Cranes, in expectation of heavy future growth in cargo volume.The cranes to be procured were supposed to be technically sophisticated and versatile in nature, to cater to diverse type of commoditieswith longer reach, for loading/unloading cargo into large vessels, thus justifying a very high level of investment by the Port (nearly **Rs 38 Crores** at that time). After the tendering process, a contract was placed on a company and the cranes were delivered during FY 2000-2001. However, within a very short period followingtheir arrival,these cranes were found to be unsuitable forport-use as envisaged earlier. While one of the three cranes did not work even for a single day, the other two fell out of operation very quickly, leading to their eventual disposal as scrap, through auction, after a few years.

1.2 Case Analysis :

While negotiating a Contract for procurement of high value Machinery & Plant (M & P) items, one of the critical areas where greatcare is required to be exercised is the design of an appropriate "payment clause". If the M & P item intended to be procured is of technicallycomplexnature,the inspection, testing, erection and commissioning activities automatically assume huge significance. In such cases, adoption of a calibrated / staggered payment clauseis a must. Otherwise, if an unduly large payout is made to the Vendor/Contractor before successful testing, erection and commissioning, then such vendor would have less incentive to complete these activities, which are more complexthana simple delivery.

Study of the above case shows that the contract for the three gantry cranes envisaged a payment term that was highly detrimental to both technical and financial interest of Chennai Port Trust. This clause envisaged release of nearly 90% of the total contract consideration to the vendor before successful commissioning or even testing of these high value cranes. Even within this 90%, payment of 80% was meant for "imported components", to be released merely on establishment of aLetter of Credit. In the subject case, overwhelming portion of the contract-value was meant forimported components. Even for the indigenous components, 85% of purchase value was envisaged to be paid merely against the proof of dispatch, without any quality inspection.

With such defective and one-sided payment terms, the incentive for a vendor to complete the technically complex part of testing / erection / commissioning (and thereby discharge their full contractual obligation) was very low, since theystood to corner almost the entire payment,simply on delivery. This is exactly what happened later.

Records reveal that immediately after the delivery, information on non-supply of spare parts, technical defects and non-commissioning of the project started pouring in from the user department. Out of the 3 Cranes, the concerned authorities could issue a proper "Commissioning Certificate" for the one crane which was the first to arrive. Even after issue of a successful commissioning certificate, this crane was never put to use for a single day.As for the two remaining cranes, no commissioning couldbe done. Repeated correspondence by Port authorities with the vendor for rectifying the technical deficiencies of these two cranes fell into deaf earsas the vendor had already receivednearly 90% paymenton or before delivery.

A subsequent audit report revealed that parts of the first crane had actually been cannibalized, to make the other two cranes operational to some extent, for a limited time. Even for this, the Port Authorities claimed that a sum of Rs 3.65 Crores had been spent for rectifying defectswhich the vendor did not attend during the warranty period,and towards procurement of required spares. In spite of such additional expense, these two cranes had handled a cargo of just 20 ships in 3 years of operation amounting to hardly 0.2 Million Tons before being reduced to a totally inoperative state. The cargo handled by these 2 cranes represented a handling rate of 0.022 Million Tons per Year, i.e.just 3% of the 0.75 Million Ton /Year handling envisaged at project justification stage. Although improper supply, technical defects and non-supply of spare parts (as claimed by Port), led to near-total non-utilization of these costly cranes, ChPT authorities could only hold back 10% of the Contract Value, since 90% of order value had already been released to the vendor before commissioning. But even this 10% payment hold-up by Port authorities, and their claim to recover the Rs. 3.65 Crores, which had supposedly beenspent for rectifying warranty defects for the other two cranes, were dismissed later - both by an Arbitration Tribunal and Hon'ble High Court - on the ground that the Port Authorities could not produce a single document in support of having spent such a sum.

Another reason why the Port Authorities lost out on their claim during arbitration was that they had never categorically "rejected" the cranes despite reporting technical defects several times to the vendor. Section 42 of the Sale of Goods Act states that ifabuyer does not categorically reject a consignment, within reasonable period,duly intimating the sellerthe reason for such rejection, his actioncan be deemed to be an "implied acceptance" of the suppliedmaterial. In the subject case though there were frequent and protracted exchange of correspondence between the Port Trust authorities and the Vendor about various types of technical deficiencies and spare parts and the said authorities had not issued commissioning certificate in respect of two cranes, none of these correspondenceexpressed any desire by the Port to reject the cranes. The Learned High Court interpreted such conduct as an act of implied acceptance of cranes by the Port Authorities, and dismissed Port's claim.

B. <u>SUGGESTED SYSTEM IMPROVEMENT</u>:

1.0 Time is regarded as the essence of a contract. It has been noticed that many a time, extension of time to a contractor/supplier is granted by authorities in a liberal and routine manner. There is also a tendency not to apply the LD clause,by attributing the delay to Port because of lack of proper documentation and project monitoring, whereby the delay of the contractor / vendor can be unambiguously pinpointed. To prevent such scenario, it is desirable to maintain a"**Hindrance Register**" showing the trail of project execution and reason of delay. The site engineer should record the reason for delay,if any, in delivery/execution/testing/commissioning and get the same signed periodically by the Engineer of the Contract, or his nominated officer.

2.0 CVC, in a booklet titled "*Common Irregularities/Lapses Observed In Award And Execution Of Electrical, Mechanical And Other Allied Contracts And Guidelines For Improvement Thereof*" does advise maintaining a proper "Hindrance Register" with the following caution:

> *"Hindrance Registers, though are sometimes found as maintained at site but in most of the cases either entries are not made at all or bogus entries are made in collusion with the contractors. In quite a few cases rains during the monsoon were considered as hindrance and the benefit was given to the contractor.*

3.0 Payment schedule, in case of high value procurement, especially having technical complexities, should be well calibrated / graded, and released in stage-wise tranches. The amount of payment released to a contractor/vendor should be in proportion to the overall progress as well as the importance of the stage of completion. In cases of procurement of heavy machinery, a good portion of payment should be held back till entire testing, installation and commissioning are completed properly to the satisfaction of the end-user. The amount of payment to be made to a vendor corresponding to a particular stage of the contract, will vary from case to case and type of project/procurement. But releasing overwhelming portion of payment without confirming total compliance to contracted terms and standards by the end-user, may create perverse incentive for the contractor to abandon the project without completing installation and commissioning. CVC instructions have repeatedly cited cases where the contractor got paid 90%/95% of the payment for the supply of equipment and then shirked the responsibility for erection and commissioning on one pretext or the other. The payment terms should be defined unequivocally and should not be changed after award of the contract without compelling reason. An appropriate control on the flow of funds should be exercised while making payments.

4.0 **Good Project Monitoring:**The specific schedule of completion of various stages in a project should be stipulated in the contract document in an unambiguous manner. Completion of contract should imply overall completion of all events of the project. If the work is broken into small contracts, each and every contract should have its specific schedule of completion which, inter alia, should be within the overall completion schedule of the main contract. The contractors should be asked to submit the completion schedule of various activities in advance and progress should be monitored in accordance with such schedule.

5.0 Providing a defect-liability clause: It is good practice to incorporate a "defect-Liability-period-clause" in the bid documents and in the resultant contract. In the contracts involving installation/commissioning of equipment, the defect-liability period should be reckoned only from the date of successful installation/commissioning.

6.0 Specifying a proper RejectionClause:

6.1 As soon as goods/services have been delivered in terms of a contract any technical deviation noticed should be intimated to the contractor/supplier immediately. Preferably such intimation should be in writing, and if verbal, confirmed in writing, immediately afterwards. Where, as a part of the acceptance process, issue of specific "commissioning certificate" and /or "acceptance testing" for the procured item are envisaged, they should be completed within the agreed upon timescale as stipulated in the contract.

6.2 If any defect vis-à-vis the contracted specification is noticed after supply, the concerned authorities may decide to (a) get the vendor to rectify the same to full satisfaction of the consignee; (b) Reject the supply altogether and demand replacement. In case of (b), the vendor is to be clearly intimated the reasons for rejection without losing time. It should be kept in mind that using the item or not intimating the intention to reject can jeopardize the consignee's right to reject, since silence of the consignee can be deemed as "implied acceptance". In this connection, the following is worth noting :

> ***"The Sale of Goods Act, 1930***
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> ***42. Acceptance.****—The buyer is deemed to have accepted the goods when he intimates to the seller that he has accepted them, or when the goods have been delivered to him and he does any act in relation to them which is inconsistent with the ownership of the seller, or when, after the lapse of a reasonable time, he retains the goods without intimating to the seller that he has rejected them."*

6.3 If upon intimation, the defect/deficiency itself is challenged by the vendor,immediately a joint inspection should be convened where the initial inspection authority, Port's nominated officer and Vendor's representative should be present. If required, the said joint inspection team may send random sample(s) for independent testing by a reputed third-party testing organization, with clear stipulation as to whether the result of such testing will or will not be binding on the parties to the contract.

N.B: *The above system improvement was issued when CVO (Kolkata Port Tryst) shouldered the additional charge of CVO (Chennai Port Trust). The lessons learnt are applicable and relevant to any port for avoidance of similar pitfalls.*

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