

Teething issues: Managing fraud and dispute challenges in the infrastructure sector



Preface

The infrastructure sector is poised to embark on its journey to achieve investment potential of over USD 1 trillion in the next 5 years¹ and provide an experience of quality infrastructure that is of international standards to Indian citizens in India itself. A new decisive government and the urgency that it has exhibited for the sector since their initial days are some of the factors that are gradually bringing back the confidence of developers and investors. Recent commitments from Japan and China to collectively invest around USD 55 Billion in India² is a case in point and indicate the government's commitment to tap all potential sources of capital. These efforts need to be supplemented with streamlining certain regulatory hurdles along with actions to remove bottlenecks in critical areas such as land acquisition, environmental clearance and fuel availability.

Though the recent announcements and action have regenerated investment interest in the sector, it may take time for actual investments to flow in pending action from the government in the areas mentioned. Infrastructure companies should use this period to consolidate and prepare themselves to handle these modern large scale projects, when capital actually becomes available. We already see signs of change in the approach of infrastructure companies, from an aggressive pursuit of asset addition to prioritizing projects with the ability to generate positive cash flows. A large number of projects especially in the power generation and highways sector have seen change in ownership largely to rebalance the portfolio of projects.

Further, infrastructure companies have been lax on implementing strong internal controls across their operations. The impact of this was assumed to be insignificant, as money was committed to larger projects that were under construction. A clear focus to create a robust backbone of internal controls to enhance revenue through prevention of leakages, as well as, achieve cost efficiencies can provide not only much needed cash to the infrastructure developers but also prepare them to tap the opportunities expected in the next 12 to 18 months.

We are also observing a significant shift in the approach of infrastructure companies towards managing the risks related to fraud, misconduct and non-compliance. There is a rise in infrastructure companies that are now coming forward to discuss fraud issues that they face. To understand the sentiments of infrastructure companies on how fraud impacts the sector, we launched a brief survey in August 2014 and received 29 responses from C-level professionals employed with various infrastructure companies across India. We have compiled this report on the basis of responses received and it offers insights into some of the key fraud and non-compliance risks that companies in the sector face, even as they gear up for growth.

We hope you find this report useful and relevant to your efforts in curbing fraud.

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¹ Source: http://articles.economicstimes.indiatimes.com/2014-09-26/news/54353295_1_prime-minister-narendra-modi-infrastructure-private-investors

² Source: http://www.business-standard.com/article/economy-policy/china-dashes-100-bn-hope-to-invest-20-bn-over-5-years-114091800557_1.html

Traditional frauds continue to dominate the sector

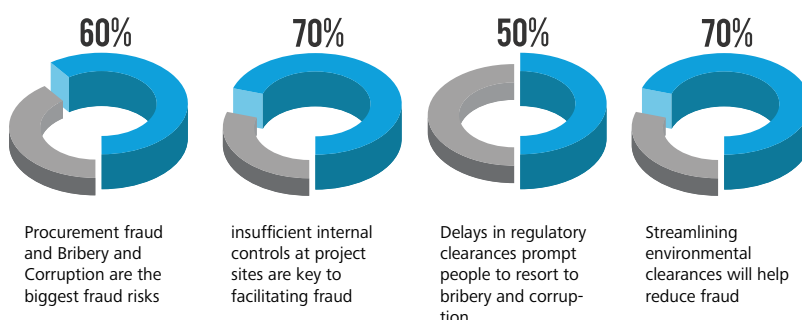
Organisations in the infrastructure sector continue to perceive procurement fraud and bribery and corruption to be the biggest fraud risks impacting the sector, according to over 60 percent of survey respondents. One of the key reasons for the prevalence of these frauds is the operating model in the sector, which has inter-dependencies on several third parties as well as the government.

Typically, large infrastructure projects rely on large scale procurement of goods and services. Even after centralizing procurement for multiple projects, companies continue to have significant dependence on local third parties for sourcing material, equipment and labour. As the project progresses and faces deadline pressures, exceptional approvals for procurement become frequent, with little focus on internal controls or due diligence. For companies that have multiple projects running simultaneously, these exceptional approvals further reduce the span of control, effectively increasing the risk of procurement fraud. Around 70 percent of our survey respondents backed this view by stating that insufficient internal controls at project sites was one of the major causes for fraud cases.

We are of the view that, lesser developed internal processes and controls can be attributed to relatively greater focus on bagging new projects and pursuing growth, which may impact sustainability of business in the long term.

Apart from internal controls, dealing with external parties – mainly the Government and other regulatory bodies - forms a significant part of infrastructure companies' day-to-day activities. Given the high level of regulation in the sector, companies need to obtain numerous clearances at multiple stages in the project lifecycle such as prior to commencement of construction, during construction, commissioning and during operations. Delays in obtaining regulatory clearances at any stage can cripple most infrastructure projects, particularly those that have been bid at very low margins in a competitive landscape. Project Monitor, a news portal on infrastructure projects, reports that there are 282 delayed projects listed in the Ministry of Statistics and Programme Implementation (MOSPI) report dated 1 May 2014. These projects were delayed by a period of one month up to 20 years and the project costs had cumulatively escalated by 22 percent or INR 1.09 lakh crores³.

Key fraud risks in the infrastructure sector and causes



Source: Deloitte Forensic survey on managing fraud and dispute challenges in the infrastructure sector.

Given the escalating project costs, companies can feel compelled to resort to back channels, bribery and facilitation payments to ensure that such delays do not befall them, as indicated by 50 percent of our survey respondents. Further, 60 percent of survey respondents indicated that at least 15 percent of their total investments in projects were delayed due to regulatory clearances, underlining the sentiment that business cannot go on without paying bribes and those who did not pay, were denied clearances.

In our experience, the key reasons for delay in infrastructure project implementation are delays in obtaining environmental clearances and acquiring land.

Environmental clearances are neither time bound, nor is the process transparent, leading to increased vulnerability to political interference and other influences, hence leading to higher incidence of bribery and corruption. There are several examples wherein projects have faced significant delays even when they have received in-principle government approvals. A case in point is a 2,800 MW nuclear power project which received in-principle government approval in 2009 but got environmental clearance only in 2013⁴. Similarly, in case of road projects, the developers chose to terminate concession agreements as delays in environment clearance and land acquisition led to delays in project schedules making them financially unattractive.

3 Source: <http://www.projectsmonitor.com/pm-specials/delays-and-cost-overruns-infest-60-of-central-sector-infra-projects/>

4 Source: <http://timesofindia.indiatimes.com/india/70-projects-worth-Rs-1-5-lakh-crore-okayed-after-Natarajans-exit-from-MoEF/articleshow/28762384.cms>

Land acquisition has been the bug-bear of many infrastructure projects with several projects ending up in dispute. Road projects face the brunt of this problem as land has to be acquired over a longer stretch that may cover multiple states.

Our survey respondents believe that changes in regulations in these two areas – land acquisition and environmental clearances - would help in reducing fraud and misconduct in the sector. Around 70 percent of respondents said streamlining and improving transparency in environmental clearances was the most important step while 65% expect the Land Acquisition Act 2013 to be an effective measure in tackling frauds. However, certain provisions of the Act need to be amended to make the Act more effective.

For starters, the Act attempts to quash the autonomy that states have enjoyed over the land acquisition process by de-recognizing them. This is likely to warrant major changes in the land acquisition process and there is currently no clarity on the new process to be followed. Also, the Act mandates obtaining consent of land owners (at least 80 percent of owners) prior to land acquisition. This may prove to be a challenge as

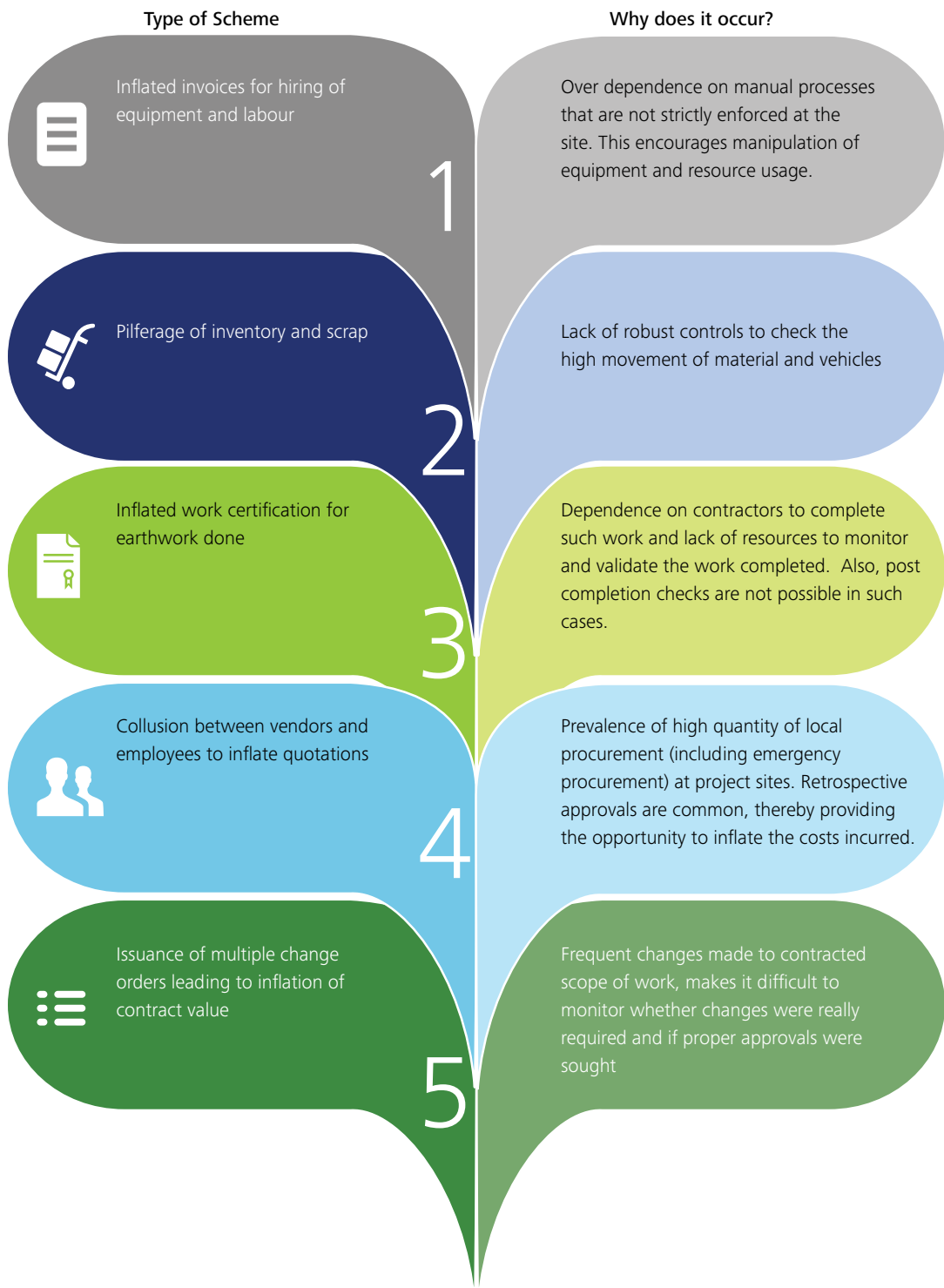
identifying owners (by private parties) has traditionally been a cumbersome process. Further, a social impact assessment has been suggested for large projects prior to land acquisition. While this is a welcome step, clarity is awaited on whose responsibility it will be. It is possible that such an assessment may further delay the land acquisition process.

Survey respondents rated revenue leakage and misappropriation of cash as the least important fraud risks impacting the sector. This can be attributed to the fact that the number and size of projects in India under construction today are far higher than those under operations. Thus, the focus of infrastructure companies tends to be more on areas wherein investment commitments/financial transactions are significantly higher. In the current macroeconomic environment, it may be useful for infrastructure developers to start focusing on process driven mechanisms to mitigate the risk of potential revenue leakages rather than people driven processes. This will help the infrastructure developers to prepare themselves for bigger challenges when larger and more complex projects commence operations.

⁵ These schemes are based on Deloitte's experience providing forensic services to infrastructure players in India. The scenarios are generic and can apply to any sub-sector within the infrastructure sector including ports, airports, roads and real estate

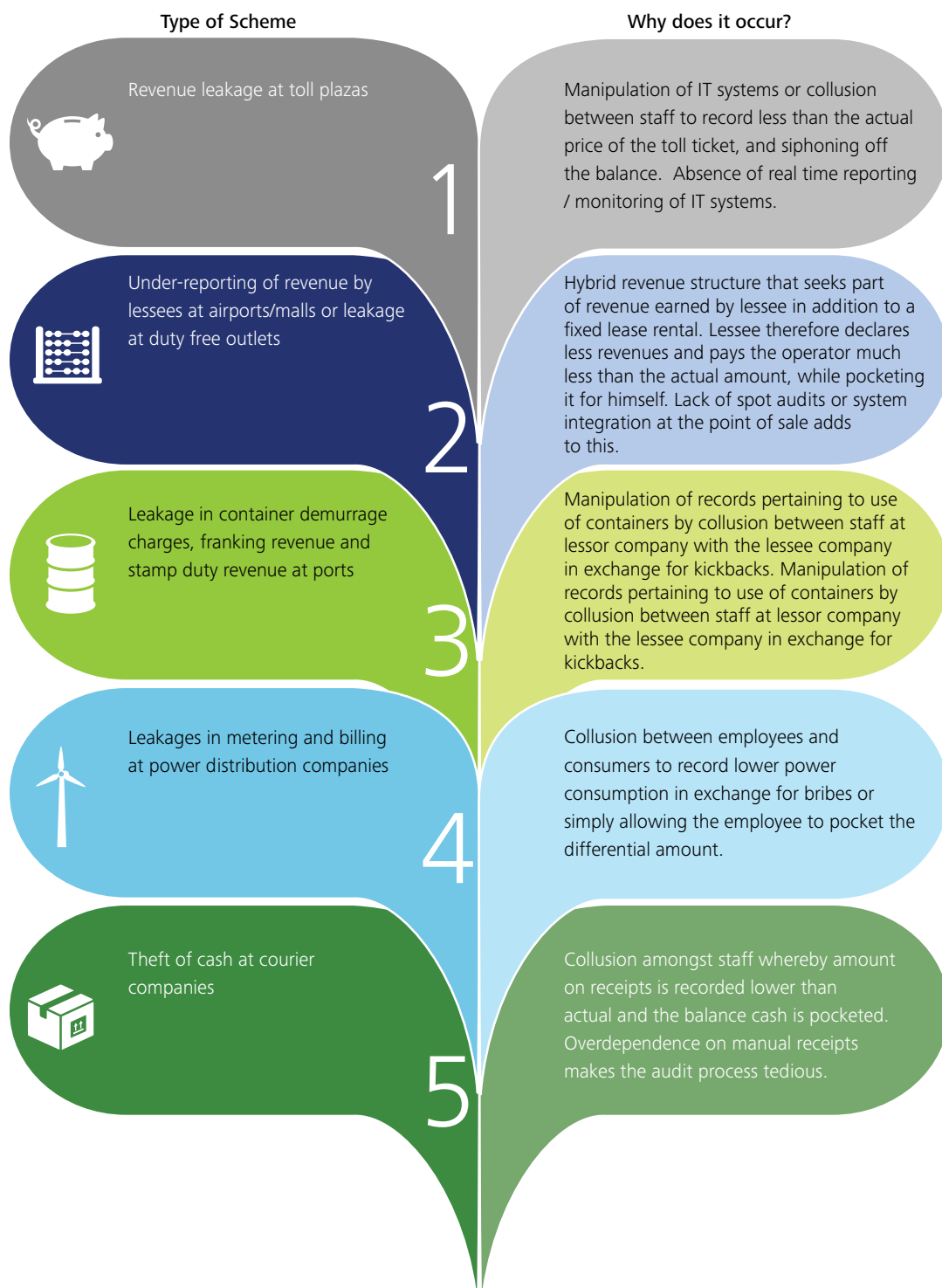
Common fraud schemes in the infrastructure sector¹

Construction phase fraud schemes



¹ These schemes are based on Deloitte's experience providing forensic services to infrastructure players in India. The scenarios are generic and can apply to any sub-sector within the infrastructure sector including ports, airports, roads and real estates

Operational phase fraud schemes



On the rise: Infrastructure sector disputes

A rough estimate of the amount of money currently blocked in construction sector disputes in India is around INR 54,000 crore⁶. Moreover, the dispute resolution mechanism in India takes anywhere between 5 to 15 years to resolve the issue compared to a global average of 12.8 months and a European average of 6 months⁷. As a result, the dispute resolution process becomes costly for most companies to pursue in India. This is highlighted by respondents to our survey where 65 percent of respondents stated that expenses on dispute resolution totaled up to 5 percent of annual revenues and 20 percent said they spent 5-10 percent of their annual revenues on dispute resolution.

The key factors listed by respondents leading to costly and delayed dispute resolution were 'poorly defined arbitration clauses' and 'inability to pinpoint responsibility for default on project obligations'. In our experience, two of the key factors leading to disputes are delays in environmental clearances and problems in land acquisition. In such scenarios, it becomes difficult to apportion blame for default on project obligations leading to complex disputes. In addition, the slow nature of the judicial and arbitration process (that often lacks urgency) makes the resolution of any commercial dispute in India even more time consuming and costly.

An example is the dispute regarding termination of a leading infrastructure group's Concession Agreement by an African Government in November 2012. The Arbitration process, seated in Singapore, went on for about 15 months and an award was made in favour of the group in June 2014, as reported by the news media⁸. In contrast, the dispute regarding termination of a large slum rehabilitation project by a domestic airport operator, being run in India, is still in early stages of the arbitration process and it may take much longer for the arbitration process to reach an award stage⁹.

Another example that indicates the long drawn out nature of arbitration in India is the dispute between a large oil and gas conglomerate and the Government of India over allocation of gas blocks. The appointment of arbitrators itself has been controversial, as reported by the news media¹⁰. Almost three years after commencement of the dispute, the two sides have not been able to agree on the panel of arbitrators. Both the parties have appointed their nominees to the panel but are fighting a case in the Supreme Court over appointment of the third arbitrator.

Arbitration clauses in contracts are often one sided and not defined comprehensively. These clauses mostly do not specify the qualifications of the arbitrator nor do they talk of a time frame in which the process is to be concluded. Another key challenge in the dispute resolution mechanism in India is the non-binding nature of arbitration awards. The enforcement of the award in India tends to have its own challenges. The party on the losing side of the arbitration process tends to opt for further litigation by challenging the award on technical grounds thus leading to costly and delayed dispute resolution.

Take for instance, the dispute between a leading road infrastructure provider and the regulatory body regarding bonus payment for early commencement of operations. It took almost 5 years for an award to be granted in the infrastructure provider's favour. However, this was challenged by the regulator not only in the High Court but also in the Supreme Court, further delaying the resolution of the dispute¹¹.

In India, arbitration has often been cited as the most preferred option for dispute resolution with bilateral negotiations and mediation taking a back seat, whereas, globally, bilateral negotiation ranks as the most preferred method of dispute negotiation followed by mediation and then arbitration. This may also partly explain faster dispute resolution in Europe and other countries as compared to India¹².

6 Indian Road Construction Industry Report, November 2008

7 Global Construction Disputes: Getting the Basics Right, ARCADIS fourth Annual report

8 Source: <http://www.livew.in/big-relief-gmr-arbitration-award-favour-gmr/>

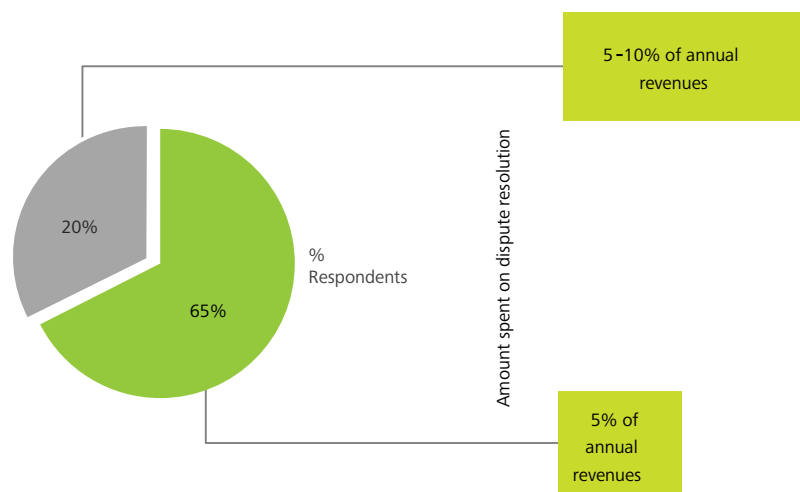
9 Source: <http://www.livemint.com/Companies/bbxW332uVghKQwCDLVofEI/Mumbai-slum-development-project-hangs-in-the-balance.html>

10 Source: http://articles.economictimes.indiatimes.com/2014-07-20/news/51780215_1_third-arbitrator-kg-d6-oil-ministry

11 Source: http://articles.economictimes.indiatimes.com/2010-09-17/news/27570459_1_nhai-national-highway-authority-road-project

12 Source: <http://www.echarris.com/pdf/EC%20Harris%20Construction%20Disputes%202013Final.pdf>

Infrastructure sector disputes are getting costly



Source: Deloitte Forensic survey on managing fraud and dispute challenges in the infrastructure sector.

Managing fraud risks

Given the impact of fraud on business, infrastructure companies would like to mitigate fraud, if not prevent it completely. When we asked survey respondents to identify best practices that they felt could help prevent fraud, 70 percent of respondents chose whistleblower hotline for vendors, customers and employees as the preferred mechanism. Historically companies in India have been hesitant in extending whistleblower hotlines to third parties. However, in sectors like infrastructure with a large number of third party dependencies, it is prudent to extend the hotline to them. In our experience, significant percentage of fraud related tips can come through third parties. However, the protocols and control mechanisms need to be controlled so that frivolous complaints are discouraged.

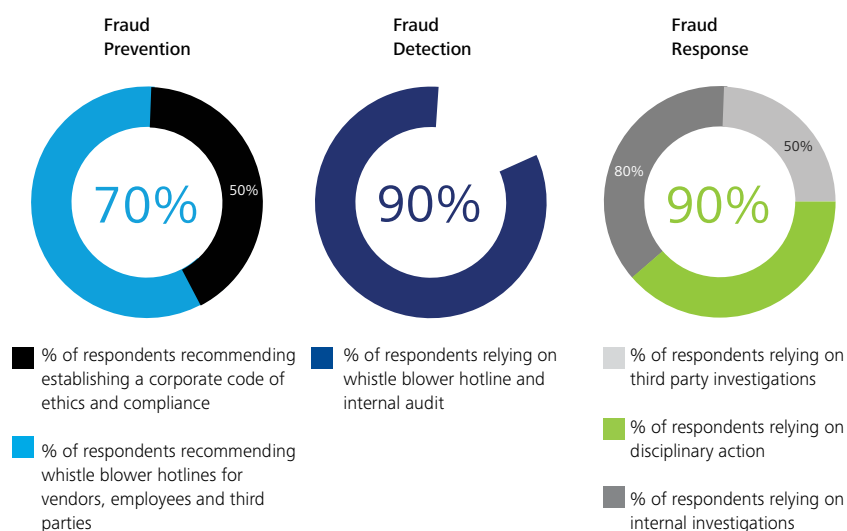
Around 50 percent of survey respondents preferred enforcement of a corporate ethics code, annual compliance checks and proactive fraud risk assessment as effective fraud prevention mechanism. This is a welcome step as companies have traditionally been wary of using proactive means like fraud risk assessments mainly because the gains from such an exercise are likely to be visible only over 18-24 months. Companies can also refer to the Project Anti-Corruption System (PACS), which is an integrated and comprehensive system designed by Transparency International and the Global Infrastructure Anti-Corruption Centre (GIACC) to assist in the prevention and detection of corruption on construction projects. PACS recommends anti-corruption measures such as independent monitoring mechanism for construction projects, adequate pre contract disclosure procedure and regular audits to identify inconsistencies/red flags.

In the area of fraud detection, almost 90 percent of survey respondents across large and small infrastructure companies said that they relied on whistleblower programs and internal audits as early warning mechanisms to detect fraud, followed by information technology related controls. While this is in line with global trends, it is surprising that none of the survey respondents highlighted the use of data analytics as a means to detect fraud.

A plausible reason could be the complex requirements of infrastructure projects and the fact that Enterprise Resource Planning (ERP) systems are not used extensively at project sites. Our experience across different industries suggests that data analytics can become an important

tool to help organisations detect fraud in its early stages. Today, companies capture large amounts of data during the routine course of doing business. This data not only covers vendors, employees and other third parties but also various approvals that are enabled through the ERP system. A set of well-designed queries on the database is likely to provide meaningful insights into patterns covering business decisions, employee/vendor behavior and can bring significant red flags to light that could be used to plan targeted internal audit and fraud management procedures.

Best Practices followed by the infrastructure sector



Source: Deloitte Forensic survey on managing fraud and dispute challenges in the infrastructure sector.

In our experience, organisations in the infrastructure sector are at different levels of maturity in terms of capturing data through ERP systems. Most organisations capture only limited data on projects and even of them, a few use the limited data captured for meaningful analysis. Organisations need to draw up a dynamic analytics framework to turn the data into meaningful information. For example, toll collection data, through customized queries, can help identify red flags that indicate incorrect classification of vehicles, incorrect use of round trip passes, incorrectly exempted vehicles, time of day toll collection patterns and various other parameters that could indicate revenue leakage at the toll plaza. Similarly, a contract compliance framework can help organisations to not only manage leakages/over-runs during construction and operation of an asset but also manage non-compliance and dispute risk. Data captured on key contract parameters can



help organisations track violation of contractual terms related to timelines and quality across multiple contracts during construction, thereby saving penalties running into crores of rupees. Companies operating assets like airports or commercial complexes can better manage revenue sharing contracts through analytics on revenue patterns, space management and waivers granted on delayed payments, anomalies in promotional schemes and much more.

When asked how infrastructure companies respond upon the detection of fraud, 90 percent of survey respondents said they conduct internal investigations, while 50% said they considered appointing third party investigators. While internal investigations ensure that the fraud/suspected fraud issue is known only to insiders, it is possible that the suspect may get to know about the investigation or that the suspect may be victimized. Organisations, therefore, need to carefully consider these aspects before commencing internal investigations.

Around 80 percent of survey respondents also favored prompt disciplinary action against the fraudster. This is particularly important as prompt management action sends a clear message that the organisation follows a zero tolerance approach to fraud. According to several research studies, in an average organisation, only 10 percent employees are likely to be always ethical, whereas 80 percent are likely to be ethical depending on the situation¹³. A strong zero tolerance approach coupled with the message that the organisation is vigilant about frauds and will prevent most employees from acting unethically.

13 Source: http://www.ethics.org/files/u5/The_National_Government_Ethics_Survey.pdf

Conclusion: To fight fraud, be proactive

The current investment sentiment in the infrastructure sector in India is grim considering the fraud and dispute environment that companies are operating in. About 60 percent of our survey respondents believe that the current situation will either significantly or drastically dampen the investment climate in the sector. This has been evident in the past few years as investments in certain key projects have dried up with companies walking out of several private-public partnership projects that faced delays.

The new government is taking steps to mitigate this scenario by leveraging the sector as a means to increasing the growth rate for the economy. It is also discussing changes in the regulatory framework, particularly making the process of obtaining environmental clearances more transparent, and has sent changes on the Land Acquisition Act for Cabinet approval. Additionally, other legislations like the Prevention of Corruption Act (amendment) Bill, 2013, the Whistle blowers Protection Act, 2011, and Prevention of Bribery of Foreign Public Officials and Officials of Public International Organisations Bill, 2011, are all aimed at significantly curbing the menace of bribery and corruption and are expected to benefit the infrastructure sector, if enforced in the right spirit. These legislations can provide a robust legal framework that can foster an ethical environment for doing business.

The practical implementation of these regulatory frameworks will be watched closely by key players in the sector.

On their part, organisations have understood the need to be proactive in mitigating fraud risks by developing a strong code of ethics and conducting regular fraud risk assessments to strengthen controls at project sites. Additionally, they should also develop a strong whistleblower mechanism accessible by third parties to enable early detection of fraud. Proactive steps and an early warning mechanism will go a long way in curbing fraud losses.

Organisations also need to re-think the mechanism and process followed for dispute resolution. The key to a faster dispute resolution process is communication between the parties on the contract and an amicable bilateral solution that appreciates the challenging business environment for either party. Organisations should also focus on defining a water-tight arbitration clause as prolonged litigation benefits no one. While it is easy to blame third parties for the current scenario, change must come from within. Infrastructure companies in India are learning the hard way.

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