

For information

Legislative Council Panel on Environmental Affairs

301DS – East Kowloon sewerage, stage 2

Purpose

On 19 March 2001, the Administration sought the Panel's views on its proposal to invite Public Works Subcommittee to recommend to Finance Committee to increase the approved project estimate (APE) of Public Works Programme Item 301DS, namely "East Kowloon sewerage, stage 2", from \$162.5 million to \$225.5 million. The increase is to cover additional costs arising from the poor performance by the forfeited contractor and voluntary liquidation, as well as additional nightworks to be undertaken. During the meeting, Members requested the Administration to provide further details on why the Government did not forfeit the first contract earlier in view of the persistently poor performance of the contractor, the policy of re-entry, statistics on the forfeiture of Drainage Services Department (DSD) contracts, financial position of the project, and the use of sewage charges for providing sewage services. This paper aims to provide Members with the said information.

Performance of the First Contractor and Actions Taken by Government Against the Contractor

2. Since the first contract commenced in March 1996, the contractor's performance had generally been poor. The main concern was that the contractor was unable to maintain continuously a reasonable rate of works progress. As soon as DSD and its Consulting Engineer were aware of the problem in end 1996, they undertook a series of contractual and administrative measures to urge the contractor to improve its performance as soon as possible and to mitigate delays. The contractor responded by improving his performance every time actions were taken by DSD. However, the contractor could not sustain the momentum of improvements and performance would again deteriorate shortly afterwards. DSD maintained pressure on the

contractor for improvements until the end of 1998 when the contractor finally went into voluntary liquidation.

3. DSD understood from the contractor that he was suffering from cashflow and financial difficulties. This led to insufficient resources being deployed by the contractor and resulted in poor work progress. In view of the poor performance, DSD considered the appropriateness of re-entry action but did not take this step for the following reasons:

- (a) As a general policy, Government only forfeits a contract as a last resort if there is no other better alternative. This is because Government would incur substantial additional costs after expulsion of a contractor and re-entry of sites. There would also be a long period of delay in arranging for re-tendering the remaining works and mobilising a new completion contractor to re-commence the works. In the interim period, there would be additional expenses for taking care of and maintaining the sites. Moreover, the costs of completing the remaining works would usually be higher under a completion contract. If the defaulting contractor is in a poor financial situation, the possibility of claiming damages from the contractor for the additional expenditure is usually limited. Re-entry action is therefore only considered when there is no other better alternative to ensure the earliest completion of the works at the lowest cost.
- (b) The contractor's performance was assessed regularly in every reporting period (initially this was quarterly but assessment was stepped up to six-weekly for closer monitoring when the performance of the contractor was found to be consistently poor). Assessment of whether progress was satisfactory in a reporting period was done by measuring the amount of works actually completed against the amount which was planned to be completed in accordance with the works programme. Although the overall progress of the contract had been unsatisfactory, the contractor was able to achieve at least around 50% of the programmed works during most of the reporting periods. On a few occasions, he even managed to achieve progress better than what was required under the works programme. A summary of the percentage of programmed

works completed during various reporting periods from September 96 to October 98 is given below:

Reporting Periods	% of Programmed works completed
1.9.96 – 30.11.96	25%
1.12.96 – 28.2.97	54%
(1.3.97 – 15.4.97 [*])	Over 100%
(16.4.97 – 31.5.97 [*])	100%
1.6.97 – 31.8.97	46%
1.9.97 – 30.11.97 [*]	52%
(1.12.97 – 15.1.98 [*])	Over 100%
16.1.98 – 28.2.98 [*]	52%
1.3.98 – 15.4.98 [*]	78%
(16.4.98 – 31.5.98 [*])	Over 100%
1.6.98 – 15.7.98 [*]	65%
16.7.98 – 30.8.98 [*]	62%
(1.9.98 – 15.10.98 [*])	Over 100%

(Reporting periods shown in brackets indicate that the contractor had managed to achieve good progress in these periods.)

Before the contractor went into voluntary liquidation, he had completed a total of 9.5 kilometres of sewers and rectified 130 expedient connections. These represented 68% and 59% respectively of the works required in the contract. In order to tighten control over the contractor, the Consulting Engineer had held weekly progress review meetings with him since December 1996 (instead of the usual practice of monthly meetings). DSD and the Consulting Engineer also held frequent ad-hoc meetings with the contractor to urge him to improve his performance. To allow the Government to step up monitoring on the performance of the contractor, the Consulting Engineer was instructed to submit weekly reports on the lengths of pipe laid and labour resources since July 1998. Even in the reporting period immediately before the contractor went into liquidation, i.e. from early September to mid

* To enhance monitoring of the contractor's performance, DSD had stepped up the reporting period from quarterly to six-weekly.

October 1998, there was a marked recovery in the performance and work progress of the contractor. After carefully reviewing the contractor's performance in each period, it was considered that there were insufficient grounds to exercise the drastic contractual action of forfeiting his contract and re-entering the sites at any time before the contractor went into voluntary liquidation.

- (c) In response to DSD's continuous pressure for improvements to his performance, the contractor had made constructive proposals to expedite works progress, for example by using trenchless technology in laying sewers and by deploying additional resources. Some of these proposals did result in periods of good progress.
- (d) In early 1998, there were signs that the contractor was suffering from very serious financial problems which apparently were not being resolved. DSD did consider taking re-entry action and a warning letter to that effect was issued in March 1998. On that occasion, the contractor had successfully brought in a major investor to inject funds and there were signs that the new financial support would be able to revive the company and hence effect substantial improvement to progress. Indeed this was followed by a period of marked improvement in progress.

Financial Position

4. The project commenced in March 1996 and was originally funded under the Sewage Services Trading Fund (SSTF) at an estimated cost of \$262.0 million. The SSTF was wound up on 31 March 1998 before the project was completed. A total amount of \$107.7 million was spent under the SSTF before its closure. The Finance Committee approved the creation and direct inclusion of 301DS "East Kowloon sewerage, stage 2" in Category A on 27 February 1998 for completing the remaining works upon closure of the SSTF. The approved project estimate (APE) for 301DS at the time was \$162.5 million

5. The contract sum of the first contract was \$144.5 million. The first contractor went into liquidation on 27 November 1998 and Government re-entered the sites on 11 December 1998. A total sum of \$103.2 million had been

paid to the contractor, with \$83.4 million funded by the SSTF (prior to its closure on 31 March 1998) and \$19.8 million funded under 301DS (paid before the voluntary liquidation of the contractor).

6. The remaining works upon forfeiture were included in a completion contract which was re-tendered and finally awarded in June 1999. The awarded contract sum of the completion contract was \$99.8 million but the part of the works funded by 301DS was estimated to cost \$86.5 million.

7. In addition to the \$19.8 million paid to the forfeited contractor and the estimated expenditure of \$86.5 million under the completion contract, other expenses were incurred under 301DS, including the cost of emergency works arising from the re-entry of sites and consultants' fees. As such, the estimated expenditure under 301DS at the time of award of the completion contract was \$160.1 million. Since the estimated expenditure under 301DS was within the APE of \$162.5 million, DSD therefore did not revert to the Legislative Council for additional funds at that time.

Policy on Re-entry

8. The poor performance of contractors does not by itself warrant a re-entry action. Government takes re-entry action only when there is a clear sign that the contractor is unable or unwilling to fulfill his contractual obligations under the contract. Re-entry is usually the last resort as it has significant adverse impact on the programme and the cost of the works; and there is always a risk that Government might not be able to fully recover its loss from the contractor should the latter declares bankruptcy. We therefore cannot solely rely on performance indicators, such as whether the contractor can achieve a certain milestone by a pre-set date or whether a certain number of adverse reports have been issued to the contractor, in making a re-entry decision. Instead, we need to rely on the judgement of the professional staff managing the contract on whether the contractor is willing to or capable of completing the works. Government can also protect its interests under the contract by claiming liquidated damages for any delays caused by the contractor.

Statistics and Reasons for Re-entry of Contracts

9. During the past three years, 4 contracts managed by DSD were forfeited out of a total of 151. A table showing information on these forfeited contracts are given below:

Contract Description	Commencement date Of contract	Original completion date	Date of forfeiture of contract	Forecast completion date	[@] Original APE (\$ million)	[@] Latest project estimate (\$ million)
East Kowloon sewerage, stage 1 phase 2	22.6.95	20.2.97	13.5.98	Aug. 01	25.4	18.8 [#]
Drainage maintenance and construction in HK Islands and Outlying Islands	27.3.96	26.3.98	19.12.98	Outstanding works order completed by other term contractors	Funded by the recurrent vote. Payment withheld is enough to set off additional costs in completing the outstanding works orders.	
East Kowloon sewerage stage 2	6.3.96	4.2.98	11.12.98	Oct. 01	162.5	225.5
Construction of sewers, sewage pumping station and rising mains in Sai Kung	14.5.97	13.5.99	8.12.98	June 01	105.0	87.0 [#]

10. The reason for the forfeiture of the 4 contracts was that the concerned contractors suffered from serious financial difficulties and most of them eventually went into liquidation within the years of 1998-99. Out of the four

[@] These estimates, except for the contract for drainage maintenance and construction in HK Islands and Outlying Islands, refer to the estimates of the project items under which the forfeited contracts were funded.

[#] Although additional cost was incurred by Government as a result of the contract forfeitures, the latest project estimate was still within the APE of the concerned project.

contracts, 3 were sewerage projects. The present project, i.e. East Kowloon sewerage stage 2, is the only one whereby a forfeiture has led to a need for an increase in APE.

Sewage Charging and SSTF

11. Since the introduction of the sewage charging scheme in 1995, all revenue collected through the scheme has contributed to only the operating and maintenance costs in providing sewage services. However, it should be noted that in 1999/2000, sewage charges recovered only about half of the annual operation and maintenance costs.

12. Before the closure of the SSTF in 1998, implementation of the capital works, viz. Stage I of the Harbour Areas Treatment Scheme (HATS) and the related Sewerage Master Plan (SMP) works, were financed by the SSTF with funds injected from the Capital Investment Fund. The capital works account was kept separate from the operating and maintenance account for the provision of sewage services under the SSTF.

13. Upon closure of the SSTF, the remaining funds under the capital works account were returned to the Capital Investment Fund. On 27 February 1998, the Finance Committee approved the creation and direct inclusion of a series of items in Category A under the Public Works Programme to complete the remaining works of Stage I of the HATS and the related SMPs.

Environment and Food Bureau
Drainage Services Department
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