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Legislative Council
Panel on Transport

**Subcommittee on matters relating to the
implementation of railway development projects**

Minutes of meeting on
Monday, 4 February 2002, at 2:30 pm
in Conference Room A of the Legislative Council Building

Members present : Hon Miriam LAU Kin-ye, JP (Chairman)
Ir Dr Hon Raymond HO Chung-tai, JP
Hon CHAN Kwok-keung
Hon LAU Kong-wah
Hon Andrew CHENG Kar-foo
Hon TAM Yiu-chung, GBS, JP
Hon Abraham SHEK Lai-him, JP
Hon Tommy CHEUNG Yu-yan, JP
Hon Albert CHAN Wai-yip
Hon LEUNG Fu-wah, MH, JP
Hon LAU Ping-cheung

Non-Subcommittee members attending : Hon LEE Cheuk-yan
Hon NG Leung-sing, JP
Hon James TO Kun-sun
Hon CHAN Yuen-han, JP
Hon Andrew WONG Wang-fat, JP
Hon Emily LAU Wai-hing, JP
Hon LI Fung-ying, JP
Hon Michael MAK Kwok-fung
Dr Hon LO Wing-lok

Members absent : Hon LAU Chin-shek, JP
Hon WONG Sing-chi

- Public officers attending** : Transport Bureau
Mr Nicholas NG
Secretary for Transport

Mr Arthur HO
Deputy Secretary for Transport
- Attendance by invitation** : Kowloon-Canton Railway Corporation (KCRC)

Mr Michael TIEN
Chairman, KCRC

Mr K Y YEUNG
Chief Executive Officer, KCRC

Mr James BLAKE
Senior Director, Capital Projects, KCRC

Mr Samuel LAI
Senior Director, Finance & Management, KCRC

Mr Leo MAK
General Manager, Railway Systems (Ag), KCRC
- Clerk in attendance** : Mr Andy LAU
Chief Assistant Secretary (1)2
- Staff in attendance** : Mr Jimmy MA
Legal Adviser

Ms Pauline NG
Assistant Secretary General 1

Miss Connie FUNG
Assistant Legal Adviser 3

Ms Alice AU
Senior Assistant Secretary (1)5
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I West Rail project update - contract management

(LC Paper No. CB(1)987/01-02(01) - Information paper provided by the Administration)

The Chairman stated that in view of wide public concern about the Kowloon-Canton Railway Corporation (KCRC)'s handling of the West Rail (WR) telecommunications systems contract (DB-1500) awarded to Siemens Limited (Siemens) and the 27 supplemental agreements (SAs) with contractors for 18 WR contracts costing about \$1,536 million, the Subcommittee had convened the present meeting to discuss the related matters with the Administration and KCRC.

Declaration of interest

2. Ir Dr Raymond HO declared interest as his company was one of the contractors of KCRC but he was personally not involved in any of the works undertaken for KCRC. As far as he knew, his company was not involved in any of the concerned WR contracts. He also declared interest as Mr James BLAKE, Senior Director, Capital Projects of KCRC (SD/CP, KCRC), was formerly a senior personnel of his company some ten years ago.

3. Mr LAU Ping-cheung declared interest as his company was one of the consultants engaged by KCRC. As far as he knew, his company was not involved in any of the concerned WR contracts.

Opening remarks by the Secretary for Transport

4. At the invitation of the Chairman, the Secretary for Transport (S for T) briefly introduced the paper provided by the Administration (LC Paper No. CB(1)987/01-02(01)). He stated that the Administration was mindful of the need to strengthen KCRC's corporate governance structure as well as the functions of its Managing Board. For this purpose, the Administration had introduced the Kowloon-Canton Railway Corporation (Amendment) Bill 2001 last year to separate the duties and functions of the Chairman and the Chief Executive of KCRC so that the Corporation would be better prepared to meet the challenges ahead both in terms of network expansion and service improvement.

5. Regarding contract DB-1500, S for T said that the Administration was also gravely concerned about the Corporation's tender evaluation and contractual performance monitoring systems. In view of the importance of the matter, the Administration had approached the newly-appointed Chairman of KCRC and suggested that a thorough investigation be conducted so that necessary follow-up actions could be taken to strengthen relevant work in these respects for future projects. As a result, the Managing Board had decided to appoint KCRC's external auditors to investigate into the matters pertaining to contract DB-1500 and the 27 SAs.

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Statement made by the Chairman of KCRC

6. Acknowledging the wide public concern on the WR contracts, Mr Michael TIEN, the Chairman of KCRC, stressed that the first priority of his work as the new Chairman of KCRC would be to ensure that railway projects being undertaken by the Corporation were implemented in a cost-effective and efficient manner so that the public money involved would be worthily spent. In this connection, he had intended to carry out a comprehensive review on the existing mechanism for the evaluation, award and management of contracts by KCRC. After the incident with the Siemens contract had come to light, the Managing Board accepted his suggestion that the Corporation's external auditors, KPMG, be engaged to conduct a thorough investigation into the Corporation's tender evaluation and contractual performance monitoring systems in connection with contract DB-1500. The investigation was expected to be completed within eight weeks. In addition, KPMG was also asked to investigate and report on the 27 SAs for 18 WR contracts.

7. The Chairman of KCRC assured members that the public would be given a clear account of the matter after the investigation was completed. The Managing Board would also carefully review the findings and recommendations of KPMG's report so that all necessary steps would be taken to strengthen contract management for future works. In this connection, he said that with concerted effort from all parties concerned, satisfactory progress was achieved for the WR project. He hoped that with continued support from both LegCo Members and the public, the WR project would be completed on schedule and within budget.

8. As a separate issue, the Chairman of KCRC said that since taking up office, he had reviewed the Corporation's need on fare increases in 2002. Taking into account the changing circumstances, he considered that it would not be appropriate to effect any fare increase in such difficult times and the Corporation should explore alternative ways to alleviate the pressure for fare increases. In this respect, he had taken up the matter with the KCRC Management. After further consideration, the Management was hopeful that savings could be achieved by implementing a series of cost-cutting measures. He said that the matter would be raised at the Managing Board's forthcoming meeting in February for discussion. Both Mr CHENG Kar-foo and Mr LEE Cheuk-yan welcomed the Chairman of KCRC's decision to review the need for fare increase in 2002. They hoped that an early decision could be made by the Managing Board.

Contract DB-1500

9. At the invitation of the Chairman, SD/CP, KCRC recapitulated the events in connection with the award of contract DB-1500 to Siemens and the subsequent negotiations held between the two parties. He set out the chronology of events as follows:

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Event/Date	Activities
Pre-qualification exercise	Five companies including Siemens were shortlisted.
Tender evaluation	Tenders were submitted by three pre-qualified companies. After detailed study by the Corporation's technical and financial assessment teams, two conforming tenders were identified. The lowest conforming tender submitted by Siemens was 37% lower than the second lowest conforming tender. Notwithstanding the substantially lower tender price, the overall view of the assessment team was that given the size, background and ability of Siemens and the fact that its tender was conforming, there was no reason not to award the contract to Siemens. Not to do so would be in contravention of the provisions in the World Trade Organization (WTO) Agreement on Government Procurement which required that having examined in care all of the relevant background, the award should go to the lowest conforming tender. The Corporation might also be subject to a bid challenge by Siemens. The view of the assessment team was subsequently supported by the Corporate Tender Board.
Award of contract	Contract DB-1500 was awarded to Siemens in the sum of \$287 million.
During 2000	Siemens fell behind on works for the development of software for three of the seven systems under the contract, namely, the public address system, the passenger information display system and the closed circuit television system.
December 2000	The Corporation accepted Siemens' proposal to employ a specialist subcontractor to undertake software development for the three systems.
January 2001	The progress in developing software and meeting targets was still slipping. The General Manager, Railway Systems visited Germany to discuss with Siemens and obtained certain commitments on performance.
May/June 2001	Another visit to Germany was paid by the Director of West Rail to hold further technical

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Event/Date	Activities
	discussions with Siemens. Confirmation of actions was obtained and further measures to monitor the work of Siemens and its subcontractor were secured.
September 2001	The specialist subcontractor in question was still unable to deliver the work. The Vice President in charge of the Transport Group of Siemens came to Hong Kong to hold discussions with the Corporation. Further commitments were obtained. However, it was quite clear at that stage that Siemens and its subcontractor would be unable to meet their end-of-the-year requirement for factory acceptance tests and hence, the very important first key date in March 2002 might not be achieved. The situation had become so serious that it was putting the whole WR project at risk.
November 2001	The critical software development programme for the three systems was some 13 weeks behind schedule. There was no legal basis for terminating the contract but the Corporation was of the view that this situation could not be allowed to continue if the target completion date for WR was to be met. The Managing Board thus accepted the Management's advice to negotiate a commercial settlement with Siemens. A negotiating team was formed and went to Germany to negotiate with Siemens' top management. Following three days of negotiations between 23 November 2001 and 27 November 2001, an <i>ad referendum</i> agreement was reached. The Corporation had agreed to pay the sum of \$100 million to Siemens for variations, settlement of claims and recovery of time lost.
December 2001	The <i>ad referendum</i> agreement was approved by the Corporation's Managing Board.

10. Members in general were dissatisfied that under the SA approved by the Managing Board, an additional \$100 million was paid to Siemens as compensation for mistakes on its part. While considering that the settlement was unjustified, they were concerned that the spirit of contracts had not been upheld and that the incident might have far-reaching consequences on the tendering system. Some members opined that the incident might prompt other contractors to make use of the loophole to bid for

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contracts at low price, and then deploy the same delaying tactic in the hope of getting extra payment for delay recovery measures, given the Corporation's intention to complete the WR project on schedule at all costs. Some other members opined that the senior management should be held accountable for the incident. Further, S for T and the Secretary for the Treasury (S for Tsy), being the Government's representatives in the KCRC Managing Board, had failed to perform a monitoring role to oversee the Corporation's affairs for the purpose of safeguarding public interest and to ensure the prudent use of public funds by the Corporation. A summary of discussions was set out below.

11. Given the contractual obligations of Siemens, Miss CHAN Yuen-han opined that the Corporation should stand firm in its position and hold the contractor responsible for the delay by claiming damages. Hence, she found it quite absurd that the Corporation should instead compensate Siemens for its mistakes. Emphasizing the importance of Government oversight on contract matters, she asked whether back-up support within the Government such as technical advice from the Architectural Services Department was available for S for T and S for Tsy in their scrutiny of WR contracts to be entered into by the Corporation.

12. In response, S for T stressed that the matter was taken seriously by the Administration. That was why the Administration had approached the Chairman of KCRC in the first place suggesting that a thorough investigation be conducted. Once the investigation was completed, the Administration would carefully review all the findings and recommendations, and take follow-up actions as necessary.

13. In respect of the role played by the two public officers on the KCRC Management Board, S for T explained that similar to other KCRC Board Members, S for T and S for Tsy were required to act in good faith in the interest of the Corporation. The functions of the Managing Board were exercised by all Members of the Board collectively. As such, S for T and S for Tsy had the same roles and responsibilities as other Board Members. However, being S for T, he had the additional responsibility of ensuring the compliance of all terms and conditions set out in the project agreement signed between the Government and KCRC for the implementation of railway projects. In the case of WR, it would involve overseeing the performance of KCRC as well as the relevant government departments under the project agreement to ensure that WR was completed on schedule, within budget and up to the required safety standard. Hence, he emphasized that control and oversight would be exercised at two levels, one level in his capacity as a Board Member and the other as S for T. As far as the scrutiny of contracts was concerned, S for T advised that it would come under KCRC's responsibility. The Administration would not interfere in the day-to-day operation of the Corporation.

14. Expressing serious dismay with the way in which contract DB-1500 was handled by the Administration and KCRC, Mr Albert CHAN opined that three very important principles, viz. Hong Kong's dignity, the integrity of Hong Kong's tendering system and the sanctity of the spirit of contracts had been sacrificed in the course of

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the Corporation's desperate attempt to bring the WR project on track. Thus, the adverse impact resulting from this incident far outweighed any loss that might be incurred by the late opening of WR. Mr CHAN also queried whether the highest level of Government including the Chief Executive of the Hong Kong Special Administrative Region (CE) was being properly informed of and supported the KCRC Managing Board's decision.

15. In response, S for T did not agree that the Corporation was going to extreme to achieve target opening of WR. As the WR programme was formally agreed by the Government and KCRC, KCRC was obliged to complete the project on schedule and within budget. However, he stressed that the Corporation would only take reasonable actions to achieve this objective. Having carefully considered all relevant factors including the data and assessments submitted by the Management, the Managing Board collectively came to the reluctant decision that a commercial settlement with Siemens represented the best possible way out at that moment. It was a reasonable decision to make considering all the surrounding circumstances. The Government's primary concern was that after resolving the problems in connection with contract DB-1500, the progress of the WR project would be recovered to achieve target opening in 2003.

16. S for T further stated that as the implementation of WR was entrusted to KCRC, all matters in connection with the WR project such as tender preparation, contract management, etc. would come under KCRC's duties and responsibilities. Hence, it was not necessary for CE to get involved in the decisions made by the Managing Board.

17. Referring to paragraph 6 of the paper provided by KCRC (Annex to LC Paper No. CB(1)987/01-02(01)) which stated that "九鐵願意承擔西門子因採取措施彌補工程失誤所可能引致的合理費用", Mr CHENG Kar-foo expressed serious concern that KCRC was making use of public monies to "compensate" for Siemens' non-performance and commercial misjudgement. Instead of being penalized for the delay, Siemens was "awarded" with additional payment. As he saw it, the Corporation's handling of contract DB-1500 was tantamount to endorsing the contractor's mistakes. Echoing similar views, Mr LAU Kong-wah considered it unfair for KCRC to pay an extra sum for delay recovery of 3 sub-systems, bearing in mind Siemens was at fault at the outset. He was worried that other contractors would resort to the same delaying tactics in the hope of getting compensation from the Corporation. In this connection, Mr Tommy CHEUNG sought assurance from the Chairman or CEO of KCRC that no similar problems would be encountered for other WR projects.

18. Taking the view that a very bad precedent had been set in the Siemens contract, Mr LEE Cheuk-yan was worried that other contractors might deliberately hold up their works in the hope of getting extra payment for delay recovery measures. Given the Corporation's intention to complete the WR project on schedule at all costs, it would have no choice but to negotiate for settlement with the contractors. Sharing this view, Mr Albert CHAN was concerned about the measures that would be taken by the

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Administration and KCRC to prevent a recurrence of similar incidents for works projects in future.

19. In reply, the Chairman of KCRC said that as far as contract DB-1500 was concerned, he was quite convinced that it was Siemens' fault right from the beginning and this view had not changed. While acknowledging members' concern that the Corporation might be regarded as endorsing the contractor's non-performance by paying \$100 million to Siemens, he stressed that it was absolutely not the case. While \$35 million was the sum due to the contractor arising out of legitimate contractual entitlements for variations and historic claims, the remaining \$65 million was for introducing delay recovery measures to re-establish key dates. While the Corporation did not concur with Siemens' actions, it was one of those situations where at the eleventh hour, the Corporation had its hands completely tied. In the absence of better alternatives, the Corporation would have to negotiate a settlement with Siemens to ensure that the programme of WR project would not be adversely affected. In this respect, he said that the phrase “彌補工程失誤.....所引致的合理費用” in the Chinese version of the paper might not have conveyed the correct message to members.

20. To supplement, Mr K Y YEUNG, the Chief Executive Officer of KCRC (CEO of KCRC) said that according to the Corporation's calculations, \$65 million would be needed to make up for the 13-week delay. On Siemens' part, it was known that an extra \$131 million was incurred for replacing the under-performing specialist subcontractor and allocating extra resources to complete the work. Hence, the negotiating team had maintained its position that the Corporation would not compensate Siemens for the consequences of its commercial misjudgement. He further advised that the WR project was approaching an advanced stage with more than 90% of civil works completed. As most of the outstanding works were related to the railway systems, he considered it unlikely that similar problems which might result in additional SAs with the contractors would occur during the remainder of the programme.

Contract preparation and tender assessment

21. Ir Dr Raymond HO opined that as there were only two tenderers who could perform and deliver fully in conformity with the Corporation's specifications during tender evaluation, the Corporation should break up the contract into smaller work items and conduct a separate tendering exercise for participation of more companies.

22. In response, SD/CP, KCRC explained that for railway projects, system integration normally presented the biggest problem resulting in the greatest risk of delay. In the present case, the seven systems were all related to communications and there was integration between many of them. Hence, the decision was taken during the contract preparation stage that these systems would be lumped into a single contract to make the successful bidder responsible as the main contractor to integrate and manage the seven systems. To supplement, Mr Leo MAK, the General Manager,

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Railway Systems (Ag) of KCRC (GM/RS, KCRC) reported that the Main Control System had already been split into another contract. If the seven systems under contract DB-1500 were further divided into smaller contracts, the risk of interface management would increase substantially.

23. Given that there were only two technically conforming tenders and in view of the substantial difference in their tender prices, Ir Dr Raymond HO considered that the Corporation should have been more cautious in the award of contract DB-1500. As such, he queried the Corporation's judgement to go ahead and award the contract to Siemens under such dubious circumstances, particularly when there were clearly other options available. Echoing this view, Mr LAU Kong-wah queried whether any mistakes had been committed by the Corporation's senior management in coming to the conclusion that Siemens was able to deliver the work at the price quoted.

24. In response, CEO of KCRC stressed that the award procedures for contract DB-1500 were strictly in accordance with the Corporation's internal procurement rules. Guidelines for assessing exceptionally low tenders were also specified. The conclusion of the Corporate Tender Board was subsequently put to the Managing Board for approval before the contract was awarded to Siemens.

25. SD/CP, KCRC supplemented that at the time of award, the proposals from Siemens and the next lowest contractor were analyzed in considerable details by the technical assessment team, including visits to ensure that the tenderers were fully aware and capable of meeting the specifications. The conclusion at that time was that Siemens did have full understanding of the technical requirements. Notwithstanding the significantly lower bid price, Siemens had also given the assurance that all necessary resources would be deployed. Basically, under the WTO rules which the Corporation had to abide, there was little alternative but to award the contract to Siemens as the lowest tenderer. In this connection, CEO of KCRC said that various aspects of work carried out during the tender assessment stage would be clearly accounted for in KPMG's report. In this respect, Mr LAU Kong-wah requested KCRC to provide members with the report prepared by the technical assessment team after its visit to Germany in November 1999 before the contract was awarded. SD/CP, KCRC agreed to provide members with supplementary information on the details of work done by the Corporation during tender assessment as well as the report requested by Mr LAU.

KCRC

26. Responding to members' enquiry about the relevant WTO rules, CEO of KCRC explained that under Article XIII of the World Trade Organization Agreement on Government Procurement (WTO-GPA), an entity such as KCRC would have to award a contract to the lowest conforming tenderer. Had contract DB-1500 not been awarded to the lowest conforming tenderer, Siemens would have been entitled to claim that the WTO-GPA had been breached by the Corporation and consequently, might have issued a bid challenge. Such challenges if instituted in Hong Kong would then be heard by a specially convened Bid Challenge Review Panel.

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27. Ir Dr Raymond HO said that the WTO rule did not necessarily dictate the award to the lowest tender, and quoted the case for the Tsing Ma Bridge. CEO of KCRC responded that for Tsing Ma Bridge, the lowest tender did not conform with the tender requirements.

KCRC 28. At members' request, SD/CP, KCRC agreed to provide further information on the following:

- (a) details of the relevant WTO-GPA rules on awarding contracts to the lowest conforming tenderer; and
- (b) internal or external legal advice obtained by the Corporation that Contract DB-1500 would have to be awarded to Siemens, i.e. the lowest conforming tenderer, even though the tender price submitted was much lower than KCRC's estimated cost.

Terms and conditions of the contract

29. Ir Dr Raymond HO considered that the Corporation should have resorted to re-tendering the contract instead of negotiating with Siemens for commercial settlement. In this connection, he expressed grave concern about the lack of provisions in contract DB-1500 which would vest the Corporation with the right to re-tender the contract in case key dates or milestones were not achieved. Sharing this view, Mr LEE Cheuk-yan considered that when preparing the contract, the Management should have the duty to ensure that the Corporation's best interest was served.

30. Referring to the concept of "railway paramount" which dictated that railway operation should not be in any way impeded by construction projects, Mr Abraham SHEK said that the terms and conditions of WR contracts entered into by the Corporation should adequately safeguard the Corporation's right in taking actions to achieve WR's target opening, including the right to terminate and re-tender the contract and claim damages from the defaulting contractor. In response, Mr Samuel LAI, Senior Director, Finance & Management, KCRC said that "railway paramount" only applied to projects that might affect existing railway operation.

31. In reply, SD/CP, KCRC stated that the Corporation had already considered re-tendering during the process. However, according to the legal advice obtained by the Corporation, Siemens' failure to meet certain milestones did not in itself constitute a breach of contract. Notwithstanding the 13-week delay, Siemens was still trying to meet its endeavours and theoretically, the first key date in March 2002 could still be achieved. Hence, at that point of time, the Corporation was still not in a position to re-tender the contract from a legal point of view. To do so would mean that the Corporation was repudiating the contract and hence, giving cause to Siemens to take action against the Corporation.

32. CEO of KCRC also confirmed that the possibility of re-tendering had been

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examined by the KCRC Management. As Siemens was able to achieve satisfactory progress on the remaining four systems under the contract, legal advice obtained both internally and externally indicated that there were insufficient grounds to re-tender the contract. Under the circumstances, the Corporation had considered many relevant factors before coming to the decision to enter into negotiation with Siemens. Firstly, if nothing was done to turn around the situation, the opening of WR would be delayed resulting in a great loss of revenue for the Corporation. Secondly, as the WR contracts were inextricably linked with one another, any delay in the telecommunications systems contract might lead to claims from other contractors. After thorough discussion, the Managing Board came to the decision to negotiate a settlement with Siemens.

33. SD/CP, KCRC further explained that in accordance with normal practice, there were two means of control in KCRC contracts. Firstly, there were milestones which controlled the way in which payments were made to contractors. Each contract would be broken into different sections with different milestones. Throughout the programme, the Corporation would carefully monitor the milestones to ensure that the Corporation was not exposed to payments in excess of the value of work completed to that date. Secondly, there were key dates which were programme requirement, i.e. a certain amount of work would have to be completed up to that date. If the contractor failed to meet a key date, liquidated damages (LD) would immediately kick in against that key date. GM/RS, KCRC added that both milestones and key dates were set under contract DB-1500. As Siemens had failed to achieve certain milestones, payments had been withheld accordingly.

Contract management

34. Noting that by November 2001 when the matter was getting out of hand, a delay as much as 13-week was detected, Ir Dr Raymond HO queried whether the Corporation had exercised due care in contract management during the process. He opined that if the slippage was detected at an early stage with formal warnings issued to Siemens, negotiations could have started much earlier and hence, prevented the situation from escalating into a crisis which threatened the whole WR project.

35. To prevent similar incidents from recurring, Miss Emily LAU considered that the Corporation should be more vigilant in monitoring the progress of a contractor's work. In this respect, the Corporation might need to thoroughly review the terms and conditions of its contracts, particularly in respect of the requirements of milestones and key dates as well as the Corporation's right to re-tender in case of the contractor's under-performance. In response, the Chairman of KCRC said that he would further consider the member's view in the context of KPMG's findings and recommendations.

36. In reply, SD/CP, KCRC stressed that the Corporation had all along monitored the progress of contract DB-1500. The first alarm bell was rung as early as January 2001 when a formal warning letter was issued to Siemens. At that time, software development was about six weeks behind schedule. Arrangements had been made

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with Siemens to subcontract the software supply to Optical Network Limited (ONL) in addition to the hardware supply with a view to catching up the delay. However, the relationship between Siemens and ONL did not proceed as intended. It later emerged that throughout the process, the personnel in charge of the contract on the Siemens' side had not fully informed the Corporation's management team of the issues between Siemens and ONL. Hence, during the negotiations with Siemens, the Corporation had insisted that this particular individual be replaced and the control system be changed so that a more direct line of communication between Siemens and the Corporation was established.

37. The Chairman of KCRC added that negotiations of this sort were often quite delicate. Whenever the Corporation brought up the matter with Siemens, it managed to give commitments and promises with substantiation and deliver some work thereafter. But Siemens and its subcontractor were never able to recover the delay. While acknowledging that Siemens' international stature might have to a certain extent given its commitments added credibility, the Chairman of KCRC said that after reviewing the relevant documents, he considered that the Corporation could have taken tougher actions against Siemens. For these reasons, as part of the objective of the KPMC review, KCRC would pursue if there could be an earlier alarm system for better control in the future, for example, to allow the contract to be re-entered if certain milestones/key dates were not met.

38. Mr James TO was concerned about the kind of information, particularly those on the financial implications involved, made available to the KCRC Managing Board during the process. Ir Dr Raymond HO also asked whether any assessment had been made by the Corporation on a monthly basis to determine the possible ramifications of Siemens' delay on other WR contracts. In reply, SD/CP, KCRC stated that while no overall assessment had been made, the Corporation did carry out a risk assessment to determine the impacts on the WR project.

The negotiation

39. Referring to the three trips made by the Corporation's representatives to Germany for discussion with Siemens, Mr CHENG Kar-foo remarked that the Corporation might have been too obliging from the outset, and it had effectively put the Corporation in a very disadvantageous position during its negotiations with Siemens. Mr James TO also pointed out that while KCRC was eager to bring the WR programme on track, both Siemens' reputation and its chance to bid for other projects in Hong Kong were also at risk if it could not deliver the systems on schedule. Hence, the Corporation should have strong grounds to bargain with Siemens. He therefore asked whether the Corporation had thoroughly assessed the strategic positions of both sides at that time. Mr Tommy CHEUNG said that he would accept that it was the Corporation's commercial decision to come to a settlement with Siemens.

40. In reply, the Chairman of KCRC said that the points raised by members were all legitimate concerns and he had been asking the same questions himself. In this

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respect, he hoped KPMG's investigation would shed light on all these questions regarding the manifest problems with the Siemens contract and its settlement, such as the stance adopted by the negotiating team when it went to Germany in November 2001 and whether the right moves were made and the right decision taken on the spot. Notwithstanding, he said that for such contentious negotiations, both sides would no doubt carefully weigh up the situation and play their cards accordingly. As far as he knew, vigorous discussions did take place during the final round of negotiation with Siemens. While only those in the negotiation team would know for sure what factors had been taken into account during the whole process, his understanding was that it was of paramount importance to achieve target completion of WR. The negotiation team would thus be willing to consider any proposals within their mandate so long as the whole project would remain within budget.

41. To supplement, SD/CP, KCRC advised that the problem on claims for additional cost and time was addressed in Mr Henry TANG's report on the construction industry. While acknowledging that such claims were particularly common for railway projects which involved a complexity of interfaces, the report recommended that in the event that a dispute became inevitable, various means such as negotiation, mediation and arbitration should be identified to settle the matter as quickly as possible. The approach adopted by the Corporation was thus in keeping with the TANG report.

Damages and settlement

42. Mr James TO expressed appreciation for the Chairman of KCRC's sincere and forthcoming attitude in having a frank and open discussion with members. Given that Siemens' tender price was much lower than the second conforming bid, he questioned whether a 10% LD was sufficient to cover the loss that might incur in case of non-performance by the contractor. In this respect, Mr Abraham SHEK enquired about the difference between Siemens' tender price and the Corporation's pre-tender estimate.

43. SD/CP, KCRC replied that the Corporation's internal estimate was much higher than both of the lowest conforming tenders. While Siemens' tender was 37% lower than the second lowest conforming tender, that tender was only about 60% of Corporation's own estimate. The reasons for such a great difference had been exhaustively examined during tender assessment. To facilitate members' understanding, SD/CP, KCRC undertook to provide supplementary information in writing after the meeting.

44. To avoid similar incidents from recurring, Mr TO suggested that the Corporation should examine whether it was possible under the relevant WTO rules to increase the level of LD in case of exceptionally low bids so that the Corporation's interest could be better safeguarded.

45. Advising generally on the determination of LD for works projects, SD/CP,

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KCRC said that a 10% ceiling was more or less the standard practice in Hong Kong and it was consistent with the practice of government departments and similar corporations such as the MTR Corporation Limited. The LD was a pre-estimate of the genuine loss based on standard formulae, and could not be increased without violating the contract spirit. Even if a higher LD ceiling might be imposed, it could also deter contractors from submitting a tender. Even if they tendered, the price would be extremely high to cover the added risks. If the Corporation changed the LD ceiling after the bids were received, the contractors would also be entitled to revise their tender price. This might result in the Corporation having no tender on the table for consideration.

KCRC 46. Mr Abraham SHEK however did not agree that a 10% LD ceiling was a standard practice in the construction industry. Instead, the level of LD should be determined in such a way as to ensure the delivery of works by the contractor according to the programme. In this respect, he requested KCRC to provide members with information on the factors taken into account by KCRC in deriving LD and the documentation supporting KCRC's view that it was a common practice to set the level of LD at 10% of the tender price.

KCRC 47. Mr Tommy CHEUNG asked whether the Corporation could claim other damages from Siemens for all losses, such as loss of revenue, incurred for the delayed opening of WR. CEO of KCRC replied that for contract DB-1500, a performance bond and retention money, respectively calculated at 10% of the tender price, were held by the Corporation against the contractor in addition to the 10% LD. To supplement, SD/CP, KCRC advised that in case the opening of WR was delayed as a result of the contractor repudiating his obligations, that depending on the circumstances, could be a breach of contract, and the Corporation might recover general damages in respect of all of its direct losses. At members' request, SD/CP, KCRC agreed to provide supplementary information on the Corporation's legal position in this respect as well as relevant provisions in the original contract and SA entered into with Siemens, particularly those on LD.

(Post-meeting note: KCRC subsequently advised that the performance bond held against the contractor should be 20% of the tender price, instead of 10% as stated in the meeting.)

48. Mr LAU Ping-cheung considered that the execution of SAs by the Corporation might be acceptable under the circumstances. However, he was concerned about the safeguards being put in place to ensure that Siemens would meet its contractual obligations under the SA. In this respect, he asked whether there were provisions in the SA linking Siemens' performance under this contract with their other contracts for the WR project, so that the Corporation could withhold payments to Siemens for other contracts in case of their non-performance under this SA.

49. In reply, SD/CP, KCRC assured members that under the SA entered into with Siemens, requirements on Siemens' performance were particularized in great detail so

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that their progress could be closely monitored. Moreover, as part of the agreement, the entire structure of Siemens' organization in Hong Kong had been reviewed. As a result, Siemens had so far been performing in accordance with the agreement and the programme of WR opening was secured as far as the Siemens contract was concerned.

50. Noting that the 13-week delay was recovered within merely two months after the relevant SA was signed, Ir Dr Raymond HO was concerned that this might be indicative of Siemens' reluctance to overcome the delay in the first place without seeking compensation from the Corporation. In reply, SD/CP, KCRC explained that as a result of the agreement reached by both parties, the under-performing specialist subcontractor was replaced by three separate specialist subcontractors. Instead of developing a package of software to integrate the hardware for the three systems, the new specialist subcontractors were able to provide proven hardware and standard software requiring minimal customization. Siemens could then develop a simple software to link up the systems which had enabled it to recover the delay within a relatively short period of time.

The investigation

51. Referring to KPMG's role as the Corporation's external auditors and the conflicting roles played by the CEO of the Corporation in the whole incident, Mr CHENG Kar-foo was worried that the potential conflict of interests involved might jeopardize the integrity and impartiality of the investigations. In this connection, he called on the Chairman of KCRC to consider setting up an independent panel to undertake the investigation and to suspend the duties of the incumbent CEO of KCRC pending the completion of the investigation. Mr CHENG added that if any serious mismanagement was identified, CEO of KCRC should be held responsible personally and be dismissed. Mr Abraham SHEK however pointed out that the implementation of WR was not CEO of KCRC's only duty. He was also in charge of the operation of East Rail and Light Rail which provided a high quality of service for the passengers. Hence, he did not agree that CEO of KCRC should be suspended merely on account of the WR incidents.

52. In response, the Chairman of KCRC assured members that his prime concern was the quality of the investigation. He was confident that as an internationally-renowned auditing firm well-versed with commercial operations, KPMG would be capable of undertaking thorough and impartial investigations into the matter. KPMG's role as the Corporation's external auditor would be an added advantage as it could start the investigation right away without having to get familiarized with the Corporation's affairs. He further said that another consideration was the time taken to complete the investigation. As KCRC was an important public transport operator in Hong Kong serving more than a million passengers every day, he believed that it would be to the best interest of all parties concerned if the investigation was completed as soon as practicable. In this respect, he called for members' trust in his intention and determination to clear the matters up. While noting the explanation, Mr CHENG cautioned that the time requirement should not be allowed to compromise the integrity

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of the investigation.

53. The Chairman of KCRC further said that full co-operation from the Management which was headed by CEO of KCRC was pivotal in the success of the investigation. He was hopeful that the investigations would benefit from the CEO's support. He assured members that he would closely monitor the investigation and maintain daily contacts with the investigators. If the investigation was stonewalled in any way, he would get involved personally to ensure that all necessary information and assistance were provided to KPMG.

KCRC 54. Responding to Ir Dr Raymond HO, the Chairman of KCRC said that according to the instructions given to KPMG, the auditors would engage independent professionals with the requisite expertise to assist in their investigations. At Ir Dr HO's request, KCRC would provide members with the terms of reference of KPMG's investigation for information.

SAs

55. Given the substantial amount of additional payments arising out of the SAs for the WR project, Mr CHENG Kar-foo was doubtful as to whether S for T and S for Tsy had duly fulfilled their responsibilities. In this connection, he called on the Administration to adopt an open attitude and accept the criticism made by the public and learn from the mistakes in this incident so that improvements in respect of the monitoring and management of works contracts would be made. Moreover, the Administration should also review the existing system of tendering works projects by lump-sum contracts.

56. Mr LEE Cheuk-yan noted with dismay that including contract DB-1500, 15 out of the 27 SAs involved delay recovery measures, costing a total sum of \$647 million. Referring to some opinion from the engineering profession that the value of SAs should not normally exceed 10% of the contract sum, Mr CHENG Kar-foo considered that it should be a cause for concern if either the number or value of SAs for the WR project was unusually high. While stating that it was a common practice to enter into SAs for construction contracts, Ir Dr Raymond HO considered that valid grounds should be ascertained.

57. In reply, CEO of KCRC explained that the circumstances with the other SAs were different from the Siemens contract. As far as he knew, there were valid grounds for entering into SAs with the contractors, such as for carrying out delay recovery measures with the contractor having a valid case for extension of time, compensation due to the contractor because of unforeseen ground and other conditions, or remeasurement provisions.

58. Responding to Mr James TO's enquiry about the appropriation of risks between the Corporation and the contractor under the WR contracts, CEO of KCRC elaborated on the grounds for entering into SAs in respect of KCRC contracts. In the case of the

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WR project, the total value of SAs was around 9% of the construction cost, which was acceptable both in terms of Hong Kong's general practice and international standard. The Hong Kong Institution of Engineers had provided a support statement saying that these additional cost items would normally amount to 10% for capital projects of a similar scale.

KCRC 59. At members' requests, KCRC agreed to provide further information on the following:

- (a) detailed breakdown of the 27 SAs, including the original contract sum, the SA's value vis-à-vis the original contract sum, and the basis on which the SAs were approved by the KCRC Managing Board;
- (b) details of other WR contracts awarded to Siemens; and
- (c) details of MOS Rail contracts awarded to Siemens and the contractors of the 27 SAs.

KCRC 60. At Mr LAU Kong-wah's request, the Chairman of KCRC agreed to provide the following KCRC documents to facilitate members' consideration:

- (a) the two proposals presented to the KCRC Managing Board in September 2001 for resolving the situation as well as the document which gave the negotiation team the mandate of a maximum payment of \$98 million;
- (b) the memorandum submitted by the negotiating team after its final visit to Germany in November 2001; and
- (c) the report presented to the KCRC Managing Board seeking authorization for the \$100 million payment.

61. Responding to Miss Emily LAU, S for T advised that tenders submitted for the Sha Tin to Central Link were still being assessed. An announcement would be made in due course when the decision was finalized. However, he stressed that the bids would be assessed in an open manner under the principle of fair competition. In this respect, the Administration would only consider the proposals against the requirements set down in the tender documentation.

62. Members agreed that another meeting would be held on Thursday, 28 February 2002 at 4:30 pm to continue discussion with the Administration and KCRC. The Chairman reminded the Administration and KCRC to provide the information requested by members before the next meeting.

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II Any other business

63. There being no other business, the meeting ended at 5:45 pm.

Legislative Council Secretariat
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