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Panel on Transport

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

**Background Brief on Kowloon-Canton Railway Corporation
West Rail Contracts**

Purpose

This paper provides background information on Kowloon-Canton Railway Corporation (KCRC)'s handling of the contract for the West Rail telecommunications systems awarded to Siemens Ltd and the 27 supplemental agreements with contractors for 18 West Rail contracts costing about \$1 536 million.

Background

2. The Corporation's agreement to pay Siemens the sum of \$100 million for variations, settlement of claims and recovery of time lost for the West Rail contract DB-1500 - Telecommunications Systems has aroused wide public concern. 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 the Corporation's external auditors, KPMG, to conduct a thorough investigation into the Corporation's tender evaluation and contractual performance monitoring systems on 29 January 2002. The investigation also covers 27 supplemental agreements (SAs) with West Rail contractors for 18 West Rail contracts. To ensure the independence and impartiality of the investigation, a Steering Committee, chaired by the KCRC Chairman with four independent members who are well-respected senior members of their professions, was set up to oversee and guide the investigation. Subsequently, the Managing Board had decided to appoint Ernst & Young to take over from KPMG the investigation, having regard to its

willingness to undertake the investigation without an indemnity from KCRC for possible claims from third parties against the Corporation arising from the disclosure of the investigation report.

3. The Subcommittee has held three meetings to look into the circumstances leading to the incidents. It has reviewed with the Administration and KCRC the tender evaluation system and contractual performance monitoring in respect of the DB-1500 contract with Siemens.

4. The key dates and events in connection with the award of contract DB-1500 to Siemens and the subsequent negotiations held between KCRC and Siemens are set out in the **Annex**.

5. The Subcommittee has requested KCRC to provide the relevant documents in their original form to facilitate members' deliberation. KCRC has advised that it would not be appropriate to furnish these documents to the Subcommittee in their original form. Some of the documents requested are Managing Board and Tender Board documents which are regarded as commercially sensitive information. To release the documents in the public domain would not only prejudice the Corporation's ability to procure contracts in a fair and non-discriminatory manner, but also breach the confidentiality provisions contained in the General Conditions of Contract and Supplemental Agreement. Contractual documents requested by members are likewise subject to the same confidentiality provisions. Furthermore, the matter would also have to be considered in the context of any possible litigation that might arise.

Supplemental agreement

6. Members in general are dissatisfied that under the SA approved by the Managing Board, an additional \$100 million was paid to Siemens as compensation for Siemen's own fault. While considering that the settlement are unjustified, they are concerned that the spirit of contracts has not been upheld and that the incident may have far-reaching consequences on the tendering system. Some members are of the view that the senior management should be held accountable for the incident.

7. While acknowledging members' concern that the Corporation might be regarded as endorsing the contractor's non-performance by paying \$100 million to Siemens, the Chairman of KCRC has stressed that it was not the case. Out of the \$100 million, \$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 could not concur with Siemens' actions, it was one of those situations where at the eleventh hour, the

Corporation was completely tied in its hands. In the absence of better alternatives, the Corporation would have to negotiate a settlement with Siemens to ensure that the programme of West Rail project would not be adversely affected.

Tender evaluation system

8. The Subcommittee has examined the tender evaluation system in respect of contract DB-1500, particularly the reason for not using the 70:30 weighting for assessing the technical and financial aspects of tenders, and whether the Corporation had critically evaluated all aspects of the tenders to safeguard the interest of the Corporation.

Evaluation criteria

9. According to a document provided by KCRC, in the final technical evaluation, the second lowest conforming bid is better than Siemens (the former scored satisfactory in 8 items and the latter only in 5 items). The Subcommittee has queried whether the tender evaluation panel had formed their recommendation purely on the basis of price in reaching the decision not to make the award to the second lowest bid.

10. KCRC has advised that in accordance with KCRC's procurement rules, a set of evaluation criteria was approved by the Corporate Tender Board before tenders were invited. For contract DB-1500, there was no technical weighting. The requirement was for the tenderer to demonstrate its ability to achieve a pass rating in all of the relevant technical aspects. The financial evaluations likewise were not weighted, but simply confirmed that each tenderer had adequate financial strength to undertake the contract.

11. Having satisfied itself that Siemens' tender was fully conforming, and that the contractor was able to fulfil the terms of the contract, KCRC had no choice but to award the contract to Siemens. Had the contract not been awarded to the lowest conforming tenderer, Siemens would have been entitled to claim that the World Trade Organization (WTO) Agreement on Government Procurement had been breached by KCRC and consequently may have issued a bid challenge under Article XX. Such challenges if instituted in Hong Kong are heard by a specially convened Bid Challenge Review Panel, which has the power to suspend the procurement process, correct the breach or award compensation.

Exercise of due enquiry during tender evaluation

12. The Subcommittee notes that Siemens and the second lowest tenderer had both priced well below the Corporation's pre-tender estimate, in the case of Siemens at 66% below the estimate and the other at 46% below the estimate. Given that there were only two technically conforming tenders and in view of the substantial difference in their tender prices, the Subcommittee considers that the Corporation should have been more cautious in the award of contract DB-1500, or should have split the contract into smaller components for tender.

13. According to KCRC, 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. At the time of award, the proposals from Siemens and the next lowest tenderer 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.

14. On the award of a single contract for related systems, KCRC has advised that for railway projects, system integration normally presents the biggest problem resulting in the greatest risk of delay. Indeed, 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.

Contractual Performance Monitoring

15. The Subcommittee is concerned whether the Corporation had exercised due care in contract management during the process. If the slippage were 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 West Rail project.

16. According to KCRC, 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 with Siemens to subcontract the software supply

to Optical Newtork 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.

Terms and conditions of the contract

17. Some members have pointed out that the Corporation should have resorted to retendering the contract instead of negotiating with Siemens for commercial settlement. They are concerned about the lack of provisions in contract DB-1500 to vest the Corporation with the right to re-tender the contract in case key dates or milestones are not achieved. In preparing the contract, the Management should have exercised due care to safeguard the interest of the Corporation.

18. According to KCRC, 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 his endeavours and theoretically, the first key date in March 2002 could still be achieved. As Siemens was able to deliver 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 West Rail would be delayed resulting in a great loss of revenue for the Corporation. Secondly, as the West Rail 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.

19. Since Siemen's tender price is much lower than the second conforming bid, the Subcommittee has queried whether a 10% liquidated damages (LD) is sufficient to cover the loss that might incur in case of non-performance by the contractor. Some members are of the view that the level of LD should be determined in such a way so as to ensure the timely delivery of works by the contractor in accordance with the programme. Separate milestones and key dates should be set out for individual items under the same contract. For contracts of high technology items, particular attention should be paid to the additional risks and financial implications involved if the contractor fails to

deliver on schedule. Additional safeguards is also required in respect of payment for contracts of such nature. For essential items which have significant implications on other contract items, due care should be exercised before finalizing the relevant milestones, key dates and amount of LD.

Government's role in the incident

20. The Subcommittee has expressed concern about the monitoring role played by the two Policy Secretaries who sit on the Managing Board to oversee the Corporation's affairs.

21. The Administration has advised that it is 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 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. The Administration was also the party to suggest to the Chairman of KCRC that a thorough investigation on contract DB-1500 should be conducted. Once the investigation is completed, the Administration would carefully review all the findings and recommendations, and take follow-up actions as necessary.

22. In respect of the role played by the two public officers on the KCRC Management Board, the Administration has explained that similar to other KCRC Board Members, Secretary for Transport (S for T) and Secretary for the Treasury (S for Tsy) are required to act in good faith for the benefit of the Corporation. The functions of the Managing Board are jointly exercised by all Members of the Board collectively. As such, S for T and S for Tsy have the same roles and responsibilities as other Board Members. S for T also has 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 West Rail, it would involve overseeing the performance of KCRC as well as the relevant government departments under the project agreement to ensure that West Rail is completed on schedule, within budget and up to the required safety standard. As far as the scrutiny of contracts is concerned, it would come under KCRC's responsibility. The Administration would not interfere in the day-to-day operation of the Corporation. The Administration also clarifies that negotiations relating to the supplemental agreement are commercial decisions of the KCRC. It has not been necessary to involve the Chief Executive of the Hong Kong Special Administrative Region in such a decision.

23. The Chairman of KCRC has taken note of members' views. He says that KCRC would examine further the views expressed by members in the

context of the investigation.

Legislative Council Secretariat
15 May 2002

Key dates and events in connection with the award of contract DB-1500 to Siemens and the subsequent negotiations held between KCRC and Siemens

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 proposals 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, there was no reason not to award the contract to Siemens. Not to do so would be in contravention of the relevant World Trade Organization (WTO) rules 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 to integrate the operation of 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

Event/Date	Activities
	certain commitments on performance.
May/June 2001	Another visit to Germany was paid by the Director of West Rail to hold further technical discussions with Siemens. Confirmation of actions was obtained and further measures to monitor and overview 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 could 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.