

## Chapter 2

### The Postal Mechanisation System at the Air Mail Centre

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The Audit Commission (Audit) conducted a review of the Postal Mechanisation System (POMS) at the new Air Mail Centre (AMC) at the Hong Kong International Airport at Chek Lap Kok.

2. In July 1993, the Post Office (PO) appointed a Consultant, i.e. the British Post Office, at a cost of \$7.1 million to provide assistance in the design, procurement, installation, testing and commissioning of the POMS. The Contract for the supply and installation of the POMS at a cost of \$187.2 million was signed between the Government and the Contractor in April 1995.

3. The Committee held three public hearings on 9, 20 and 24 May 2005 to receive evidence from the witnesses.

4. **Mr Allan CHIANG Yam-wang, Postmaster General**, made an opening statement at the third public hearing. His statement is in *Appendix 9*.

#### Acceptance tests of the Postal Mechanisation System

##### *Factory and site acceptance tests*

5. The Committee noted from paragraphs 2.6 and 2.7 of the Director of Audit's Report (Audit Report) that the factory acceptance tests of the integrated mail processors (IMPs) of the POMS had not been carried out in accordance with the terms of the Contract. Performance standards lower than those specified in the Contract had been adopted for the factory acceptance tests of the read rates and error rates of the IMPs. According to the Contract, the read rates for the acceptance tests for inward mail and outward mail should be 74% and 67% respectively. However, the corresponding figures adopted for the tests were only 60% and 50% respectively. The error rates specified in the Contract for inward mail and outward mail were 0.6% and 0.3% respectively, but the rates adopted for the tests were both 1.5%. The PO could not provide Audit with the results of the factory acceptance tests of the supporting systems. In addition, the overflow rates of the IMPs were not tested. The Committee asked why the PO had accepted the adoption of lower standards in carrying out the factory acceptance tests.

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6. The **Postmaster General** said that:

- the POMS project was the biggest infrastructural project in the history of the PO. Given that the new AMC had to commence operation upon the opening of the new airport, the implementation programme of the POMS was very tight. The procurement process and the acceptance tests for the system had all been geared to the planned opening of the new airport. Some work processes had, therefore, been suitably adjusted to ensure that the target completion date of the project would be met; and
- the British Post Office had purchased more than 100 IMPs, and the two IMPs reserved for the AMC were in the same batch of supply. The machines had already undergone an exhaustive testing programme under the direction of the British Post Office during which many thousands of items had been processed. Having regard to the track record of the IMPs and the fact that the machines would be further examined in the site acceptance tests and hence any deficiencies might be followed up in subsequent tests, the Consultant considered it appropriate to modify some of the factory acceptance tests in order not to affect the progress of the project. Having regard to the tight timetable of the POMS project, the PO considered this arrangement acceptable.

7. According to paragraph 2.8 of the Audit Report, the Contractor proposed to exclude the throughput test of the packet sorting systems (Packet SSs) from the factory acceptance tests because of the non-availability of compressed air. The Electrical and Mechanical Services Department (EMSD) advised the PO that it would be undesirable to exclude the test as it was a key performance aspect of the Packet SSs. Nevertheless, the throughput test was not conducted. Instead, the Contractor tested the speed of the conveyor belts of the Packet SSs and then used a formula to compute the throughput. Moreover, although the Packet SSs failed the factory acceptance tests of the overflow rate and the jam rate, the Contractor was not required to remedy the defects. The Committee asked:

- why the PO did not take the advice of the EMSD regarding the throughput test of the Packet SSs;
- what the throughput of the Packet SSs computed by the Contractor was; and
- why the Contractor was not required to remedy the defects.

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8. The **Postmaster General** replied at the hearing and in his letter of 18 May 2005, in *Appendix 10*, that:

- there were problems with the compressed air supply in the part of the factory where the Packet SSs were constructed. As an alternative, the Consultant conducted tests of individual diverters at a separate test-rig to test the diversion function. The Consultant also conducted conveyor belt speed tests and confirmed that the machine would be able to meet the throughput criteria with an adequate supply of compressed air. As the machines built for the AMC were based on well-proven machines used by many postal administrations in other parts of the world, the Consultant therefore decided to test the throughput by an alternative method in view of time constraints and to allow the shipment of the machines in order to keep the project on schedule;
- the throughput of the Packet SSs computed by the Contractor was 10,374 items per hour, whereas the contractual requirement was 10,000 items per hour; and
- the Consultant was satisfied that the compressed air supply problem was the reason for the diverters not operating quickly enough. Thus, items passing through the intended selections were easily jammed, resulting in higher overflow rate and jam rate. Tests on a separate test-rig confirmed that, subject to an adequate supply of compressed air, the diverters could operate quickly enough. The Contractor was, therefore, not required to remedy the defects.

9. Paragraph 2.9 of the Audit Report revealed that the parcel sorting system (Parcel SS) was not ready for testing at the scheduled time. As a substitute for the factory acceptance tests, the Contractor only demonstrated the operation of the parcel flow using a similar Parcel SS at the Contractor's plant with two sections of spiral chute connected by a section of conveyor. The Committee questioned why the Contractor was allowed to skip the tests which were required by the Contract.

10. The **Postmaster General** explained that the Parcel SS had been manufactured based on a well-established machine of proven reliability installed in many mail centres around the world. As the Parcel SS to be installed in the AMC was to be mounted on a custom-built frame some five metres above floor level and joined to 44 large spiral chutes imported from a supplier in another country, it was not practicable to fully assemble the machine in the factory for testing purpose. The Consultant therefore accepted that the factory acceptance tests could be replaced by an examination of the manufactured

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components, modules and assemblies together with visits to sites with this kind of machines installed so that their functions under operating conditions could be observed. This was a normal practice for tests of similar machines to be conducted in this way.

11. The Committee pointed out that no matter how good similar machines were operating in other postal administrations, a test on the fully assembled Parcel SS manufactured for the AMC should be conducted at the supplier's plant if there was such a requirement in the Contract. If it was considered not practicable to conduct such a test, it should not have been included in the Contract.

12. The **Postmaster General** responded that:

- in drawing up the terms and conditions of the Contract, the PO was not sure who would be the supplier of the POMS. Hence, the most stringent terms had been adopted in the Contract to safeguard the best interest of the PO; and
- after the signing of the Contract and having regard to the track record of the supplier, the Consultant had exercised its professional judgment that flexibility should be exercised in the conduct of the testing of the system in order not to compromise the tight work schedule.

13. Paragraph 2.10 of the Audit Report revealed that despite the deficiencies mentioned in paragraphs 2.7 to 2.9 of the Report, the Consultant had issued to the Contractor the Factory Acceptance Certificates for the IMPs, the Packet SSs and the Parcel SS. The Committee questioned:

- whether the PO had been aware of the deficiencies before the certificates were issued and whether the deficiencies had been mentioned in the Factory Acceptance Certificates for follow-up by the Contractor; and
- given that the performance of certain components of the system did not meet the contractual requirements and, in some cases, the components had not even undergone the required tests at all, why acceptance certificates were still issued for these systems.

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14. The **Postmaster General** explained that:

- the deficiencies were not mentioned in the Factory Acceptance Certificates. However, they were recorded in the factory test reports and followed up in subsequent tests. The Consultant's comments on the follow-up action required by the Contractor for other aspects of the POMS were included in the factory test reports;
- the factory acceptance tests were only the first round of tests in a series of tests, such as site acceptance tests and confidence trial which would be carried out at a later stage to ascertain if the performance of the POMS complied with the contractual requirements. The Contract provided that should the system fail any factory acceptance test, site acceptance test or the confidence trial, the Contractor should remedy the defects and/or the deficiencies, and the relevant tests should be repeated within a reasonable time specified in the Contract;
- if the Consultant considered that the nature and severity of the defects or deficiencies did not warrant the withholding of the certificates so as not to delay the project schedule, "conditional" acceptance certificates would be issued to the Contractor. The Consultant would mark "passed conditionally" on the relevant test result form. A detailed list of the defects and/or the deficiencies would be drawn up after each test to facilitate follow-up on the outstanding issues. If the same defect and/or the deficiency was not mentioned again in the acceptance certificate issued at the next stage, it meant that the problem had been rectified by the Contractor. If there were still outstanding defects after the confidence trial, the Contractor was required to follow them up during the warranty period; and
- while the PO agreed that the Contractor should be required to fulfil all contractual requirements, there were circumstances during the various stages of testing under which the PO had to accept the Consultant's professional advice to advance, defer or modify certain tests in order to ensure the smooth progress of the project, as long as the performance of the whole system would not be compromised. According to international practice and experience, when special circumstances arose which made it difficult to strictly follow the contractual procedures, flexibility in the conduct of testing was allowed provided that there were valid reasons.

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### *Confidence trial*

15. The Committee noted from paragraph 2.16(a) of the Audit Report that although the Contract specified a confidence trial period of 90 days, the actual confidence trial period of the POMS had been shortened to 64 days. The Committee asked about the basis for shortening the confidence trial period.

16. The **Postmaster General** responded that:

- the confidence trial was originally scheduled to start on 6 July 1998 and end on 5 October 1998. As the lack of training of the PO postal staff in using the new equipment had hampered the conduct of the confidence trial, it was agreed among the Consultant, the PO and the Contractor that the first four weeks of the confidence trial period would be considered as the “preliminary settling down period” for the postal staff to get acquainted with the operation of the equipment prior to actual system evaluation. The down time of the system during these four weeks was excluded from the total down time of the confidence trial. The actual confidence trial commenced on 3 August 1998 and ended on 5 October 1998. The Consultant considered that the aggregate down time during the shortened confidence trial period was acceptable; and
- the PO had estimated that it would cost an additional \$6 million if the actual confidence trial period was to be extended by four weeks from 64 days to 90 days as originally planned. In the Consultant’s view, the deficiencies identified during the shortened confidence trial were comparatively minor in nature and did not justify an extension of the trial period because a significant amount of additional payment would be incurred. In the circumstances, an acceptance certificate was issued to the Contractor after the confidence trial to allow the project to move on to the warranty period, with a list of outstanding items drawn up for rectification by the Contractor.

17. The Committee queried why an additional payment had to be made to the Contractor if the confidence trial was maintained at 90 days as specified in the Contract. The **Postmaster General** replied that although the first four weeks were considered as the “preliminary settling down period” and were not counted as part of the confidence trial, the Consultant still had to assist the PO’s staff in operating the new system during this period. If the duration of the confidence trial, which had commenced four weeks after the start day originally scheduled, had to be maintained at 90 days, this would be tantamount to an extension of the trial period. In the circumstances, extra manpower on the Consultant’s side would be required. As a result, the PO would have to reimburse the Consultant with the additional staff costs incurred.

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### *Postponement of the opening of the new airport*

18. It appeared to the Committee that the postponement of the opening of the new airport from June 1997 to July 1998 should have allowed sufficient time for the Consultant and the Contractor to conduct more thorough acceptance tests. However, to the contrary, many of the tests had not been carried out in accordance with the terms of the Contract. According to the PO, this was mainly due to the need to meet the tight timetable of the POMS project. In this connection, the Committee asked when the PO was formally informed of the postponement.

19. The **Postmaster General** informed the Committee, in his letter of 18 May 2005, that the PO had been informed of the postponement of the opening of the new airport at different times, as set out below:

- responding to the PO's written enquiry, the New Airport Projects Co-ordination Office (NAPCO) advised on 12 April 1995 that the opening of the new airport would be postponed from 30 June 1997 to 30 September 1997;
- on 12 July 1995, at a meeting convened by the NAPCO on the programme of construction of the new AMC, the PO was informed that the opening of the new airport would be further postponed to 1 April 1998; and
- on 13 January 1998, the Government announced that the new airport would open on 6 July 1998.

20. Given that the opening of the new airport was postponed for about one year, the Committee asked:

- why the timetable for the POMS project was still so tight at that time; and
- about the type of work performed by the Consultant during the period of postponement.

21. The **Postmaster General** stated that:

- as in the case of the third postponement, the PO had only become aware of the new airport opening date several months before the actual opening. It was practically difficult for the PO to plan ahead as to whether or when the works

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of the POMS project should be suspended in view of the further postponement of the airport opening;

- in practice, the actual timing for performing the key activities of the POMS project, such as the delivery of the various component systems to the AMC and their installation, had to tie in with other infrastructural and construction works being undertaken at the airport at that time. The actual work schedule of the POMS project very much depended on the requirements and progress of the airport project;
- as a number of works were still underway at the airport during the postponement period, the Consultant had to closely liaise with the relevant works departments and contractors on the preparation for the installation of the POMS. In order not to compromise the progress of the airport project, the installation of the POMS had commenced in mid-January 1997 upon the PO's obtaining possession of the AMC site. A project engineer appointed by the Consultant had resided in Hong Kong to supervise the project since the commencement of the installation; and
- according to the work schedule of the POMS project as at July 1995 when the PO was informed of the postponement of the opening of the airport to 1 April 1998, the factory acceptance test of the Parcel SS was required to be completed by 20 August 1996. At the request of the relevant authorities of the airport project, the Consultant had arranged the delivery of the Parcel SS to Hong Kong by 1 November 1996, which was less than three months after the conduct of the factory acceptance test. In January 1998 when the Parcel SS had already arrived in Hong Kong pending installation, the Government announced that the opening of the new airport would be further delayed to 6 July 1998. This was one example which demonstrated that the postponement of the airport opening had had a negative impact on the work schedule of the POMS project. Hence, the postponement of the airport opening by a certain period of time did not necessarily mean that the Consultant's work schedule could be postponed by the same period of time.

22. According to paragraph 1.5 of the Audit Report, the Consultant was appointed at a cost of \$7.1 million but the consultancy fee was revised to \$10.1 million due to additional work resulting from the delay in the opening of the AMC. It appeared to the Committee that it was unreasonable for the delay in the opening of the AMC, which was due to the postponement of the opening of the new airport, to have cost an additional consultancy fee of \$3 million. The Committee asked:

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- about the justifications for increasing the consultancy fee from \$7.1 million to \$10.1 million and the basis for the additional fee of \$3 million; and
- which party had initiated the fee increase.

23. The **Postmaster General** advised in his letter of 18 May 2005 that:

- the additional consultancy fee of \$3 million covered the following:
  - (a) *Prolonged project management work before machine installation arising from the postponement of the airport opening from 30 June 1997 to 1 April 1998*

As a result of the postponement, the installation of the POMS was deferred from May 1996 to January 1997. During this period, the Consultant had to continue to manage the Contract, co-ordinate the preparation work with all parties concerned, and attend project meetings in Hong Kong. As the Consultant was paid by man-days incurred, its work in a period extended by eight months had entailed additional cost. The additional work required was equivalent to six man-weeks from the non-resident project director and ten man-weeks from the resident project engineer. Clause 6.2 of the Consultancy Agreement provided that where additional work was required of the Consultant, the work would be provided at an additional fee chargeable in accordance with the Agreement;

- (b) *Prolonged supervision work for machine installation and testing arising from the postponement of the airport opening from 30 June 1997 to 1 April 1998*

As a result of the postponement, the agreed duration of the project engineer's stay in Hong Kong to oversee the machine installation and testing, originally scheduled for mid-January 1997 to mid-March 1998, had to be extended to mid-January 1997 to end-June 1998 to accommodate the confidence trial following the commencement of the operation of the new AMC. This had necessitated work equivalent to three man-weeks from the project director and 14 man-weeks from the project engineer;

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- (c) *Prolonged supervision work for machine installation and testing arising from the postponement of the airport opening from 1 April 1998 to 6 July 1998*

The postponement had necessitated work equivalent to four man-weeks from the project director and 18 man-weeks from the project engineer; and

- (d) *Claims for reimbursement for airfares not included in the contract fees*

The Consultant had to travel to the factories of the POMS Contractor and sub-contractors in Europe to carry out the necessary inspections and tests on the system in order to ensure compliance with the requirements stipulated in the system specifications. Although this requirement was set out in the Consultancy Agreement, the airfares for this job were not included in the consultancy fee specified in the Agreement because the country of manufacture of the system was not known when the Agreement was drawn up. Thus, the Consultant submitted to the PO in July 1997 a claim for the airfares incurred by its staff between April 1996 and May 1997 for carrying out inspections and tests on the POMS at the Contractor's and sub-contractors' factories;

- the total additional costs added up to HK\$2,973,000. The rates on manpower, overseas allowance and accommodation had been set out in the Consultancy Agreement, and additional travelling expenses had been charged by the Consultant at cost against invoices. In July 1997, the Consultant submitted a request to the PO for the costs mentioned in (a), (b) and (d) above. As regards the cost mentioned in (c) above, the PO saw the need for the additional cost when the postponement of the opening of the new airport was known in January 1998; and
- the increase of the consultancy fee from \$7.1 million to \$10.1 million had been approved by the then Secretary for the Treasury in March 1998.

24. To further demonstrate how the postponement of the opening of the new airport had affected the work schedule of the POMS project, the **Postmaster General** provided in his letter of 26 May 2005, in *Appendix 11*, a table setting out the original and revised completion dates for the key activities to be performed by the Consultant as a result of each of the postponements.

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25. **Mr Martin Glass, Deputy Secretary for Financial Services and the Treasury (Treasury)**, supplemented that in February 1998, the PO submitted to the then Secretary for the Treasury a request for variation to the Consultancy Agreement in respect of the increase in the consultancy fee by \$3 million. After considering the justifications provided by the PO, the then Treasury Bureau approved the variation in March 1998. In the letter of 24 May 2005, in *Appendix 12*, he provided the two relevant memoranda for perusal by the Committee.

26. The Committee noted that it was stipulated in the Consultancy Agreement that the “Completion Date” shall be no later than 30 June 1998, and the target date for submitting the final acceptance test report was also 30 June 1998. As the installation and commissioning of the POMS had been deferred by about one year due to the postponement of the opening of the new airport, the Committee enquired whether amendments to the Agreement had been made to take into account the revised installation and commissioning dates.

27. The **Postmaster General** responded, in his letter of 26 May 2005, that the Consultant had been informed in writing by the PO on 23 April 1998 that the completion date of the Consultancy Agreement would be amended in accordance with Clause 1.1 of the Agreement.

### **Monitoring the performance of the Consultant and the Contractor**

28. The Committee enquired whether there was a mechanism in place to ensure effective monitoring of the Consultant’s performance in order to ensure that its performance met the requirements specified in the Consultancy Agreement.

29. The **Postmaster General** said that a co-ordination body, namely, the New Air Mail Centre Co-ordination Meeting, had been set up to monitor the progress of the construction of the AMC and the installation of the POMS. The Co-ordination Meeting was chaired by a senior officer of the PO with the Consultant and representatives from a number of relevant government departments as members. The progress and performance of the work of the Consultant and the Contractor were monitored through the monthly meetings of this body. Moreover, from time to time, the Consultant submitted reports on its work to the PO.

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30. The **Secretary for Financial Services and the Treasury** supplemented in his letter of 8 June 2005, in *Appendix 13*, that procuring departments had the responsibility to monitor the performance of their consultants. In general, departments should devise an effective monitoring mechanism to ensure that a consultant would perform to standard and comply with the terms of contract, and should evaluate the performance of the consultant regularly. The mechanism for monitoring the performance of the Consultant's work in the case of the POMS project was spelt out in Clauses 6 and 7 of the Consultancy Brief attached to the Consultancy Agreement.

31. Given that the PO had from time to time received reports on the work of the Consultant, the Committee enquired whether any of these reports had reflected that the performance of the Consultant, in particular its work relating to the inspections and testing of the POMS, did not meet the contractual requirements.

32. The **Postmaster General** stated, at the hearing and in his letter of 18 May 2005, that:

- the PO had gone through the reports submitted by the Consultant in connection with the installation, testing and commissioning of the POMS, and noted that the Consultant had agreed with the Contractor that factory acceptance tests were not required for the Elevating Transfer Vehicle, Container Storage and Retrieval System, tractor units and scissor lifts. These were the only deviations the PO had found, apart from those covered in the Audit Report;
- the PO had also found that the Consultant's performance in the following areas was not entirely satisfactory:
  - (a) the IMPs had passed the site acceptance test of read rate when using electronic images but failed marginally when using test packs. The advice of the Consultant was that tests using electronic images were as valid as tests using physical test packs. With the benefit of hindsight, the Consultant should have been more stringent in enforcing the requirement to pass the tests using physical test packs; and
  - (b) the results of the acceptance tests of some of the components and supporting systems of the POMS had not been retained. The PO would ensure that, in future, records relating to the results of the acceptance tests for all equipment, including postal equipment, would be properly kept for seven years, in line with the retention period for accounting records.

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As the deficiencies mentioned above were not serious in nature, the PO considered that they did not warrant the withholding of the acceptance certificates or the taking of any action against the Consultant;

- there was one aspect, namely the read rates of the IMPs, which the PO had found consistently unsatisfactory after the commissioning of the POMS. In the legal proceedings concerning the Contractor's claim against the Government, the Government had made a counterclaim in respect of the unsatisfactory read rates. In September 2003, the Government reached a settlement agreement with the Contractor. The settlement took into account the Government's counterclaim; and
- although there were provisions for remedies in the Consultancy Agreement to deal with deviations from or non-compliance with the contractual requirements, in the PO's view, the overall performance of the Consultant and the Contractor was generally acceptable and so, despite the unsatisfactory read rates of the IMPs, it was not considered necessary to pursue a claim against the Consultant and/or the Contractor in respect of the performance of other aspects of the POMS. Nevertheless, in the light of the audit recommendation, the PO had sought legal advice on whether there were breaches of the contractual terms in respect of the performance of the POMS, and concluded that there was insufficient evidence to pursue a claim against the Contractor and the Consultant.

33. In response to the Committee's enquiry about the details of the legal advice obtained by the PO and the amount of the counterclaim in respect of the unsatisfactory read rates, the **Postmaster General** advised, in his letters of 18 and 26 May 2005, that:

- the PO had discussed with the Department of Justice (DoJ) at various meetings whether there had been breaches of the contractual requirements in respect of the performance of the POMS. The DoJ's view was that there appeared to be breaches of the requirements in the light of the test results given in the Audit Report. However, the DoJ did not advise the PO to lodge a claim against the Contractor and the Consultant, mainly because there was insufficient evidential proof to pursue a claim;
- insofar as the claim against the Contractor was concerned, the legal advice obtained by the DoJ was that it was a "weak" claim. There were difficulties in proving liability and quantum. As regards the claim against the Consultant, the DoJ's view was that there was insufficient evidence to hold the Consultant liable for negligence. The burden of proving negligence is onerous;

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- the PO had also been advised that the records provided by the Consultant were not useful in a claim against the Contractor. The PO could not simply rely on the test results given in the Audit Report to hold the Contractor liable as there could be other factors affecting the performance of the POMS. In order to further consider the technical aspects, the DoJ advised that the PO would need to obtain expert advice, which might or might not assist the claim eventually. In the DoJ's view, much efforts and expenses would have to be incurred before a proper case could be made out. Furthermore, there would be difficulties in quantifying the amount of damages as the calculation could only be based on assumptions;
- given that there were insufficient evidence, uncertainties in obtaining assistance from witnesses as some of the key persons involved in the project had already retired, difficulties in calculating the quantum of damages, as well as the efforts and expenses that might be incurred, and the risks in litigation, it was considered that it would not be worthwhile pursuing a claim against the Contractor and/or the Consultant; and
- the original amount of claim against the Contractor for the unsatisfactory read rates of the IMPs, i.e. the estimated amount before the settlement agreement was reached, was HK\$11.2 million.

34. The Committee further enquired whether the PO had estimated:

- the amount of money required in obtaining expert advice on the technical aspects of the case; and
- the amount of claim(s) against the Contractor and/or the Consultant before deciding not to pursue a claim.

35. The **Postmaster General** replied, at the hearing and in his letter of 26 May 2005, that the fee for obtaining the necessary expert advice was estimated to be \$0.5 million. As the PO considered that it would not be worthwhile pursuing a claim against the Contractor and/or the Consultant in the light of the legal advice, it had not estimated the amount of such claim(s).

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36. As there were a number of acceptance tests which had not been carried out strictly in accordance with the terms of the Contract, the Committee asked:

- whether the PO had held internal meetings and/or communicated in writing with the Consultant, Contractor and/or the DoJ to discuss the relevant issues; and
- whether there were any documents which demonstrated the justifications for and the circumstances leading to the acceptance of the deviations from and non-compliance with the contractual requirements by the Consultant and/or the Contractor.

37. The **Postmaster General** replied in his letter of 26 May 2005 that:

- the PO had not been able to find written records of internal meetings and communications among the PO, the Consultant, the Contractor or the DoJ relating to the conduct of the acceptance tests where there were deviations from or non-compliance with the contractual requirements. It seemed that there was little internal discussion on the subject and the PO had relied heavily on the Consultant to supervise the tests; and
- for future similar projects, the PO would manage the work and performance of a consultant more proactively so as to ensure that performance tests would be conducted in accordance with the contractual requirements. In cases where deviations from or non-compliance with the contractual requirements were warranted, they would be fully justified and properly documented.

38. As the duties of the Consultant covered the drafting of tender and contract documents, evaluation of the tenders received and advising the PO on the selection of the Contractor, monitoring of the conduct of inspections and testing of the system as well as issue of acceptance certificates, the Committee wondered if there had been conflicts in the roles played by the Consultant. The Committee therefore enquired:

- about the type of procurement procedures for the POMS Consultancy; and
- whether the arrangement for the appointment of the Consultant, including the range of duties performed by the Consultant, was in line with the normal practice for engaging consultants for government projects, and whether there were any safeguards against possible conflict of the roles played by the Consultant and over-reliance on the Consultant.

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39. The **Secretary for Financial Services and the Treasury** informed the Committee, in his letter of 8 June 2005, that:

- in procuring the POMS Consultancy, the Postmaster General followed the procedures for Appointment and Payment of Consultants which were prevailing in 1993 and were basically similar to the present procedures. The procurement of consultancy services was governed by a set of consultant selection procedures;
- based on the consultant selection procedures, before a proposal was submitted to the Central Consultants Selection Board (CCSB), procuring departments had to establish the need for the consultancy service, obtain policy support from the relevant bureau and seek approval to commit funds. Subject to policy support being given and funds being available, the department would submit to the CCSB for consideration a consultancy brief together with the names of consultants considered eligible to undertake the assignment. The CCSB would consider whether or not to endorse the recommended list of shortlisted consultants for the purpose of inviting proposals;
- procuring departments had to justify their need for the consultancy service and decide on the scope of work required of the consultant before making a submission for selection and appointment of a consultant to the CCSB. Upon receipt of a submission, the CCSB would consider whether the requirements set out in the consultancy brief were reasonable and appropriate for the purpose of meeting the objectives and tasks of the consultancy service, and whether the shortlisting and selection of the consultant had been conducted in a fair and competitive manner. The consultant selection exercise for the POMS Consultancy was conducted in a like manner and hence was in line with the established practice;
- according to the consultancy brief for the POMS Consultancy, the Postmaster General had addressed the issue of conflict of interest. The distinct roles and responsibilities of the Postmaster General, the then Government Supplies Department (GSD), the Consultant and the POMS Contractor were set out in the consultancy brief. Briefly, while the Consultant was to design and prepare the POMS system specifications, assist in the preparation of tender documents and evaluation and selection of tenders for the POMS, oversee the manufacture of, supervise the installation of and conduct tests on the POMS, it was the then GSD and the Postmaster General to prepare the POMS tender documents. It was also the GSD's responsibility to call for tenders for the supply of the POMS and the Postmaster General's responsibility to make the recommendation on the award of the contract to the POMS Contractor.

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While the Consultant was appointed as the project manager under the POMS Contract, both the Consultant and the POMS Contractor were subject to directions from the Project Steering Committee, which was chaired by a representative of the PO to provide the Consultant with guidance on policy matters, monitor the progress of the Consultancy and consider major recommendations from the Consultant through meetings at regular intervals. Most importantly, neither the Consultant nor his associates had been permitted to bid for the supply of the POMS or any associated equipment and services; and

- the Postmaster General's brief research revealed that it was not uncommon for consultants in postal projects of this kind to be involved in the full range of responsibilities which covered planning, preparation of tender documents, evaluation of tenders, monitoring of the manufacture of, as well as supervision of the installation, testing and commissioning of a system.

40. In response to the Committee's enquiry as to whether the then GSD had been involved in the preparation of the POMS Contract, the **Director of Government Logistics** provided in his letter of 13 June 2005, in *Appendix 14*, a factual account of the involvement of the then GSD in the tendering, acceptance and implementation stages of the supply of the POMS, which included the following:

### *Tender preparation*

- in preparing the tender document, a sample tender document was forwarded by the then GSD to the PO in November 1993 for reference. Based on the sample tender document, the PO together with its Consultant prepared the first draft tender document. The then GSD provided the PO with comments and advice on the proposed tender terms and contract conditions in the first draft in order to ensure that they were in line with the government procurement policy and standard terms and conditions. The then GSD also referred the set of terms and conditions to the DoJ (previously known as the Attorney General's Chamber) for legal clearance. The then GSD was, however, not involved in the preparation of the system specifications of the POMS;

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### *Tender issue*

- when the tender document was finalised, the then GSD arranged for the issue of the tender document to potential tenderers and the publication of the tender notification in the Government Gazette and local newspapers. During the tender issuing stage, the then GSD was responsible for answering enquiries from potential tenderers on the tender arrangements as well as the terms and conditions, whilst the PO was responsible for answering enquiries on the system specifications;

### *Tender evaluation/recommendation*

- a Tender Evaluation Committee chaired by the PO, comprising representatives from a number of government departments concerned including the then GSD, was formed to decide on the recommendation to be made as regards tender award. The then GSD was represented at the meetings of the Committee to render advice on the procurement process and the tender terms and conditions;

### *Tender negotiation*

- a negotiation team led by the then Director of Government Supplies, comprising representatives from the PO and the DoJ, conducted negotiation with the recommended tenderer to improve the offer. The then GSD focused on commercial issues, whilst the PO and the DoJ focused on user requirements and technical issues, and legal issues respectively;

### *Tender award*

- based on the recommendation of the Tender Evaluation Committee, the then GSD sought approval from the Central Tender Board (CTB) for the award of a contract to the POMS Contractor. Upon the CTB's approval, the then GSD issued a letter to the Contractor informing it of the acceptance of its offer;

### *Contract signing*

- the POMS Contract was signed by the then Director of Government Supplies on behalf of the Government;

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### *Change in requirement*

- the PO, in consultation with its Consultant, was required to provide justifications for any additional requirements or change in requirements. The then GSD was responsible for seeking approval for contract variations. During the period between 1996 and 1997, the PO submitted to the then GSD a total of four requests for contract variation which mainly involved hardware and software enhancement of the system. At the request of the PO, the then GSD informed the Contractor of the change in the contract completion date due to the postponement of the opening of the new airport; and

### *Contractual claim*

- the contractual claim in relation to the issues of prolongation of contract period and delays and disruptions to the installation work as a result of the postponement of the airport opening was mainly dealt with by the DoJ, the PO and the Architectural Services Department. The then GSD's representative attended meetings to keep the GSD abreast of the development, as the then Director of Government Supplies was the signatory to the POMS Contract.

41. The Director of Government Logistics also stated that the then GSD was not involved in the administration and monitoring of the contract, the conduct of acceptance tests and the making of payments.

## **Performance of the Postal Mechanisation System**

### *Proposal to introduce a postcode system*

42. As revealed in paragraph 3.7 of the Audit Report, the Consultant advised the PO in 1997 that the introduction of a postcode system in Hong Kong could improve the read rates of the optical character recognition machines (OCRs) of the IMPs. An OCR captured the images of addresses written or printed in English and performed character recognition and address interpretation of letters. The Consultant recommended the PO to introduce a postcode system with seven digits. In paragraph 3.39(b), Audit also recommended that the PO should consider introducing a postcode system to improve the performance of the POMS and the overall efficiency of postal operation.

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43. In response to the Committee's enquiry about the Government's stance on the proposal to introduce a postcode system, **Hon Stephen IP Shu-kwan, Secretary for Economic Development and Labour**, stated that:

- generally speaking, the purpose of introducing a postcode system was to improve the efficiency of the postal operation, i.e. improving the read rates of the OCRs and obviating the need for a postman to sort letters before delivery;
- the Government had completed a study on the introduction of a postcode system. The postcode adopted in overseas countries consisted typically of five to seven digits, denoting the buildings by district and by street. The current system in Hong Kong was already capable of sorting mail to the delivery sequence by buildings. Hence, merely assigning a postcode to each building in Hong Kong would not achieve further benefits. The study concluded that a separate postcode had to be assigned to each of the 2.5 million postal addresses in Hong Kong and the postcode could involve up to 15 digits. A possible alternative was to have a postcode with eight random digits, including the "checksum" digit. However, such a postcode would give no indication of the actual address;
- the Panel on Economic Services of the Legislative Council had agreed at its meeting in June 2000 that the use of the postcode should be on a voluntary basis. In the circumstances, the use of the postcode by business organisations would depend on their line of business, volume of mail, need for address data management and information technology infrastructure. The use of the postcode by the general public would also influence the use of the postcode by organisations. If the usage among the general public was low, the postcode could not be expected to be widely adopted by business organisations;
- a postcode with eight random digits would not be user-friendly to the public because a person wishing to use the postcode would have to memorise not only his or her own postcode, but also those of the recipients of the mail. It was likely that people would be inclined to use the postal address. Thus, it was not expected that there would be popular adoption of an eight-digit postcode in Hong Kong. In addition, the PO would replace the existing letter sorting machines later this year to achieve efficiency in the sorting of mail. The OCRs of the new letter sorting machines would have a better read rate and thus reduce the benefits to be obtained from the adoption of the postcode system;

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- furthermore, the POMS had not been premised on and/or designed for the introduction of a postcode system. If a postcode system was introduced in Hong Kong, improvement to the performance and the utilisation of the POMS would at best be minimal because:
  - (a) the constraints of a postcode system for Hong Kong would limit its use by the local community; and
  - (b) over 60% of the mail items handled at the AMC were outward air mail, a postcode system for Hong Kong would not make any difference in their processing by the POMS; and
- against the above background, the Administration considered that it was not appropriate to introduce a postcode system in Hong Kong at the moment. Nevertheless, it would adopt an open mind and review the need for introducing a postcode system in the light of future technological development.

### *Read rates of IMPs*

44. According to Appendices B and C of the Audit Report, the read rates of the IMPs for inward mail and outward mail for the period from April 1999 to September 2004 fell far short of the minimum read rates specified in the Contract. Moreover, the read rate of the IMPs for inward mail was on the decline in recent years. In this connection, the Committee asked about:

- the reasons for the decline in the read rate of the IMPs for inward mail;
- the percentage of the mail items, which were within the physical characteristics that could be handled by the IMPs, screened out by the IMPs as not recognisable, since the commissioning of the POMS; and
- the advice, if any, offered by the Consultant to the PO in respect of the unsatisfactory read rates of the IMPs.

45. The **Postmaster General** replied in his letter of 26 May 2005 that:

- to relieve the congestion at the International Mail Centre (IMC) in Hung Hom, and at the same time increase the utilisation of the POMS at AMC, the PO had in recent years transferred from the IMC to the AMC the processing

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of letters collected from some street posting boxes in the New Territories. Such street collections, as opposed to bulk business postings presented at post offices, normally comprised a higher proportion of mail which could not be easily read by IMPs, including those bearing hand-written addresses. This had lowered the read rate of the IMPs for inward, including domestic, mail;

- the percentages of mail items screened out by the IMPs before 1999-2000 were not retained. The relevant figures for the period from 1999-2000 to 2004-05 were as follows:

	<b>1999-2000</b>	<b>2000-01</b>	<b>2001-02</b>	<b>2002-03</b>	<b>2003-04</b>	<b>2004-05</b>
	(million)	(million)	(million)	(million)	(million)	(million)
Total number of items fed into IMPs	61	60	59	60	65	55
Items screened out by IMPs for manual processing	27	22	19	15	20	20
Percentage of items screened out by IMPs for manual processing	44.3%	36.7%	32.2%	25%	30.8%	36.4%

- to enhance the read rates of the IMPs after the commissioning of the POMS, in March 2000, the Consultant advised the PO to improve the address database of the IMPs to facilitate address recognition. The PO had since been implementing the measure.

46. The Committee enquired why the low read rates of the IMPs had only been reported to the Contractor six months after the end of the confidence trial period, as revealed in paragraph 3.6(c) of the Audit Report.

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47. The **Postmaster General** advised that:

- as there were many factors, such as the address quality and composition of mail, that would affect the read rates of the IMPs, the low read rates recorded on a particular day might not accurately reflect the performance of the OCRs. Therefore, the PO had allowed more time to test the read rates of the IMPs under live operating conditions after the commissioning of the POMS; and
- as the read rates were found to be unsatisfactory throughout the first few months of the warranty period and the Consultant had also confirmed that the read rate was an ongoing problem, the PO requested the Contractor to improve the unsatisfactory read rates. The issue was subsequently settled as a counterclaim against the Contractor in response to its claim against the Government. The Contractor had no further liability on this performance issue after the settlement agreement was reached between the two parties.

48. The Committee noted from paragraph 3.6(e) of the Audit Report that according to the Contract, the Contractor was not required to adapt the IMPs to changes in the characteristics of live mail after they had passed the acceptance tests. The Committee asked whether, in drawing up such provision, the PO had taken into consideration that a change in the characteristics of mail would affect the read rates of the IMPs.

49. The **Postmaster General** replied that as there were many factors which could affect the read rates of the IMPs, the PO was unable to accurately forecast the read rates under live operating conditions at the time the Contract was signed. The PO could only stipulate in the Contract an objective and reasonable standard expected of the IMPs, so that the machines could be tested against that standard. Once the IMPs had passed the relevant acceptance tests, it meant that they had generally complied with the contractual requirements and so any problems relating to the actual operating performance of the IMPs should be dealt with as a separate issue.

### *Throughput of the Packet SSs*

50. The Committee noted from paragraphs 3.17 to 3.22 of the Audit Report that each Packet SS was manned by four staff members, i.e. coders, who keyed in the sorting codes of the packets. In addition, each Packet SS was manned by two other staff members who were fully engaged in clearing the sorted packets at the outlets of the Packet SS. In sorting inward packets, one additional staff member was required to feed packets to the Packet SS. In sorting outward packets, the staff member who opened the mail bags and segregate the

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mail items fed the packets to the Packet SS at the same time. Therefore, each Packet SS was manned by seven staff members in sorting inward packets, and six staff members in sorting outward packets.

51. In October 1993, the Consultant stated in its draft Study Report on the proposed design of the POMS that each Packet SS would be able to process at least 9,000 packets (i.e. 2,250 packets per coder x 4 coders) per hour under live operating conditions. In January 1994, the Consultant reiterated in its final Study Report that each Packet SS would be able to process at least 9,000 packets per hour under live operating conditions.

52. In February 1994, based on the final Study Report, the PO sought the approval of the Finance Committee for funding of the POMS. It was stated in the Contract that each of the Packet SSs should be capable of processing mail items having the characteristics specified in the Contract at an overall system throughput of better than 10,000 items (i.e. 2,500 packets per coder x 4 coders) per hour. It was also stated in the Contract that, if the packets were sorted by bar code reading instead of keyboard coding, the minimum hourly throughput of each Packet SS should be 14,000 packets (i.e. 3,500 packets per coder x 4 coders).

53. In November 1998, the PO conducted a review on the operations of the AMC. The review indicated that there was a significant gap between the planned hourly throughput of 10,000 packets and the actual hourly throughput of 3,000 packets. The Committee queried why there was such a big difference between the planned and actual throughput.

54. The **Postmaster General** said that:

- the throughput of the Packet SSs specified in the Contract referred to the mechanical throughput attained by the machine if the manual steps, such as keying in the sorting codes of the packets and feeding the packets to the machines by operators, were carried out incessantly at a very high speed. The actual throughput under live operating conditions varied according to operators' efficiency and mail characteristics. Normally, the actual operational throughput was lower than the mechanical throughput, as the latter referred to optimal machine performance. According to operational experience, the better the quality of the mail and the higher the operators' efficiency, the closer would be the match between the day-to-day operational throughput and the mechanical throughput; and

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- after the PO had revised the sorting plan of the Packet SSs in October 2001, the average operational throughput had increased from 3,000 to 4,194 packets per hour.

55. **Mr Peter CHAN Bar-keung, Assistant Director of Audit**, referred the Committee to paragraph 3.19 of the Audit Report which stated that the Consultant had included in its final Study Report a cost-benefit analysis based on the hourly processing rate of 9,000 packets for a Packet SS. He pointed out that according to the analysis, compared with manual sorting, using the Packet SSs for sorting packets would result in an annual saving of \$0.6 million in staff cost. Based on the cost-benefit analysis, Audit observed that, in order to justify the purchase of the Packet SSs, the Packet SSs must achieve an hourly throughput of at least 7,150 packets (i.e. about 1,790 packets per coder x 4 coders). Having regard to the basis used by the Consultant in the cost-benefit analysis, i.e. adopting the hourly processing rate of 9,000 packets in the calculation, Audit's interpretation was that the hourly throughput of 10,000 packets specified in the Contract should refer to the operational throughput rather than mechanical throughput.

56. In response to the Committee's further enquiry about the throughput of the Packet SSs, the **Postmaster General** stated, at the hearing and in his letter of 26 May 2005, that:

- on 19 October 1993, the PO had asked the Consultant whether the expected hourly throughput of 2,250 items per coding station, as specified in the Consultant's draft Study Report, was realistic. In its reply of 19 October 1993, the Consultant advised that an hourly coding rate of 2,250 items per coding station was realistic provided that the coding operation involved the entry of a numeric two-digit memorised code and the operators were kept supplied with mail for input. Subsequently, the Consultant confirmed in its final Study Report that the Packet SSs should be capable of processing an average of at least 9,000 items per hour under live operating conditions, which was equivalent to 2,250 items per coding station;
- in the process of the audit review of the POMS conducted in 2000-01 which had been held in abeyance because of the pending court case against the Government at that time, the PO had also sought confirmation from the Consultant regarding the contractual requirement that the throughput of the Packet SS should be at least 10,000 packets per hour. This contractual requirement had been set out in paragraph 3.23 of the draft Audit Report of the 2000-01 review. In response to the PO's enquiry in July 2001, the Consultant pointed out that the hourly throughput of 10,000 packets referred to the mechanical performance of the machine;

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- on the suggestion of the Committee, the PO had recently conducted a test to check the mechanical throughput of the Packet SSs, i.e. the machine capability based on a specified performance test. The test result showed that the Packet SSs were capable of processing mail items at an overall system throughput of 9,600 items per hour; and
- in the PO's view, it was not entirely appropriate to compare the actual operating performance of the POMS with the contractual performance requirements because the contract specifications only referred to the functional standards for evaluating the machine capability based on specified performance tests.

57. As the actual average day-to-day throughput of the Packet SSs was only some 4,000 packets per hour in the past few years, which fell far short of the contractual throughput of 10,000, the Committee asked about the difference between the actual cost-effectiveness achieved by using the Packet SSs and that under the original target set at the time the Contract was signed.

58. The **Postmaster General** stated, at the hearing and in his letter of 26 May 2005, that:

- in 2004-05, the average operational throughput of the Packet SSs was 4,170 items per hour. Applying the actual 2004-05 packet traffic, the annual costs for sorting packets were HK\$1.96 million based on the Consultant's assumed hourly operational throughput of 9,000 items, and HK\$3.31 million based on the actual hourly operational throughput of 4,170 items. If the packets were sorted manually, the annual cost would be HK\$3.46 million. The figures suggested that the use of the Packet SSs was still more cost-effective than manual sorting;
- although the actual daily throughput achieved by the Packet SSs was lower than the original target, it was worth noting that the use of the Packet SSs had brought about such advantages as enhancing health and safety at work and higher efficiency in postal operations, especially in times of pressure such as the arrival of Christmas postings;
- as the low operational throughput of the Packet SSs was mainly due to the lower than expected air packet traffic, it now transpired that the Consultant's estimate of the average operational throughput of 9,000 items per hour, which formed part of the basis of the cost-benefit analysis for the purchase of the POMS, was over-optimistic; and

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- as the letter sorting capacity of the General Post Office (GPO) in Central and the IMC in Hung Hom had reached saturation, the PO would replace their existing letter sorting machines later this year to achieve efficiency in the sorting of mail. The procurement of the two letter sorting machines had undergone the standard tendering procedures. The PO had also engaged a consultant, based on the required procedures, to assist in the design and management of the project. In the light of the audit recommendations, the PO was actively reviewing the follow-up actions to be taken in order to benefit from the lessons learned from the POMS project. It would adopt a more prudent and thorough approach in forecasting the postal traffic, evaluating the costs and benefits of the equipment and monitoring the project management work of the forthcoming project, so as to prevent recurrence of similar problems.

### Utilisation of the Postal Mechanisation System

59. The Committee noted from paragraphs 4.3, 4.7 and 4.9 of the Audit Report that the bases used by the Consultant in the cost-benefit analysis were that 90% of the letters processed at the AMC would be sorted by the IMPs and 99% of the packets would be sorted by the Packet SSs. In January 2005, Audit conducted a survey on the physical characteristics of the letters handled by the AMC on three days. Audit selected a sample of 5,300 letters screened out by the staff at the AMC as not suitable for sorting by the IMPs and measured their physical dimensions and weights. Audit found that 81% of these letters were within the physical dimensions and weights specified in the Contract as suitable for sorting by the IMPs. Audit also conducted a similar survey on packets in the same month. It selected a sample of 3,300 packets screened out by the AMC staff as not suitable for sorting by the Packet SSs and measured their physical dimensions and weights. It was found that 90% of these packets were within the physical dimensions and weights specified in the Contract as suitable for sorting by the Packet SSs. The Committee questioned why those items of dimensions and weights suitable for sorting by the IMPs or the Packet SSs had been screened out as not suitable for sorting by the machines.

60. The **Postmaster General** explained that:

- the cost-benefit analysis was based on the forecast air mail traffic and expected mode of operation of the AMC at the time the analysis was conducted. At that time, the AMC was designed to handle outward air mail items only. Nowadays, 86% of the outward air mail letters processed at the AMC were sorted by the IMPs;

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- the drop in the utilisation of the IMPs and the Packet SSs was partly due to the change in the quality of mail items. For example, a number of mail items were not suitable for putting into the machines, such as those in plastic or loose wrappings and those containing stiff objects like compact disks. The change in mail characteristics was not foreseen at the design stage of the POMS; and
- although some of the mail items were within the physical dimensions and weights that could be sorted by the IMPs or the Packet SSs, they had not been fed to the machines for sorting because it was considered that manual sorting would be more efficient and cost-effective. For example, in order not to affect the performance of the IMPs and prolong the sorting process, those mail items bearing poor addresses would be sorted manually. Moreover, one of the Packet SSs was not used to sort Speedpost items as originally planned because the volume of such items had not grown as fast as originally projected. The current volume was more cost-effectively handled on a manual basis in order to meet the stringent service standards for this time-sensitive product.

61. In response to the Committee's enquiry as to whether the Contract had specified the types of mail items that were not suitable for sorting by the IMPs and the Packet SSs, the **Postmaster General** answered in the affirmative. He, however, pointed out that the allowable proportion between machinable and non-machinable items of different components of the POMS was not specified in the Contract. This information was only used by the Consultant in conducting the cost-benefit analysis. At the suggestion of the Committee, the **Postmaster General** agreed that the requirements in this aspect should also be included in the contract in future procurement of postal equipment.

62. The Committee further enquired whether the PO had approached the Consultant and/or the Contractor to see if there was any supporting system which could be installed to the IMPs or the Packet SSs, so as to enable them to sort those mail items that were in plastic wrappings or containing stiff objects such as compact disks.

63. The **Postmaster General** said that the proposal might not be technically feasible. However, he would seek the advice of the Consultant and the Contractor about the possibility of the proposed course of action. Depending on the advice, the PO would consider the modification in the light of operational requirements and cost implications.

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64. The audit findings in paragraphs 4.11 to 4.18 of the Audit Report mentioned that a number of the supporting systems of the POMS had either been under-utilised or left idle. The Committee asked:

- whether, in planning the design and procurement of the POMS, the PO had seriously assessed the need for the supporting systems; and
- whether the PO had drawn up any plans to enhance the utilisation of these systems.

65. The **Postmaster General** responded that:

- the capital investment of a mail centre was high and once it was established, it would need to operate for a considerable length of time. For such reasons, the infrastructure and equipment of a centre had to be so designed that they would be capable of meeting the requirements for the anticipated growth in mail traffic in the coming years. The capacity of the AMC was designed to cope with traffic growth for 15 years. The design and procurement of the POMS were done on the best available knowledge and forecasts at that time and according to best cost-benefit analysis;
- the PO recognised that some supporting systems of the POMS were under-utilised or left idle. This was largely attributed to the change in circumstances that were not foreseen at the design stage of the system, such as changes in mail characteristics and operational procedures, the economic downturn in the region and the keen competition from other operators. These had made the previous traffic projection unrealistic; and
- the PO had constantly reviewed its operations to make the best use of available resources to enhance efficiency, quality of service and utilisation of the facilities. For example, the PO had transferred from the GPO and the IMC the sorting functions of all inward air mail to the new AMC after its inception. The PO had also made use of the POMS to set up an operation centre for the new logistics service and transshipment service. Moreover, the container storage and retrieval system had been used for the storage of foreign empty air mail bags pending return to their countries. This had streamlined the processing of empty bags and enhanced efficiency. In addition, there were two postal operations committees which conducted constant reviews and planned new initiatives for optimum utilisation of resources and facilities.

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66. In response to the Committee's enquiry as to whether the PO would consider adjusting the postage rates to encourage mailers to post items that met the required standards, the **Postmaster General** stated that the current postage rates had reflected, to a certain extent, the difference between handling standard items and non-standard items. Nevertheless, the PO would explore the possibility of the proposal.

### Payments for the Postal Mechanisation System

67. According to paragraph 5.6 of the Audit Report, there were overpayments of \$7.1 million to the Contractor by the PO. The Committee asked whether the Contractor had only provided in the invoices concerned a lump sum without deducting the discounts to which the PO were entitled.

68. In response, the **Postmaster General** said that:

- in the first invoice issued by the Contractor in May 1995, the special discounts had been deducted from the amount due, in proportion to the invoice amount. However, in the subsequent invoices, the discounts allowed in the Contract had not been deducted;
- in the PO's view, the omission of the discounts was due to the absence in the Contract of a clear agreement with the Contractor on how and when the discounts were to be honoured. Apart from the few words at the end of the price list in the Contract concerning the discounts, there was no further elaboration on the discounts in the Contract;
- in the light of the audit recommendation and the advice of the DoJ, in February 2002, the PO had recovered from the Contractor \$8 million, which included the overpayments of \$7.1 million and the accrued interest for the overpayments amounting to \$0.9 million; and
- to prevent recurrence of the mistakes, the PO would include in future contracts detailed procedures for honouring discounts offered by contractors.

69. Noting from paragraph 5.15 of the Audit Report that the PO had already tightened up its payment checking procedures, the Committee asked:

- about the details of the new procedures; and
- whether the PO had reviewed the effectiveness of the new procedures.

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70. The **Postmaster General** informed the Committee that:

- under the new payment checking procedures, a payment schedule would be drawn up before the payment cycle commenced. The schedule set out the payment terms and conditions (including the discounts to which the PO were entitled), statement date, payment due date, etc. There were two officers responsible for monitoring payments. Upon receipt of an invoice, one of the officers would check the invoice against each item of the payment schedule while the other officer would conduct a further check of the invoice against the payment schedule to ensure accuracy before certifying and authorising the payment; and
- the PO's internal audit team would check the payment records from time to time to ensure full compliance with the payment checking procedures. So far, no irregularities had been found by the audit team since the introduction of the new payment checking procedures.

71. **Conclusions and recommendations** The Committee:

### **Monitoring the performance of the Consultant and the Contractor**

- notes that the duties of the Consultant appointed in July 1993 by the Post Office (PO) for the Postal Mechanisation System (POMS) included drafting the tender and contract documents for the supply and installation of the POMS, assessing the tenders received, advising the PO on the selection of the Contractor, monitoring the conduct of inspections and testing of the system as well as issuing acceptance certificates;
- finds it unacceptable and inexcusable that the PO did not effectively monitor the work and performance of the Consultant and the Contractor, and had relied heavily on the Consultant in supervising the inspections and testing of the POMS. As a result:
  - (a) although a number of acceptance tests for the POMS were not conducted strictly in accordance with the terms of the Contract, the PO agreed that the Consultant should issue acceptance certificates to the Contractor; and
  - (b) there was little internal discussion in the PO relating to the conduct of inspections and testing of the POMS, and there was no written record of internal meetings and communications among the PO, the Consultant,

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the Contractor or the Department of Justice (DoJ) which demonstrated the justifications for and the circumstances leading to the PO's and/or the Consultant's acceptance of the deviations from and non-compliance with the contractual requirements;

- recommends that, when purchasing equipment, including postal equipment, through tendering procedures or engaging consultancy service in future, the Postmaster General should ensure that:
  - (a) the requirements specified in the agreement or contract are realistic and attainable, and that the terms and conditions therein are fully enforceable;
  - (b) all the terms and conditions of a contract are strictly adhered to, and seek the advice of the Government Logistics Department or the DoJ, as appropriate, if there are any difficulties in enforcing or handling cases of non-compliance with the conditions of contract by a contractor; and
  - (c) the mechanism to monitor the work and performance of a consultant/contractor is implemented effectively and proactively;

### **Acceptance tests of the Postal Mechanisation System**

- expresses serious dismay and finds it unacceptable that:
  - (a) the factory acceptance tests of the integrated mail processors (IMPs), the packet sorting systems (Packet SSs) and the parcel sorting system (Parcel SS) were not carried out in accordance with the terms of the Contract;
  - (b) despite the deficiencies in the factory acceptance tests of the IMPs, the Packet SSs and the Parcel SS, the Consultant issued to the Contractor the Factory Acceptance Certificates for these systems;
  - (c) the site acceptance tests of the IMPs and the Packet SSs were not properly carried out in accordance with the terms of the Contract;
  - (d) despite the deficiencies in the site acceptance tests of the IMPs and the Packet SSs, the Consultant issued to the Contractor the Site Acceptance Certificates for these systems;

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- (e) the confidence trial period was shortened from 90 days to 64 days, which did not meet the contractual requirement, and the PO had not assessed the implications of the shortened trial period on the maximum down time allowed in the Contract;
  - (f) the performance of the IMPs during the shortened confidence trial period did not meet the contractual requirements and this was not mentioned in the End of Confidence Trial Report; and
  - (g) the PO did not keep the results of the acceptance tests of many component systems of the POMS;
- notes that the Postmaster General has agreed:
- (a) to implement the audit recommendations mentioned in paragraph 2.21 of the Director of Audit's Report (the Audit Report); and
  - (b) that, for future similar projects, the PO will manage the work and performance of a consultant more proactively so as to ensure that all contractual requirements are met and, where deviations from and non-compliance with the contractual requirements are warranted, ensure that the cases are fully justified and properly documented;

### **Performance of the Postal Mechanisation System**

- expresses serious dismay and finds it unacceptable that:
- (a) the performance of the IMPs in respect of the read rate, error rate, overflow rate and jam rate did not meet the contractual requirements;
  - (b) the performance of the Packet SSs in respect of the throughput, jam rate and overflow rate did not meet the contractual requirements; and
  - (c) the hourly throughput of the Parcel SS ranged from 1,393 to 2,085 parcels and this fell substantially short of the capacity of 5,500 parcels specified in the Contract;

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- notes that the Postmaster General:
  - (a) has sought legal advice on whether there were breaches of the contractual terms in respect of the performance of the POMS and concluded that there was insufficient evidence to pursue a claim against the Contractor and the Consultant; and
  - (b) has agreed to implement the audit recommendations mentioned in paragraph 3.39(a) and (d) of the Audit Report;

### **Utilisation of the Postal Mechanisation System**

- expresses serious dismay that:
  - (a) during the years from 1999-2000 to 2003-04, the IMPs were used to sort only 55% of the letters at the Air Mail Centre (AMC) each year and the average daily operating hours of each IMP ranged from 3.9 hours to 4.8 hours;
  - (b) during the years from 1999-2000 to 2003-04, the Packet SSs were used to sort only 31% of the packets at the AMC each year and the average daily operating hours of each Packet SS ranged from 2.6 hours to 7.2 hours; and
  - (c) Unit D of the conveyor system is used only occasionally. Since the opening of the AMC, the container storage and retrieval system has never been used to store mail, and major parts of Unit E and Unit F of the conveyor system, the vacuum lifting devices, the unit load device transfer system and the mail segregation system have been left idle;
- notes that the Postmaster General has agreed to implement the audit recommendations mentioned in paragraph 4.23 of the Audit Report;

### **Payments for the Postal Mechanisation System**

- expresses alarm and strong resentment that:
  - (a) there were overpayments of \$7.1 million to the Contractor; and
  - (b) 15 payments were not made to the Contractor within one month of receipt of the invoices in order to obtain the special discounts of \$0.2 million;

## The Postal Mechanisation System at the Air Mail Centre

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- finds it unjustified that, although the PO had been informed of the postponement of the opening of the new airport from June 1997 to July 1998 at different times, an additional consultancy fee of \$3 million was still incurred for reason that the opening of the AMC in the new airport was delayed;
- notes that:
  - (a) the Post Office recovered \$8 million (i.e. the overpayments of \$7.1 million and the accrued interest of \$0.9 million) from the Contractor; and
  - (b) the Postmaster General has implemented the audit recommendations mentioned in paragraph 5.14 of the Audit Report;
- recommends that the Postmaster General should ensure that the officers in the PO responsible for monitoring payments exercise due care in certifying and authorising payments, and that all the payment checking procedures are strictly followed; and

### **Follow-up actions**

- wishes to be kept informed of the progress made by the PO in:
  - (a) implementing the recommendations relating to the strengthening of the monitoring of the performance of a consultant/contractor;
  - (b) improving the performance and utilisation of the POMS; and
  - (c) implementing other audit recommendations mentioned above.