

A Review of the National Broadband Network-ZTE supply contract

I. Summary

The National Broadband Network (NBN) Project is a scandal-ridden controversy. The project, awarded to Chinese state-owned ZTE Corporation, is the subject of a continuing Senate inquiry for alleged over-pricing and illegality, involving bribery of high-ranking government officials. Commission on Elections (Comelec) Chairperson Benjamin Abalos, one of those accused of “peddling” the project, has resigned from office, in view of possible impeachment by the House of Representative.

UP School of Economics Professors Raul Fabella and Emmanuel de Dios¹ also raised economic arguments against the NBN. For one, broadband “backbones” already exist, operated by the private sector. The government, according to them, should just take care of the “last mile” connection that the market cannot provide.²

Considering also the inexperience and poor track record of government in maintaining telecommunication networks (e.g. the failed Telepono ng Barangay project), as well as the big amount of money that it will borrow for the construction of the NBN, it makes for bad policy.

Former Transportation and Communications Secretary Josefina Lichauco raised legal issues, criticizing the government turnaround from making the private sector provide public telecommunication services as mandated by the Public Telecommunications Policy Act of the Philippines.³

On October 3, 2007, after weeks of criticism, President Macapagal-Arroyo finally announced the cancellation of the contract during her meeting with Chinese officials in Beijing. However, recent events do not render moot the issues (economic and political) and the policy findings regarding the contract. Lessons on policy proposals and reform can still be gleaned from this experience and be adopted, perhaps in better times.

Lack of Transparency

At the outset, it must be said that the ZTE contract, like other questionable projects, suffered from sheer lack of transparency. The NBN was originally a Build-Operate-Transfer (BOT) project, before it was scrapped in favor of its current form, i.e. a direct government undertaking financed by a Chinese sovereign loan. The circumstances surrounding the approval and awarding of the contract to ZTE were not clear.

¹ Fabella, Raul and Emmanuel De Dios. Lacking a Backbone: The Controversy over the “National Broadband Network” and the Cyber Education Projects. *Unpublished paper*.

² This involved connecting, for instance, far-flung municipalities to the existing main networks.

³ Republic Act 7925, Sec. 4(e) declared it a national policy to have “[p]ublic telecommunications services ... provided by private enterprises. The private sector shall be the engine of rapid and efficient growth in the telecommunications industry.”

The government was also not forthcoming in providing copies of the contract. On June 10, 2007, Action for Economic Reforms (AER) and the Ateneo de Manila University-Economic Policy Reform and Advocacy (EPRA) held a forum on the NBN. Department of Transportation and Communication (DOTC) Assistant Secretary Lorenzo Formoso let it slip that the original contract was lost by a government commercial attaché in China. He said that that his department was trying to reconstitute the contract.

AER and EPRA subsequently wrote Mr. Formoso and requested a copy of the contract. The letter was sent on June 25 but he only replied on September 03 saying that they could not provide a copy of the contract because “the Confidentiality Clause of the Contract provided for under Article 39 restricted (them) from doing so.” (See Section 8 part II of this report.

Later on, a copy of the contract was obtained sans the attachments. But these attachments have the more substantive parts, containing the priced bill of quantities⁴ (Attachment A), the technical specifications and performance standards of equipment (Attachment B), the ZTE’s scope of work (Attachment C), scope of work for managed services (Attachment H), and the implementation schedule (Attachment D).

The unavailability of these annexes is a major handicap in making an objective evaluation, especially on its technical aspect.

Pricing and Costs

The most striking section of the contract is on ZTE’s scope of work, which includes the finalization of the detailed engineering design of the project. There is no engineering design yet but the contract already contains an estimated cost of the project, i.e. US\$ 329,481,290.

With the lack of the engineering design and in the absence of attachments mentioned earlier, the basis for this valuation is questionable. There are no references, cost breakdowns, and technical specifications that can be used to ascertain the accuracy and fairness of the costing. In the end, government may end up paying more than what will actually be delivered by ZTE.

Change orders

In addition, the contract has very liberal provisions on change orders⁵. Under the contract, change orders become final upon the signature of the DOTC officials. (The department is the representative of the government in its negotiations and agreements with ZTE.) It is not clearly specified if such change orders will be reviewed by the NEDA Investment Coordination Committee, which is necessary to measure the fiscal impact of any change in the project cost, resulting from the change order/s.

⁴ “A list of numbered items, each of which describes the work to be done in a civil engineering or building contract. Each item shows the quantity of work involved.” (http://www.aggregain.org.uk/terminology/bill_of.html)

⁵ any change in the scope of work

The same incident happened in the PIATCO project. The changes in the contract after implementation stage were found to be onerous to government but the NEDA ICC did not have the opportunity to do technical and financial review of the same, as required under the NEDA Charter.

Change order provisions are not unusual in contracts such as this; however, they can be abused if there is lack of transparency as encouraged by many of the provisions of the ZTE contract. They can result in unnecessary increase in the project price.

Quality Control and Warranty

The government also effectively limited ZTE's liability for any malfunctioning equipment to mere replacement or repair of the same. It waives its rights to other damages, for example, from loss of business and delays in transactions that may result from the equipment problem. This is legal because under the Philippine Civil Code, damages arising from fraud are the ones that cannot be waived. However, on a policy point of view, this may encourage lapses on the part of the contractor.

No bidding

Finally, there are legal questions about the applicability of the Procurement law on the contract.

The contract purports to be a result of an executive agreement between China and the Philippines, which exempts it from the bidding requirements of RA 9184 (Government Procurement Act) in accordance with the Supreme Court Decision in *Abaya v. Ebdane*.⁶ However, the said executive agreement has yet to be presented to the public and doubts as to its ratification or even its existence have been raised. If that is the case, then the contract is void for violating government procurement and accounting procedures since it puts the project with the purview of RA 9184 and the Revised Administrative Code.

The contract also contains a provision on Post-Warranty Service. It says that ZTE can provide maintenance and technical service to the government after the NBN has been commissioned and after the warranty period for its equipment has ended. The service is for a minimum of 3 years (without setting a maximum period). This allows the ZTE to have continuing transactions with government without the benefit of bidding. The Procurement Law, which was intended to generally cover all government transactions, becomes inutile.

II. Contract Provisions

⁶ G.R. 167919

Part II follows the ordering of the provisions in the contract. This report cites the pertinent provisions of the contract. Some annotations are also provided on some sections of the contract.

1. The ZTE Contract is based on an executive agreement

1.1 The contract acknowledged that there is an executive agreement between Chinese and Philippine governments, wherein China agreed to finance the NBN project through a loan from the Export-Import Bank of China “on the condition that Equipment and Services to be procured from the proceeds of the loan come from ZTE Corporation.” (Preamble Clause D)

The assertion that the ZTE contract is an offshoot of an executive agreement has important implications. According to the opinion issued by the Department of Justice (DOJ) Secretary, projects procured through executive agreements fall outside the purview of RA 9184, the Government Procurement Act. The opinion is based on a reading of Sec. 4 of that law that is cited below:

SEC. 4. *Scope and Application.* - This Act shall apply to the Procurement of Infrastructure Projects, Goods, and Consulting Services, regardless of source of funds, whether local or foreign, by all branches and instrumentalities of government, its departments, offices and agencies, including government-owned and/or -controlled corporations and local government units, subject to the provisions of Commonwealth Act No. 138. **Any treaty or international or executive agreement affecting the subject matter of this Act to which the Philippine government is a signatory shall be observed.** (emphasis supplied)

The DOJ Opinion is also in line with a February 14, 2007 decision⁷ of the Third Division of the Supreme Court. In that decision, the Supreme Court said that a loan agreement between the Philippines and the Japan Bank for International Corporation would fall outside the coverage of RA 9184. The terms of the agreement would therefore govern.

But another consideration is the statement by Sec. Romulo Neri (Philippine Daily Inquirer, Sept. 14, 2007) that there is still no loan agreement signed between China and the Philippines. This is contrary to the opinion of the DOJ that an exchange of correspondence between former Presidential Chief of Staff Mike Defensor and Chinese Minister of Commerce Bo Xian/Chinese ambassador to the Philippines Li Jinjun is already an executive agreement.⁸ In *Abaya vs. Ebdane*⁹, the exchange of notes between DOF Sec. Domingo Siazon and Japanese Ambassador Yoshihisa Ara was recognized as an executive agreement. “...[A]n exchange of notes is considered a form of an executive agreement, which becomes binding through executive action without the need of a vote by the Senate or Congress”, the Supreme Court said. However, in that case, a loan

⁷ *Abaya vs. Ebdane*, GR No. 167919

⁸ Letter of DOTC Sec. Leandro Mendoza to Asst. Sec. Lorenzo Formoso III dated 06 August 2007.

⁹ *Abaya vs. Ebdane*, GR No. 167919

agreement was a signed *after* the exchange of notes, which is not so in ZTE, if Neri is to be believed.

Thus, the issue arises as to whether or not the executive agreement embodied in the letters exchanged by Filipino and Chinese officials has been ratified and made effective.

“Executive Order No. 459 issued by President Fidel V. Ramos on November 25, 1997 provides the guidelines in the negotiation of international agreements and its ratification. ... Section 7 of Executive Order No. 459 reads:

“Sec. 7. Domestic Requirements for the Entry into Force of a Treaty or an Executive Agreement. — The domestic requirements for the entry into force of a treaty or an executive agreement, or any amendment thereto, shall be as follows:

“A. Executive Agreements.

“i. All executive agreements shall be transmitted to the Department of Foreign Affairs after their signing for the preparation of the ratification papers. The transmittal shall include the highlights of the agreements and the benefits which will accrue to the Philippines arising from them.

“ii. The Department of Foreign Affairs, pursuant to the endorsement by the concerned agency, shall transmit the agreements to the President of the Philippines for his ratification. The original signed instrument of ratification shall then be returned to the Department of Foreign Affairs for appropriate action.”¹⁰

If the executive agreement has not been ratified, then:

- the NBN project should have been subjected to public bidding in accordance with the Government Procurement Law
- Absent the loan agreement, the contract should not have been executed without a certificate from the Department of Budget and Management (DBM) that funds have been duly appropriated and are available for expenditure on account of the project. The certificate should be attached to the contract, as part thereof, otherwise the whole contract is deemed void in accordance with Revised Administrative Code.¹¹

2. Price and Financing

¹⁰ Pimentel et al. v. Executive Secretary, G.R. No. 158088, July 6, 2005.

¹¹ Jalandoni v. Salas, G.R. No. L-27150, November 28, 1969

2.1 According to the ZTE contract’s Article 5 “**Priced Bill of Quantities**” (i.e.) shall be revised in accordance with the actual requirement of the project to be determined and approved by the Purchaser and the Contractor during the **detailed engineering stage** i.e. the stage where the equipment (including quantity) that ZTE will deliver and supply and the services it will provide shall be determined.

This shows that there was no detailed project design at the time the contract was signed. However, there are already contract estimates/prices indicated in Article 7 [stated in 2.2, below]. In addition, Articles 19.1 and 19.2 clearly state that the finalized design by ZTE will be reviewed only *at the beginning* of the effectivity of the contract. Absent the detailed engineering design, how can government claim this is the more cost-effective option compared with other similar proposals? Price escalations will surely happen in the future because of the failure to do the detailed engineering design prior to contract approval.

2.2 Contract Price

Equipment (set out in Attachment A)	- US\$ 194, 051 628
Engineering Services	- US\$ 118, 605, 650
Managed Services	- US\$ 14, 875, 507
Training (set out in Attachment A)	- US\$ <u>1,948,505</u>
Total	- US\$ 329,481,290

2.3 “[P]rices above are **net prices, exclusive of all taxes.**” Obviously this means, government is giving a tax holiday for ZTE. Article 9.1 states “All taxes, import or customs duties and other taxes and duties, including without limitation VAT and Income tax, in connection with or in respect of the performance of this Contract levied by relevant authority in the Republic of the Philippines, shall be borne and paid by the Purchaser (Philippine Government).” Taxes imposed outside the Philippines shall be borne by ZTE.

2.4 In Article 8.3, (schedule of payment for engineering services) an advance payment (15% of the price) becomes due after certain conditions are met including “the completion of site survey and engineering design” (Art 8.3.2). This is the only point where they can really determine actual engineering costs.

3. ZTE’s Scope of Work

3.1 The Scope of Work of ZTE (Art. 3.1) includes the “design, supply, construct, install, test, commission [i.e. put into operational status] and provide technical support” for the NBN project. (**Note:** A more detailed description of the SOW is in Attachment C of the contract, which was not included in the documents given to us)

- 3.2 Within 36 months after the effectivity of the contract, ZTE “shall supply all the Equipment and complete installation, testing and commissioning thereof.” (Art.17). In the next, 1 and ½ years, ZTE is to provide “Managed Services.”
- 3.3 Art. 6.1 Managed Services i.e. operation, maintenance and repair services shall be provided by ZTE for **1 and ½ years** beginning at the time government issues a Provisional Acceptance of Certificate.¹² However, Art. 6.5.1 says that government shall be responsible for spare part management and asset management¹³ while Art. 6.5.2 states the maintenance of “certain Equipment” will be transferred to the government within **6 months** of the term for Managed Services.” (**Note:** These pieces of equipment are stated in Attachment K, which was not included in the documents given to us). The related attachments must be reviewed because the government may be paying more than what ZTE will actually provide as part of these “managed services”, considering the government will already take care of (some or most) maintenance work within six months into the term of the contract.
- 3.4 Included in the scope of work is the preparation and completion of the detailed Engineering Services, the plans, specifications and designs and submission of the same for approval of the purchaser (Articles 16.2 and 16.3a). Again, these should have been done prior to the contract signing.
- 3.5 **Article 29 Post Warranty Service** – ZTE may provide maintenance and technical support to the government in respect of all the Equipment and Services for at least three years after the expiry of the relevant warranty period.

This provision gives ZTE an open-ended deal with government considering that the provision only sets a minimum (not maximum) period for this service. In effect, ZTE will continue to have transactions with government after the lifespan of the contract, which is supposed to be only 4.5 years and after the warranty period for the equipment.

Again, these possible transactions will be approved without benefit of bidding. In the first place, the loan agreement, assuming that it exists, should not even provide for this post-warranty service. If it is not covered by the assumed loan agreement and therefore not covered by the executive agreement, then this service should definitely be subject to bidding.

4. Terms of Payment (Art. 8)

4.1 For Equipment

¹² Article 1.20 states that this will be issued after ZTE satisfactorily installed and commissioned the equipment.

¹³ The cost of spare parts will be shouldered by government. We need to look at the details of “Managed Services” and find out whether or not they included estimates for spare parts in the amount stated in Article 7.

- **15% of cost** – advance payment i.e. before the equipment is delivered to the government
- **50% of cost** – delivery payment, after certain documents are presented including invoices, certificate of quality and quantity, etc. Noteworthy is the requirement of a “factory test certificate to be issued by the Contractor witnessed by or, **if not witnessed duly notified** to the purchaser.” (Art. 8.2.2.1.1.6) There is **no strict quality control**.
- **35% of cost** – Payment on provisional acceptance.

4.2 Engineering Service

15% - Advance payment

15% - “10 days after site survey and engineering design covering the upgrading portion set out in Attachment D have been completed” by ZTE and approved by government

15% - “10 days after the site survey and engineering design covering the extension portion set out in Attachment D” have been completed by ZTE and have been approved by government

55%- Payment upon Provisional Acceptance. It will be paid after the receipt of the following from ZTE: a) copy of Provisional Acceptance Certificate; and commercial invoice covering this provisional certificate.

4.3 Managed Services

– 15% advance payment; balance of 85% to be divided into 18 monthly installments (period for Managed Services is 1.5 years). But see 3.2 below.

4.4 Training

– 15% advance payment; 85% after completion of training course

5. Warranty

“If it appears that any Equipment, or part thereof, contains a defect in materials or workmanship or otherwise fails to conform to the Specifications, during the Warranty Period, the Contractor shall at its expense correct any such defect by repairing such defective Equipments (sic) or part or, at the Contractor’s option, by delivering to the Purchaser an equivalent equipment or part replacing such defective Equipments (sic) or part in accordance with the equipments (sic) as set out in Attachment G (Service Level Agreement) as soon as practicable. Any further right or remedy of the Purchaser against the Contractor and its employees or agents in connection with or based on the defects in materials or workmanship excluded.” (Art. 26.2)

The cited provision precludes the government from claiming damages for losses that it may incur (e.g. loss in revenue, delays in government business, etc.) as a result of the defective equipment. Government effectively waived certain rights (for damages) available to it under the Civil Code. Of course, such waiver does not include damages

that may arise from fraud since that is prohibited by law. This provision is not illegal; however, from a policy point of view, this can result in poor implementation by the contractor.

6. Obligations of RP

- 6.1 Government will take care of national and local taxes imposed on any phase of the project (See Articles 9, 14)
- 6.2 Secure authorizations, licenses, and visas for personnel that ZTE may bring into the country. (Article 21.1)

(Note: Art. 20.3 states that ZTE shall “**whenever possible**, utilize Filipino Personnel in the execution of the project.”).

- 6.3 In charge of acquiring right of way and right of access (Art.22)

7. Change Order

Both ZTE and the Government can suggest/request changes in the work plan. The change order must be in a written document which incorporates the changes, their effect on the implementation schedule and in the contract price. (Article 25.4.1) “A party’s signature on the Change Order shall indicate such party’s full, final and unconditional agreement with matters prescribed in such Change Order.” (Article 25.4.2)

The DOTC represents the government in negotiations and agreements with ZTE (Art. 41.13.1) and DOTC Secretary’s approval of any Change Order is considered binding and final under the quoted Art. 25.4.2. The problem with this provision is that it can result in NEDA being by-passed. This is what happened with the PIATCO project. The NEDA-Investment Coordination Committee approved the original contract, having passed both technical and financial evaluation. However, subsequent changes in the contract, which were disadvantageous to the Philippine government, did not go through NEDA-ICC review anymore. The NBN project also got NEDA approval. If the change orders do not pass through NEDA for review, then the mandate of NEDA-ICC under Sec. 6 of Executive Order 230 is negated. The said section states:

“Investment Coordination Committee (ICC) -The ICC to be composed of the Director-General of the National Economic and Development Authority Secretariat, the Executive Secretary, the Secretaries of Finance, Agriculture, Trade and Industry and of Budget and Management and the Governor of the Central Bank shall have the following functions:

- (i) **Evaluate the fiscal, monetary and balance of payments**

implications of major national projects and recommend to the President the timetable of the implementation of these projects on a regular basis; and

(ii) Recommend to the President a domestic and foreign borrowing program updated each year, and **subsequently submit to the President a status of the fiscal, monetary and balance of payments implications of major national projects.**”

8. Confidentiality

8.1 “Confidential information” means “all non-public information disclosed by or relating to a party that is designated as confidential or that given the nature of the information or the circumstances surrounding its disclosure, reasonably should be considered confidential.” (Art. 39.1)

8.2 However, both parties are not prevented from disclosing confidential information, when they are required to do so under any applicable laws, by the orders of the courts, governmental body or authority of competent jurisdiction, or by the mandatory requirements of regulatory bodies or by the rules of any recognized stock exchange. (Art. 39.3)

8.3 “The Receiving Party shall return or destroy all Confidential Information, in any form and including without limitation, all summaries, copies and excerpts of confidential information, promptly following the Disclosing Party’s request.” (Art. 39.4)

Provisions quoted in 8.1 and 8.3 are antithetical to greater transparency and government disclosure. There are no clear criteria on what can be designated as confidential information. In addition, there is no evaluation process regarding the requests for the return or destruction of confidential information under Art. 39.4. An automatic grant of the request can be understood from said provision.

9. Effectiveness of the Contract

9.1 The contract becomes effective upon the fulfillment of the following conditions:

- a. Contract has been duly authorized, executed, and delivered by the Parties.
- b. All authorizations necessary for the execution, delivery, performance of the contract and the transactions contemplated hereby have been obtained and are in full force and effect; and
- c. The loan agreement has become effective (Art. 41.11.1)

9.2 In addition, the following are conditions precedent to the effectiveness of the contract

- a. Issuance of a Forward Obligation Authority of the DBM

- b. Conclusion of the loan agreement between Export-Import Bank China and Department of Finance (DOF)
- c. Legal opinion on the procurement process by the DOJ
- d. Ratification by the Government of RP and the PRC of the Executive Agreement “evidenced by the letter 02 December 2006 of the Chinese Ambassador Li Jinjun to Presidential Chief of Staff Michael T. Defensor relating to the NBN Project and the letter of (sic) NEDA Secretary dated 20 April 2007 addressed to the Honorable Minister Bo Xilai, Ministry of Commerce and Honorable Li Ruogu, Chairman and President of the Export-Import Bank of China, People’s Republic of China nominating the NBN Project.” (Art. 41.12)

There is some question as to whether the contract has actually been ratified (See discussion in number 1).

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