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Agenda - Economy, Infrastructure and Skills Committee

Meeting Venue:	For further information contact:
Committee Room 3 - Senedd	**Robert Donovan**
Meeting date: 17 October 2019	Committee Clerk
Meeting time: 09.30	0300 200 6565
	SeneddEIS@assembly.wales

1 Introductions, apologies, substitutions and declarations of interest

(09.30)

2 Evidence session: Retention payments in the construction sector

(09.30-10.30) (Pages 1 - 76)

Professor Rudi Klein, Barrister, Head of Specialist Engineering Contractors' (SEC) Group

Catherine Griffith-Williams, National Executive Officer for Wales, SEC Group

Kyle Spiller MCIOB, Director of SAM Drylining Ltd (representing Chartered Institute of Building Wales)

Ifan Glyn, Senior Hub Director/Wales Director, Federation Of Master Builders

Attached Documents:

Paper 1 - Written evidence from SEC Group Wales

Paper 2 - Written evidence from Scottish Futures Trust

Paper 3 - Written evidence from the Federation of Master Builders

Paper 4 - Written evidence from the Chartered Institute of Building

Paper 5 - Written evidence from the Scottish Government

Research brief

Cynulliad Cenedlaethol Cymru   National Assembly for Wales

3 Motion under Standing Order 17.42 (ix) to resolve to exclude the public from item 4 of the meeting

(10.30)

4 Consideration of evidence: Retention payments in the construction sector

(10.30–11.00)

RETENTION PAYMENTS IN THE CONSTRUCTION INDUSTRY

Joint Inquiry by the Economy, Infrastructure, Skills and Finance Committee

ABOUT THE SPECIALIST ENGINEERING CONTRACTORS' (SEC) GROUP WALES/CYMRU

SEC Group Wales/Cymru represents the specialist engineering sector which contributes the largest element (by value) to Welsh construction. The sector primarily comprises small businesses. The following trade associations are represented under the SEC Group Wales/Cymru umbrella:

British Constructional Steelwork Association (BCSA)
Building Engineering Services Associaton (BESA)
ECA - Electrotechnical and engineering services trade body
Lift and Escalator Industry Association (LEIA)
Scaffolding Association

1. **Use of Retentions in Wales and UK**

1.1 The use of retention monies is widespread across the construction industry and has been so for almost 200 years. Ostensibly the monies are deducted as security in the event that a business providing construction or engineering works fails to return to rectify non-compliant work. In practice the monies are withheld to bolster the working capital of the withholder or, in some cases, are even used to invest in the overnight money markets.

1.2 Normally 5% of progress payments are deducted but in some cases the percentage may be as high as 10%. Half the total retention withheld should be returned on handover of the works but this is not always the case. The other half should be released over the next 12 months following the expiry of a period referred to by myriad terms such as the *defects liability period*. Again, in practice, the final half of the monies are not released until 2,3 or more years after handover – usually after a considerable amount of chasing from the creditor firm.

1.3 In October 2017 the UK Government published the results of research on retentions carried out by consultants Pye Tait. The research concluded that any benefits that might be obtained from the practice of retentions were far outweighed by the abuse associated with the practice which primarily impacts SMEs. The Pye Tait report revealed that:

- £4.5 billion (at 2015 prices) of cash retentions was, on average, withheld annually.

- £700 million of cash retentions had been lost over a 3-year period up to 2016 as a result of upstream insolvencies (almost £1 million per working day!).
- Over a three-year period (ending 2016) £7.8 billion of cash retentions was still owing.

These are UK-wide figures.

1.4 The above figures did not take account of the losses arising from the Carillion collapse (it is variously estimated that firms in Carillion's supply chain would have lost between £¼ billion and £½ billion worth of retentions). The collapse of Welsh-registered construction company Dawnus in March 2019 left £39 million owing to its trade creditors; much of this would have comprised retention monies.

2. **To what extent are retentions an issue for companies based and/or operating in Wales including how issues might differ through the supply chain?**

2.1 Whilst cash retentions are supposed to provide a measure of performance security there is no concomitant security for the cash. Retentions are owned by the businesses from whom they were deducted since they are withheld from sums acknowledged as due. Moreover, when it comes to insolvency risk and retentions there is an inequality of distribution of such risk as one proceeds along the supply chain.

2.2 Where works are commissioned by public bodies such bodies do not go into insolvency. Therefore the retentions provided by a tier 1 contractor (over 90% of which are collected from its supply chain) are protected from insolvency. This does not, of course, apply along the supply chain. (Attached at **Annex 1** are suggested options which public bodies can include in their contracts with tier 1 contractors.) Even where works are procured by a private sector client a tier 1 contractor can protect itself in the event of the client's insolvency. This is achieved by inserting a pay when/if paid clause in its sub-contracts (which is permitted under section 113, Housing, Grants & Regeneration Act 1996).

2.3 Cash retentions are regarded by the overwhelming majority of SMEs in Welsh construction as a significant drain on their scarce resources; a retention usually represents their margin on any given contract. Retentions are never released automatically; they always have to be chased once the release date is past. According to a 2017 survey carried out by trade bodies in membership of SEC Group most respondents reported that they had to wait more than 12 months for release of their retentions with an average of almost £35,000 outstanding (the majority of respondents were small businesses). There was never any indication of the reason(s) for the delay, when the monies would actually be paid or whether the outstanding retention would be released in full. This financial uncertainly is intolerable for small firms and curbs their prospects for growth derived from investment in jobs, skills and business development. In many cases firms give up chasing the monies; this is acknowledged by HMRC in its internal Business Income Manual (updated in 2016) which states:

"In recent years, construction industry customers have become increasingly reluctant to pay retention monies, irrespective of whether there are defects to be made good. It is now common for such monies never to get paid."

3. **Are there any benefits to the use of retentions?**

3.1 Any benefits associated with the practice of retentions are often more apparent than real. Some clients believe that they are a "*comfort blanket*" providing a measure of protection in the event that a firm for whatever reason, fails to address non-compliant work. But, in many cases where there are extensive defects, the funds in the retention pot are insufficient to carry out the necessary remedial work or complete any unfinished work (often as a result of the insolvency of the firm in question). It has to be said that the prime benefit is the boost to working capital provided by retentions. Surveys carried out by SEC Group in Wales and in the rest of the UK have indicated that many local authorities are dependent on retentions to fund other works or other council activities.

3.2 From a macro standpoint the disbenefits outweigh the benefits. In its impact assessment prior to introducing legislation in 2017 to protect cash retentions the New Zealand Government's Ministry of Business, Innovation & Employment stated:

"The use of retentions as working capital is the key concern for the Government; funding working capital from retentions can mask and reward poor performance and poor financial management practices. For example, undercapitalisation and low-price tendering are long standing features of the Construction market that contribute to its low productivity and innovation. The use of retentions as working capital enables those features to remain with no incentive to change and no incentive for clients or lead contractors to properly manage project risks."

3.3 Far from addressing defects the retentions system and the associated abuse can, paradoxically, have a detrimental impact on quality. Dame Judith Hackitt's report in May 2018, *Building a Safer Future*, stated:

"Payment terms within contracts (for example, retentions) can drive poor behaviours, by putting financial strain into the supply chain. For example, non-payment of invoices and consequent cash flow issues can cause subcontractors to substitute materials purely on price rather than value for money or suitability for purpose."

We would suggest that the primary reason for the continuation of the cash retention system is that it has become embedded in the *"subconsciousness"* of a construction delivery model that is driven by poor capitalisation in the pursuit of the lowest possible price and falling standards.

4. **What are the alternatives to the use of retentions and what role could the Welsh Government play in developing and delivering those alternatives?**

4.1 The alternative to cash retentions that is often proposed is the use of retention bonds. Unfortunately, surety bonding is not an option for small firms. Assuming that they can have access in the first place to the surety market the cost of bonding will usually be prohibitive. Therefore, this is not considered to be a viable alternative for small businesses.

4.2 Since 2017 the SEC Group has sponsored the development of a digital platform to protect retention money. This has been led by Pay2escrow (a financial services company) as part of a proposed consortium of Willis Towers Watson (insurance broker), the University of Northumbria (for research support), and others including software developers. Underpinning the platform will be an industry-owned insurance fund to ensure retentions

are released in full and on time, even in the event of upstream insolvencies. Support for this work has come from a range of industry bodies including the Federation of Environmental Trade Associations, the National Federation of Builders and the Federation of Master Builders. Interest in this work has also been expressed by the Local Government Association in England.

4.3 Like online banking the platform will be easy to use. Contractors will be able to see what they are owed and when it will be paid. Retentions will be safely ring-fenced in a trust account with an industry-owned clearing house. A distributed ledger will be used to deliver a cost-effective insurance-enhanced service. The whole cost of the scheme will be roughly £230 for every £100,000 of contract value (a mere 0.23%).

4.4 The project is now ready for live testing. Funding is now being sought for a 12-18 month pilot. The pilot will allow industry participants to optimise the solution. **We would encourage Welsh Government to support this work and, if possible, make some funding available to help in the development of the digital platform so that it is ready for piloting.**

4.5 Most other jurisdictions (e.g. some Australian states, some US states, New Zealand, Germany) have legislation in place that ring-fences cash retentions by requiring that they are placed in trust or in a stakeholder account until released. The 1975 French Law of Sub-Contacting requires all tier 1 contractors to issue their sub-contractors with bank guarantees to guarantee that the funds will be available on the date(s) for release.

4.6 **We suggest that Welsh Government considers introducing legislation in the Welsh Assembly to protect cash retentions where they are withheld on construction operations in Wales.** Attached is the draft of a Bill which we published in 2013 as a possible Private Members' Bill. The Bill is for illustrative purposes only as developments since 2013 (such as advances in digital technology) will mean that some updating will be necessary. A useful template is the Construction (Retention Deposit Schemes) Bill which was a Private Members' Bill introduced in the House of Commons in January 2018. This outlaws cash retentions unless they are placed in a retention deposit scheme.

4.7 Other than legislation there is no other alternative that ensures the necessary protection for cash retentions. This has been the experience of most other jurisdictions. It is within the competence of the Welsh Assembly to pass the necessary legislation which would mean that Wales will lead the UK in delivering a transformative solution that both enhances the livelihoods of construction small businesses and addresses the Welsh Government's focus on the foundational economy.

Catherine Griffiths-Williams
National Executive Officer, SEC Group Wales/Cymru

Rudi Klein
CEO, SEC Group

27 September 2019

RETENTION MONIES (WALES) BILL 2013

[AS INTRODUCED]

An Act of the National Assembly for Wales to provide for the protection of retention monies in the construction industry in Wales in the event of the insolvency of the party holding such monies

Having been passed by the National Assembly for Wales and having received the assent of Her Majesty, as follows:

Interpretation

1.

1. (1) In this Act –

"adjudication" has the meaning given to it by section 108 of the Housing Grants Construction and Regeneration Act 1996 (as amended);

"construction contract" has the meaning given to it by Section 104 of the Housing Grants, Construction and Regeneration Act 1996 (as amended) but only includes construction contracts insofar as these relate to the carrying out of construction operations in Wales;

"construction operations" has the meaning given to it by Section 105 of the Housing Grants, Construction and Regeneration Act 1996 (as amended) with the exception of *subsection (2)*;

"insolvency" has the meaning given to it by Section 113 of the Housing Grants, Construction and Regeneration Act 1996 (as amended);

"month" means a calendar month;

(2) In this Act, reference to "beneficiary" or "beneficiaries" means (as the case may be) -

(a) a "tier one contractor" which has entered into a construction contract with a party procuring construction operations;

(b) a "tier two contractor" which has entered into a construction contract with a tier one contractor;

(c) a "tier three contractor" which has entered into a construction contract with a tier two contractor.

(3) In this Act, reference to a “party procuring construction operations” means the party which has entered into a construction contract with a tier one contractor to provide such operations.

(4) In this Act, reference to “retention monies” includes any sums withheld from payments otherwise due under a construction contract by way of security for current and future performance other than performance damages or liquidated damages;

(5) In this Act, reference to “trustee” is the party under *section 2* upon whom is placed the obligation to hold retention monies in trust.

Status of retention monies

2. (1) Where a party procuring construction operations under a construction contract withholds retention monies from the tier one contractor such monies shall be held in trust for the benefit of the tier one contractor and such of the tier two and tier three contractors as have had retention withheld against them under a construction contract.

(2) Where the party procuring construction operations does not withhold retention monies under a construction contract but the tier one contractor withholds retention monies from its tier two contractors, such monies shall be held in trust for the benefit of such of the tier two contractors and their tier three contractors as have had retention monies withheld against them under a construction contract.

(3) Where both the party procuring construction operations under a construction contract and the tier contractor do not deduct retention monies but a tier two contractor withholds retention monies from its tier three contractors, such monies shall be held in trust for the benefit of such of the tier three contractors as have had retentions withheld against them.

Duties of the trustee

3. (1) The trustee shall establish a trust account at a bank solely for the purpose of depositing the retention monies and shall notify the bank that the monies are held in such account in accordance with the provisions of this Act.

(2) The trustee shall be solely liable for the cost of establishing and maintaining such account.

(3) The trustee shall maintain a record of all amounts of the retention monies individually contributed by each beneficiary and shall issue each beneficiary details of the trust account.

Interest

4. Each beneficiary shall have an entitlement to a share of the interest earned whilst their respective retention monies are in the trust account in proportion to each of their retention monies held in the account.

Failure to comply with this Act

5. (1) Where a party designated as trustee under *section 2* fails to comply with any of the requirements of this Act it shall not be permitted to deduct any retention monies and this prohibition shall apply to all construction contracts in the supply chain as between tier one and tier two contractors, and tier two and tier three contractors.

   (2) Where in contravention of any of the requirements of the Act any retention monies have been deducted they shall be refunded immediately and are recoverable under the relevant construction contract as a debt exclusive of any counterclaim.

Release of retention monies

6. Subject to *section 7* the trustee shall ensure that all outstanding retention monies are released to each beneficiary no later than the expiry of twelve months following the date the party procuring the construction operations had taken them over.

Right of recourse against trust account

7. The obligation under *section 6* to release the retention monies is without prejudice to the right of the trustee to use the monies in accordance with the purpose for which such monies have been withheld under the construction contract to which the trustee is a party.

Liability of the bank

8. This Act does not impose any liability upon a bank holding an account designated as a trust account under this Act but the bank shall have no recourse to the account to offset any claim or liability which the bank may have against the trustee.

Replenishment of trust account

9. (1) Where under *subsection 7* the trustee is the party procuring the construction operations the tier one contractor shall forthwith replenish the account to the extent of the contributions of each of its tier two contractors provided that the reason for the withdrawal by the trustee from the account was not due to their insolvency or their work and/or materials not being in

conformity with their contract and this provision shall apply *mutatis mutandis* to tier two contractors in respect of their tier three contractors.

(2) Similarly where under *section 7* the trustee is a tier one contractor its tier two contractors shall forthwith replenish the account to the extent of the contribution of each of their tier three contractors provided that the reason for the withdrawal by the trustee from the account was not due to their insolvency or their work and/or materials not being in conformity with their contract.

(3) Failure by the tier one contractor or tier two contractor, (as the case may be), to comply with *paragraphs (a) or (b)* shall entitle the affected beneficiaries to the immediate release by the other party under their construction contracts of any outstanding retention monies.

Conflict with provisions in the construction contract

10. The provisions of this section should prevail over any inconsistent express or implied terms of any construction contract to which this Act applies.

Disputes

11. In the event of any dispute or difference arising under or in connection with the provisions in this Act a party to the relevant construction contract shall have the right to refer such dispute or difference to adjudication in accordance with the Housing Grants, Construction and Regeneration Act 1996 (as amended) and, where applicable, in accordance with the Scheme for Construction Contracts (England and Wales) Regulations 1998 as amended by the Scheme for Construction Contracts (England and Wales) Regulations 1998 (Amendment) (Wales) Regulations 2011.

Application to the Crown

12. This Act binds the Crown to the full extent authorised or permitted by the Government of Wales Act 2006.

Commencement

13. This Act shall come into operation on such day as the Welsh Ministers may by order appoint and shall apply to construction contracts entered into on or after such day.

Short title

14. This Act may be cited as the Protection of Retention Monies Act (Wales) 2013.

SEC GROUP SUGGESTED PROCUREMENT ADVICE NOTE FOR CONTRACTING AUTHORITIES

The Carillion debacle has highlighted the lack of security for cash retentions deducted from firms in the supply chain. Whilst tier 1 suppliers' retentions are protected (public sector clients do not go into insolvency) there isn't similar protection for the supply chain. It is common for tier 1 suppliers to delay the release of supply chain retentions for 2 or more years which increases the risk of their loss from the insolvency of the tier 1.

With this in mind all contracting authorities are invited to include the following model clauses (as options) in their contract conditions when inviting bids from tier 1 suppliers[1].

- *In the event that you were to be successful in bidding for any contract let by the authority are you able to confirm that you will accept one of the following options in your contract? Please state your preferred option.*
- *Please note that in the event of failure by you to include your preferred option in your sub-contracts or to comply with the provisions in the relevant clauses will prejudice any future listing of your company on our approved lists[2].*

Option 1

In the event that the Contractor intends to deduct cash retentions from its sub-contractors the Contractor shall include a clause in all its sub-contracts that cash retentions shall be held in trust by the Contractor until the contractual date for their release but without prejudice to the Contractor's right to have recourse to the monies in accordance with the sub-contract. For the duration of the time that the monies are held in trust they shall be held in a segregated account that is made known to the sub-contractor which shall have the right at any time to request a statement of the account showing the amount of retention monies held on its behalf. The Contractor shall be identified to the account holder as a trustee of the monies in the account and the Sub-contractors having retention monies in the account shall be identified as the beneficiaries.

Option 2

In the event that the Contractor intends to deduct cash retentions from its sub-contractors the Contractor shall include a clause in all its sub-contracts that the

[1] In Wales, where contracting authorities propose to use these model clauses they are asked to confirm this with Value Wales.
[2] Some English Local Authorities do not use "Approved Lists"; instead after 'future' there should be inserted, "inclusion of your company in our tender lists".

Contractor shall obtain a bank guarantee by way of an undertaking that the issuing bank will guarantee repayment of retention monies in the event that by reason of insolvency the Contractor is unable to repay the monies on their becoming due for release. Before commencement of the sub-contract works the Contractor shall issue to the sub-contractor a copy of the bank guarantee.

NOTE: Contracting Authorities may prefer not to deduct retentions. In such case, the above advice will not be necessary, provided that the Authority was to ensure that cash retentions were not withheld along the supply chain[3].

[3] The Local Government Association also suggested something along the lines of: "we are not including a requirement for cash retentions in this contract, we therefore do not expect that cash will be retained from subcontractors. We would expect that subcontractors through the complete supply chain will include a clause to this effect."

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10. The provisions of this section should prevail over any inconsistent express or implied terms of any construction contract to which this Act applies.

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11. In the event of any dispute or difference arising under or in connection with the provisions in this Act a party to the relevant construction contract shall have the right to refer such dispute or difference to adjudication in accordance with the Housing Grants, Construction and Regeneration Act 1996 (as amended) and, where applicable, in accordance with the Scheme for Construction Contracts (England and Wales) Regulations 1998 as amended by the Scheme for Construction Contracts (England and Wales) Regulations 1998 (Amendment) (Wales) Regulations 2011.

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With this in mind all contracting authorities are invited to include the following model clauses (as options) in their contract conditions when inviting bids from tier 1 suppliers[1].

- *In the event that you were to be successful in bidding for any contract let by the authority are you able to confirm that you will accept one of the following options in your contract? Please state your preferred option.*
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Option 2

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NOTE: Contracting Authorities may prefer not to deduct retentions. In such case, the above advice will not be necessary, provided that the Authority was to ensure that cash retentions were not withheld along the supply chain[3].

[3] The Local Government Association also suggested something along the lines of: "we are not including a requirement for cash retentions in this contract, we therefore do not expect that cash will be retained from subcontractors. We would expect that subcontractors through the complete supply chain will include a clause to this effect."

Retention Payments in the Construction Industry

Scottish Futures Trust (SFT) has been requested to provide evidence to an inquiry by the Economy, Infrastructure, Skills and Finance Committees of the National Assembly for Wales into 'Retention payments in the construction industry'.

SFT is working with Scottish Government to deliver recommendations from the Independent Review of Procurement in Construction carried out in Scotland in 2013. One of the recommendations of that Review was:

> "*Cash retentions should be used only after careful consideration by contracting authorities, and not as a default measure. Whilst contracting authorities have a duty to safeguard public funds, they should also be mindful of the potentially detrimental effects of cash retentions on their contractors*"

SFT has reviewed the various practices used by client organisations to assure contractor performance both during the construction period and during a post-completion defects liability period. The review identified the key protections which Authorities require, and assessed the impact of various approaches to delivering these protections, including the use of cash retentions, on supply chains. It gives guidance on appropriate levels of protection and proposes an approach which does not require the use of cash retentions.

The Guidance, "Guidance on Contract Assurance and on an Alternative Approach Which Avoids Cash Retentions" is published on SFT's website and included at Annex A to this paper.

This has not been made mandatory in Scotland with the focus having been on the separate but related issue of sub-contractor payment terms where Project Bank Accounts have been introduced. To date, Contracting Authorities continue to have a preference for applying cash retentions rather than adopting the proposed alternative approach.

We hope this paper is of use to the Committees in their Inquiry.

Scottish Futures Trust
October 2019

Annex A:
Guidance on Contract Assurance
and
An Alternative Approach which Avoids Cash Retentions

REVIEW OF SCOTTISH PUBLIC SECTOR PROCUREMENT IN CONSTRUCTION

GUIDANCE ON CONTRACT ASSURANCE AND ON AN ALTERNATIVE APPROACH WHICH AVOIDS CASH RETENTIONS

SCOTTISH FUTURES TRUST

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1. The Requirement for Assurance of Contractor Performance

1.1 Contract Assurance during the Construction Period

During the construction period the Procuring Authority needs protection primarily for:

a) A main contractor insolvency event

b) Default by the main contractor in performing his obligations. For instance, not diligently progressing the works, leading to the Procuring Authority terminating the contract.

This assurance has typically been provided by one or more of:

- a cash retention of between 3-5% of all interim payments;
- a retention bond for the same 3-5% of interim payments;
- a main contractor parent company guarantee;
- the value of work in progress depending on the timing of events;
- a main contractor performance bond for typically 10% of the contract sum. Bonds are sometimes "on-demand", but mostly are conditional on the Procuring Authority demonstrating evidence of default to the bondsman;

For a default not involving insolvency, the Procuring Authority would normally also have recourse to pursue damages through the contract.

1.2 Contract Assurance during the Defects Liability Period

During the defects liability period the Procuring Authority needs protection primarily for:

a) A main contractor insolvency event

b) Default by the main contractor in the rectification of defects

This assurance has typically been provided by one or more of:

- retaining half, normally 1.5 – 2.5%, of the cash retention held during the construction period;
- an on-demand, or more likely conditional, retention bond;
- a main contractor parent company guarantee.

Comprehensive 10 year defects insurance products are also available, but can be expensive and are also often conditional on proving cause.

2. Why are Cash Retentions a problem for the Supply Chain?

The Review of Scottish Public Sector Procurement in Construction (the Review) focuses many of its recommendations on the opportunity for public sector procurement to better support the sustainable development of small and medium sized enterprises and their contribution to economic growth generally. It identified concerns with the use of cash retentions as a means of contract performance assurance. These concerns centred on the negative effect which retentions have on cash flow for all contractors, but particularly smaller companies operating as sub-contractors. Release of any retention by employers has been cited as often being delayed even if only minor defects were left unrectified. In turn, the main contractor often further delayed release to its supply chain for commercial reasons. Worse, in the event of a main contractor insolvency the supply chain received nothing.

Cash retentions have been used for very many years and were appropriate when main contractors directly employed a multi-disciplinary workforce and used few sub-contractors. It is now common for 70-80% of a contract's value to be sub-contracted. In such circumstances the release of retention by the employer is dependent on the performance of the last sub-contractor rectifying a defect. For example, a groundworks sub-contractor who has satisfactorily completed its work with no defects has to wait many months for half of its typical 5% retention to be released at practical completion – and then wait further depending on the payment terms of the main contractor. It may then need to wait another 12-18 months for the final release after the issue of a certificate of making good defects, even though it was other sub-contractors' defects awaiting rectification. 5% might represent the whole of a sub-contractor's profit on the contract.

Changes to the Construction Act in 2009 meant that payment of retention under sub-contracts entered into after 1 October 2011 could no longer be conditional on the performance of obligations under a separate contract. However, this has had the unintended consequence of many main contractors inserting retention release dates in sub-contracts an inordinately long period after retention release may normally be anticipated under the main contract. This is reflective of main contractors' experiences of some procuring authorities continuing to hold 100% of the outstanding retention against very simple, small value, issues; or where there is a long lead time for material replacement; or for seasonal work; or where access is constrained by the client themselves. Feedback from SMEs is that this change to the law has in many cases extended their wait for retention release rather than reduced it.

There have been a number of reports[1] published in recent years highlighting the problems caused to the cash flow of tier 2 and 3 supply chain members by cash retentions not being released timeously, or ever. These companies are often small and medium sized enterprises (SMEs). The Specialist Engineering Contractors Group (SECG) and the National Specialist Contractors Council (NSCC) have both been vociferous in raising the issue. Representations have also been made to the Scottish Cross Party Parliamentary Group for Construction.

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[1] *The NSCC Fair payment Campaign*

Two SECG Scotland Reports on a Survey of Practices and Pre-Qualification in (i) Construction Procurement in the Scottish University Sector; and (ii) Public Sector Construction in Scotland

The effect of retention on the cash flow of SMEs is undoubtedly significant. This is then exacerbated by sub-contractors essentially bearing the risk of Tier 1 contractor insolvency. In an insolvency situation, the sub-contractor would most likely lose all of its retention unless it had been placed in a trust account.

There are unintentional indirect benefits for the cash flow of both Procuring Authorities and Main Contractors in holding cash retentions. For Procuring Authorities, and for those main contractors who apply extended payment terms to their supply chain, the application of cash retentions will contribute to their working capital requirements, unless the retention is held in trust. The supply chain does not believe it should be their function to provide working capital to either the Procuring Authority or to the main contractor.

3. Consideration of options for contract assurance

3.1 Cash Retention

Retention is a percentage (often 3-5%) of the amount certified as due to the main contractor on an interim payment certificate. It is deducted from the amount due and retained by the employer. The main contractor will also apply retention to its sub-contractors – the amount being determined by the terms of the individual sub-contract conditions which may or may not mirror those in the main contract. Half of the amount retained is normally released on completion of the works. The other half is normally released on the issue of a certificate after the end of the defects liability period confirming all notified defects have been rectified. As discussed in section 2, the use of cash retentions places risk and cash flow burdens on the supply chain. The Procuring Authority should not use cash retentions as a default measure and should only be used if other forms of contract assurance cannot provide adequate cover.

3.2. Retentions held in Trust Accounts

Most contracts give the option for those contractors and sub-contractors providing retention to request that it is placed in a trust account. This gives protection to each contractor or sub-contractor providing it. By doing so, the cash cannot be used for working capital by an employer or main contractor, respectively. Nor can it be lost in the case of an insolvency event. Trust accounts on their own do not, however, address the essential cash flow problem of retention being held. Whilst it is common in private sector contracts for main contractors to exercise the trust account entitlement, it is a rare practice in the public sector where the risk of an employer default is very low.

3.3. Cash Retention and Project Bank Accounts.

The adoption of Project Bank Accounts (PBAs) give some protection to Tier 2 and 3 contractors. PBAs prevent the practice of delayed release of cash retentions being used as a “profit centre” by main contractors, or used as free working capital provided by their supply chain. However not all Tier 2, and not most Tier 3, contractors are likely to be named beneficiaries of a project bank account if the value of their contract is small. A Project Bank Account also may not afford protection in the event of a main contractor insolvency event where the Procuring Authority itself uses the whole of the retention being held against the main contractor, as it is entitled to. Whilst Project Bank Accounts can address unfair payment terms down a supply chain, they do not of themselves address the essential cash flow problem of retention being held.

3.4. Retention Bonds.

A retention bond is offered by the main contractor to the employer, and by each sub-contractor to the main contractor, in lieu of a cash retention. Many forms of contract, including the standard NPD and hub forms, make provision for a retention bond to be used in lieu of a cash retention. There are two issues with its use however. Firstly, bondsmen are increasingly requiring these to be asset backed

by contractors – even to the extent of a cash deposit being required, or by the forced reduction of borrowing facilities. Unsurprisingly therefore, some small tier 1 contractors and many tier 2 and 3 contractors find themselves in a worse financial position compared with the deduction of a cash retention. Secondly, the retention bonds are rarely of the "on-demand" type. This means that a Procuring Authority might typically need to achieve a third party judgement, perhaps via adjudication, in order to receive payment from the bond.

3.5. Defects Liability Insurance.

Defects Liability Insurance policies are available to cover latent defects discovered up to 10-12 years after the end of the defects liability period. While such policies might possibly be considered as value for money to Procuring Authorities in certain circumstances, they do not normally respond to the non-rectification of patent defects notified to the contractor before the end of the defects liability period. They are therefore not an alternative contract assurance product.

3.6. Self-Insurance.

If cash retentions were not used, one assurance solution for Procuring Authorities might be to self-insure. For example, the absence of cash retentions might reasonably lead to (say) a 1% lower tender price. The Procuring Authority pays 1% into a fund across its whole programme of projects to provide the finance to rectify defects in the event of the contractor refusing to do so. The Authority would still, of course, be able to pursue the contractor via dispute resolution or court proceedings, as is currently the case where a cash retention amount is not large enough to cover the cost of rectification. The risk with this approach is that it could easily drive the wrong behaviours in contractors. There would be less incentive to rectify defects – relying instead on the Procuring Authority's natural reluctance to launch proceedings for perhaps relatively small amounts of money.

3.7 Key Performance Indicators

For longer term contracts and for frameworks where there is a high probability of repeat work there may be an opportunity to replace measures to assure against the non-rectification of defects with a series of key performance indicators (KPIs). The measurement of such KPIs can then be used in assessing overall contractor performance in future mini competitions under the framework, or be linked to incentivised performance payments. Procuring Authorities should be aware that main contractors may find it difficult to replicate this approach through their supply chain and cash retentions will most likely still be used instead.

3.8. Parent Company Guarantees.

The use of a Parent Company Guarantee (PCG) is often cited by large contractors as a form of assurance against the performance of, for example, their regional subsidiary companies. Unfortunately, not all contractors are part of a group structure and, even if they are, it is often the case that failure of the contracting entity will likely also lead to the failure of the parent group. Both from a competition perspective, and from an assurance perspective, it is therefore not thought that PCGs can be exclusively relied upon as a contract assurance measure.

3.9. Performance bonds

The contractor may be able to give a "default" (or "on default") bond to the public authority. This type of bond is conditional on performance of the contract or payment of damages by the bondsman if the contractor defaults. This bond is a guarantee because the bondsman assumes a secondary obligation to pay if the contractor fails to perform. The amount of the bondsman's liability is proportional to the damages sustained by the employer. Another type of performance bond is an "unconditional on demand" bond: however, it is Government policy not to use these. Maintenance bonds are also available, which provide limited security for performance of the contractor's obligations during the defects liability period. These can be of use where there has been a performance bond which has expired on practical completion or the works comprise a specialist installation demanding a high level of care after practical completion. Just as for retention bonds, the surety often insists on a third party decision, eg adjudication, before payment which can result in delay and incur legal costs.

3.10 The Avoidance of Cash retentions

Whilst not directly applicable to Scotland, the UK Government Department of Business, Innovation and Skills, via the Construction Leadership Council, published the Construction Supply Chain Charter in April 2014.
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/306906/construction-supply-chain-payment-charter.pdf

Amongst other fair payment commitments, those signing the Charter agree :

a) To eliminate cash retentions by 2025

b) Not to apply cash retentions in the supply chain where there is none in the Tier 1 contract

The three large UK contractors on the Construction Leadership Council have signed the Charter, along with a number of UK Government Procuring Authorities.

Eliminating cash retentions would meet the objective of improving cash flow for all contractors in the supply chain. Section 4 contains a possible solution to maintaining an appropriate level of contract assurance at a predicted neutral cost.

4. Guidance on an alternative approach to contract assurance

4.1 Applicability

If a programme of pilots to trial this new alternative is successful, it is recommended that this approach of eliminating cash retentions should be applied to works contracts above the OJEU threshold, and that after a period of successful operation it should be applied to all regulated works contracts in Scotland.

It is recognised that the use of retentions on low value and short term projects do not cause the same extent of cash flow problems. In such circumstances cash retentions may still be appropriate. It is also recognised that in some remote project locations procuring authorities assess there is a high risk of non-rectification of defects without a significant financial incentive and may also elect to continue to operate a cash retention system. However, the wider benefits of using public procurement to support the cash flow of small companies should also be taken in to account.

Section 5 contains guidance on contract assurance for projects not using this alternative approach.

4.2 Principles

It is proposed that a combination of all the following measures would provide a realistic basis for satisfactory contractor performance assurance whilst at the same time eliminating cash retentions. This would provide a financial boost to SME's working on public sector projects thereby supporting economic growth. Legal implications are addressed in more detail at Annex A.

<u>During the Construction Period</u>

No Retention in the main contract

- A main contract condition which precludes cash retentions being applied through the whole supply chain
- A 10% Performance Bond for the main contract, expiring on issue of a Completion Certificate, thus providing assurance against an insolvency event.

<u>At Completion</u>

- Adoption of the BSRIA Soft Landings[2], or similar approach, where it is judged appropriate, and value for money, for the type and scale of the project.

[2] https://www.bsria.co.uk/services/design/soft-landings

- Incorporation of a rigorous practical completion test

- The formal valuation at practical completion of incomplete work or work subject to snagging

During the Defects Liability Period

- Introduction of a 1% Project Specification Performance Payment (PSPP), payable at the end of the defects liability period, and linked to a range of tests of performance.

- Alternatively, instead of a PSPP, the use of Key Performance Indicators and Track Record Tests for long-term contracts, e.g. frameworks, and the hub programme.

4.3 Further Details – During the Construction Period

4.3.1 No Retention in the main contract

- Neither cash retentions on interim payments, nor retention bonds, will be used.
- Minor amendments may need to be made to standard forms of contract that specify the use of such retentions.
- Annex A includes a commentary on the likely legal considerations - which are not thought to be a barrier.

4.3.2 A main contract condition precludes cash retentions being applied through the whole supply chain.

- In order to achieve the objective of improved cash flow throughout the supply chain, the head contract must contain a new clause which prevents retention being applied by main contractors in their sub-contracts. Legal advice on the drafting of such a clause will be required and will be project specific depending on the form of contract chosen.
- It is also envisaged that the head contract would contain a provision that sub-contracts must give the sub-contractor a right to make representations, perhaps anonymously, directly to the Procuring Authority if the main contractor still seeks to impose retentions.

4.3.3 A 10% Conditional Performance Bond for the main contract

- The maximum cover is 10% of the contract sum, subject to demonstration of the actual loss incurred by the Procuring Authority.
- “On-demand” bonds, whilst common for international construction contracts, are not available for even medium sized contractors at reasonable cost, or at all. It is also not Scottish

Government policy to use them. A “conditional” bond will, therefore, need to be relied on for insolvency events. However the use of careful wording in the bond on what evidence would constitute such an insolvency event should ensure that a third party decision is not required prior to payment. Annex A contains further commentary on this, and Annex B contains sample bond wording.

- For other defaults, for example the failure to rectify defects, it would again be a “conditional” bond where the Procuring Authority would have to provide satisfactory evidence of the default to the bondsman. It is acknowledged that this often requires a third party decision (eg adjudication). This has historically often been the case where there is a dispute as to the cause of the defect, for instance in a traditional contract where the Procuring Authority might be responsible for the design.
- The bond would cease to exist on a specified date or event – it is recommended this be the issue of the practical completion certificate.
- The cost of such a bond will be passed on to the Procuring Authority as part of the contractor’s tender. Depending on the financial standing of the contractor this could be between 0.5% - 25% of the bond amount, but more typically in the range of 4% -10% which equates to between 0.4%– 1.0% of the contract sum.
- It is vital that the bondsman is reputable – as measured by a rating agency, and the bond is put in place with the appropriate wording at the same time the contract is awarded. The legal jurisdiction governing the bond’s operation should also be considered.
- A legal commentary is included at Annex A and sample bond wording at Annex B.

4.4 Further Details – At Completion

4.4.1 Adoption of the BSRIA Soft Landings, or similar approach, where it is value for money

- The Building Services Research and Information Association (BSRIA) has developed a process called Soft Landings. In simple terms Soft Landings requires clients to insist that the individuals from designers and constructors stay involved with their new building beyond practical completion and into the critical initial period of occupation. This will assist building managers during the first months of operation, it will help fine-tune and de-bug the systems, and ensure the occupiers understand how to control and best use what they have been given. This is followed by a longer, less intensive period of aftercare lasting for up to three years, to monitor energy use and occupant satisfaction, and to check on the operation of systems that might need seasonal fine-tuning. At the end of three years the building’s steady performance can be fairly judged against the targets set at design, and any discrepancies accounted for.
- By specifying Soft Landings, Procuring Authorities can significantly mitigate against the risk that teething problems with their new building become disputes over alleged defects.
- A link to further information:
  https://www.bsria.co.uk/services/design/soft-landings/
- This becomes even more powerful if Soft Landings is combined with the specification of Building Information Modelling, Level 2.
- Soft Landings can be expensive and would only be appropriate on large, complex projects.
- Further legal commentary is included at Annex A

4.4.2 Incorporation of a rigorous practical completion test

- Undoubtedly the best time to ensure that the works are built as specified is prior to the issue of a certificate of completion.
- Incorporating a formal set of completion criteria in the contract leaves the contractor in no doubt that he will not achieve completion – and therefore release his liability to pay liquidated and ascertained damages for any delay – unless the criteria are satisfied.
- To get the best from this, Procuring Authorities must better plan overall development programmes such that there is time float between a contractual completion date and the date when occupation is scheduled. The practical completion test can then be rigorously applied without pressure from the eventual building users to achieve occupation.
- Further legal commentary is included at Annex A.

4.4.3 The formal valuation at practical completion of incomplete work or work subject to snagging.

- With there being no retention in the contract, it is important that at the time of practical completion/building handover the Procuring Authority does not pay the value of any incomplete or defective work. The Architect/Quantity Surveyor/Contract Administrator, as appropriate, must only include in their payment certificate the value of defect free works.
- Payment is then only made once those items have been satisfactorily attended to.
- It is recognised that care must be taken to avoid certifying defective works in one interim valuation only to omit it at practical completion. Such an approach could lead to a main contractor needing to seek repayment from a sub-contractor.
- Further legal commentary and a suggestion for a mechanism covering how this valuation would work is included at Annex A.

4.5 Further Details – During the Defects Liability Period

4.5.1 Introduction of a 1% Project Specification Performance Payment (PSPP), payable at the end of the defects liability period, and linked to a specified range of tests of performance.

- The PSPP should be described in the tender pricing document as an activity, and mandated to be priced at 1% of the total of the main contractor's other pricing.
- It is not a deduction from interim payments.
- It is added to the main contractor's tender and forms part of the overall contract sum.
- It should not exist in any sub-contracts.
- The range of tests of performance should be created on a project specific basis but might include a number of post practical completion matters. For example: the issue of the Certificate of Making Good Defects; the issue of BREEAM, EPC or similar certificates; satisfactory air tightness testing; satisfactory thermal imaging testing; compliance with any energy performance testing; completion of as-built records; completion of operation manuals; issue of all BIM data; compliance with any maintenance obligations.
- There should be no breakdown of the 1% figure between the various tests. If any test of performance is not met, the Procuring Authority would have the right to deduct from the PSPP

the cost of carrying out any of the other outstanding works themselves. This would include any outstanding defect rectification.

- The PSPP is specifically not a bonus payment for works that should be performed in any event. It is part of the Contract Sum, and is a defined activity.
- Further legal commentary is included at Annex A.

4.5.2 Alternatively, use Key Performance Indicators and Track Record Tests. e.g. for frameworks and the hub programme.

- For long term contracts a Procuring Authority might wish to consider the use of targeted key performance indicators and track record tests instead of a PSPP.

- The KPI's would need to be made project specific and closely mirror the tests of a PSPP.

4.6 Benefits for Industry

- Significant cash flow benefits to all contractors with specific benefit to the Tier 2 and 3 supply chain, often SMEs.

- Opportunities for contractors to demonstrate reputation enhancing behaviours post practical completion.

- A clear financial incentive (the PSPP) for the main contractor to remedy any defects even if a sub-contractor defaults.

- An opportunity to discount the value of the PSPP in a tender price to reflect their confidence in a well-managed and motivated supply chain to comply with contract obligations without the use of cash retention

- No resource needed to pursue the payment of outstanding retentions or to administer them.

- Sub-contractors will no longer be treated as effectively jointly waiting for the last defect to be rectified up until the retention release date specified in their sub-contracts.

4.7 Benefits for Procuring Authorities

- Retains the essential assurance for insolvency or other default up to the end of the defects liability period.

- The adoption of Soft Landings increases the probability of defect free handovers, albeit at an additional cost.
- A clear financial payment (PSPP) linked to a range of tests at the end of the defects liability period
- Less contract administration, especially compared to dealing with the placement of retention in to trust accounts.
- Compatible with the use of Project Bank Accounts
- Significantly increases the project's attraction for SMEs to tender the project, raising the level of competition.
- Opportunity for the receipt of lower tender prices
- Eases the accountancy treatment of retentions for public procuring authorities which can be difficult at financial year end.

5. Guidance for projects not using the alternative approach to assurance

5.1 Applicability

This guidance is for non-regulated Projects (below £2m) and for those circumstances where the Alternative to Cash Retention Assurance Model is not adopted.

The procuring authority must still consider the options which exist for contract performance assurance, and not select the use of cash retention as a default measure. The selected strategy must address both the risks of a main contractor insolvency event (the impact is more severe if it occurs before completion) and of a failure to rectify defects.

5.2 Proportionality

The procuring authority should not require more than one assurance tool unless a risk assessment points to a need to do so. Two examples: If a performance bond is in place which adequately assures against an insolvency event, there should be no need for a higher retention percentage during the construction period – and consequently there would then be no release of half of the retention at practical completion. After practical completion, there should be no need for both a performance bond and a retention bond, or both a performance bond and a cash retention.

An essential consideration must be the effect of the assurance strategy on the whole supply chain. For example, the use of a bond or key performance indicators between employer and main contractor may still result in cash retentions being applied between the main contractor and its sub-contractors.

5.3 Alternatives to using cash retentions

Alternatives include:

5.3.1 Retention bonds

Under a typical retention bond, the contractor's performance of its obligations to complete the works as contractually-specified is guaranteed by a third party, or surety, which undertakes to pay damages sustained by the employer in the event of any default on the part of the contractor. Normal practice is to provide conditional retention bonds that increase in value as payments are made (in full i.e. no cash retentions applied) in accordance with the contract. The surety's liability is limited to the sum which would otherwise have been held by the employer by way of cash retention at the time of any breach and is automatically reduced by half upon issue of the certificate of practical completion. The surety often insists on a third party decision, eg adjudication, before payment which can sometimes cause delay and incur legal costs.

5.3.2 Performance bonds

The contractor may be able to give a "default" (or "on default") bond to the public authority. This type of bond is conditional on performance of the contract or payment of damages by the bondsman if the

contractor defaults. This bond is a guarantee because the bondsman assumes a secondary obligation to pay if the contractor fails to perform. The amount of the bondsman's liability is proportional to the damages sustained by the employer. Another type of performance bond is an "unconditional on demand" bond: however, it is Government policy not to use these. "Maintenance" bonds are also available, which provide limited security for performance of the contractor's obligations during the defects liability period. These can be of use where there has been a performance bond which has expired on practical completion or the works comprise a specialist installation demanding a high level of care after practical completion. As for retention bonds, the surety often insists on a third party decision, eg adjudication, before payment which can result in delay and incur legal costs.

5.3.3 Parent company guarantees

This form of guarantee is given by a parent company (or holding company) to guarantee the proper performance of a contract by one of its subsidiaries (the contractor), and can only be given where the contractor is owned by a parent company or is the subsidiary of a larger group. Because the financial strength of the parent company may be linked to that of the contractor, a parent company guarantee will be acceptable only if the parent company (or holding company) is financially strong and its financial resources are largely independent of those of the contractor. Such a guarantee is free of cost to the client, but may give less certainty of redress than a bond because it is not supplied by an independent third party.

5.3.4 Key performance indicators in frameworks

Where long term relationships are established, for example in a framework, it may be appropriate to replace that element of a cash retention which is provided against defect rectification with a series of key performance indicators. The measurement of such KPIs can then be used in assessing overall contractor performance in future mini-competitions under the framework, or be linked to incentivised performance payments. KPIs might be set for: the number of defects at completion; the time to rectify defects; the number of defects at the end of the defect liability period; the time taken to investigate a defect etc. A procuring authority will still need to have an assurance strategy for a main contractor insolvency event. It may be difficult to replicate this approach through the supply chain.

5.4 If Cash Retentions are used

The amount of retention to be held should be considered on a project specific basis, and be both reasonable and proportionate to the project's characteristics. Professional advice should be taken on the amount to be specified on a project by project basis.

In normal circumstances, building projects should not exceed 5% retention during the construction period, and 2.5% retention during the defects liability period. Consideration should be given to reducing the maximum retention to 3% and 1.5%, respectively, for projects valued above £5m. For civil engineering projects the figures would normally be 3% and 1.5% respectively. Particularly low value civil engineering contracts may warrant slightly higher retentions.

	Prior to completion		Defects period	
	< £5m	>£5m	<£5	>£5m
Building	5%	3%	2.5%	1.5%
Civil Engineering	3%	3%	1.5%	1.5%

Fig 1 Typical levels of cash retention. Subject to project specific risk assessment.

After the end of the defects liability period, consideration should be given to reducing the cash retention held to reflect the total rectification cost to the procuring authority of any outstanding defects. The retention should not, by default, be held in full until the last (sometimes minor) defect is complete and the overall defects completion certificate is issued.

Procuring authorities should also be aware that standard forms of contract sometimes have different rules on retention. For example, the NEC3 form does not include retention as a core clause. Secondary Option Clause X16 needs to be chosen and this also contains the concept of a "retention free amount". Retentions are not applied until the gross interim valuation reaches a chosen threshold. The Procuring Authority decides on the amount. This is designed to assist the main contractor's cash flow in the early stages of a project but may not be similarly applied through the supply chain.

6. Feedback

Please contact Martin Blencowe, Procurement Review Director, at Scottish Futures Trust.

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Annex A – Legal Commentary

The following legal narrative has been provided, however this is not legal advice. Procuring Authorities will need to satisfy themselves on commercial arrangements, risk management and on any amendments to standard forms of contract.

A.1. No Retention in the main contract

It is common place to amend standard form contracts to suit the requirements of a particular project. We do not anticipate that it will be unduly onerous to eliminate cash retentions from the conditions of most standard form contracts.

In most of the commonly used standard forms it will be sufficient to specify in the contract particulars (or equivalent) that the retention is not applicable and/or to insert zero% if the retention percentage is to be specified, or 100% if it is the percentage of the total value of the works which is to be specified.

In the alternative, the key areas that will need to be addressed are as follows (note that key areas may vary across the range of standard form contracts):

(a) Retention – removal of clauses providing for retention percentage (including retention of sections) and associated definitions;

(b) Retention bonds – removal of clauses providing for retention bonds, associated definitions and forms of retention bond (if applicable);

(c) Interim payments – removal of clauses granting the right to the employer to remove a retention payment from each interim payment and any final payment;

(d) Practical completion certificate - removal of obligation to make payment of retention monies on issue of the certificate of practical completion; and

(e) Certificate of making good defects – removal of obligation to make payment of retention monies on the issue of the certificate of making good defects.

A.2. A 10% Performance Bond for the main contract

Subject to the points below, we can see no legal barriers to procurement of a 10% performance bond as additional security for performance. These are commonly procured for significant construction projects already. An amended version of the Association of British Insurers' ("ABI") form of performance bond is widely accepted in the current market by most major banks and insurance companies.

The Paper notes that, ideally, the bond would operate in a similar manner to an "on demand" type of bond in the case of insolvency. It is likely that banks and bondsmen will be comfortable with the principle of a conditional bond with on-demand provisions in respect of insolvency (rather than a full on-demand bond), and this is a position that has already been accepted in the current market. A proposed form of performance bond is included at Annex B.

As the demand for conditional bonds with on-demand provisions for insolvency increases, it is likely that the bond market will naturally follow suit with the cost of the on demand call arising from insolvency being built into the bond price from the outset. Following such re-calibration, the availability of these types of bond will increase, and with greater availability the eventual costs of these bonds should decrease before reaching a market level.

In the event of any resistance from the bondsman, a possible solution is inclusion of a provision for the on demand payment under the bond in the case of insolvency to be revisited when the losses suffered by the employer can be properly calculated. So, following a pay out on demand, there is a reconciliation process at a later point in time and any excess paid out initially under the bond is paid back by the employer. This is certainly a more palatable option for the "conditional bondsman" and may prove helpful in what will inevitably be a transitional period in the bond market. Moreover, this compromise can also be beneficial from an employer perspective if the reconciliation process results in a deficit rather than any excess. In such circumstances, any deficit in losses actually incurred can be paid by the bondsman to the employer. Again, refer to Annex B.

A key practical issue of note is governing law and execution formalities in Scotland where the relevant law is Scots law. As the main providers of bonds in the United Kingdom are English, often Scots law bonds do not contain the correct 'kilted' provisions and are not executed in accordance with Scots law requirements. It is important that relevant checks are in place to ensure any performance bonds granted as alternatives to a cash retention are worth the paper

they are written on and events of default that are understood to be covered by a call on the bond, can actually be the subject of a valid call.

Where cash retentions are precluded through the whole supply chain, performance bonds will likely be more common place in the case of sub-contractors.

A.3. Adoption of the BSRIA Soft Landings, or similar approach, where appropriate.

Soft Landings is a collaboration process between the client, contractor, designers and sub-contractors lasting for the whole of the construction period and 3 years after completion, with the aim of producing a building that meets both the design specification, and also the service outcomes of end users. In essence, Soft Landings is a platform for continuous improvement so that subsequent and successive procurements of similar projects (schools are a good example) can draw on that collective knowledge to achieve a higher quality and more cost effective build.

The cost for the extended aftercare period (1-3 years) could be managed by specifying levels of attendance post completion and the extent of reporting requirements.

For Soft Landings to work properly, ideally the end users will be involved from the outset.

It is anticipated that the key contractual obligations on any contractor, consultants and sub-contractors to deliver Soft Landings objectives will come principally from the scope of services or specifications documents, so only limited revisions to the contract terms and conditions should be required. Furthermore, the Soft Landings services are designed to supplement the existing standard form services, so no major revisions to industry standard forms should be needed.

For Soft Landings to work most effectively, it is recommended that it be a central requirement at the tendering stage, so that the contractor and consultants are tendering on the basis of Soft Landings being a key element of the contract, rather than an added extra. If Soft Landings is incorporated correctly at procurement stage, the shared responsibility and collaborative working aspects are clear from the outset.

We recommend that there is an express obligation on contractors and consultants to co-operate in a spirit of collaboration to identify improvements in design, building performance, energy consumption and environmental functionality. Some other specific drafting considerations may include obligations on contractors to ensure that any sub-contractors are engaged on a Soft Landings basis and are obliged to co-operate in the main contract Soft Landings process. Sample drafting:

"1.1 The Contractor shall co-operate in a spirit of mutual trust and collaboration to identify improvements in design, building performance, energy consumption and environmental functionality."

"1.1 The Contractor shall procure that in any contract appointing sub-contractors, sub-consultants and/or suppliers in relation to the [Works], there is an obligation on the such sub-contractors, sub-consultants and/or suppliers to comply with the Soft Landings Requirements.

"Soft Landings Requirements" means [●]"

A.4. Incorporation of a rigorous practical completion test

No standard forms envisage such rigorous standards at completion so a key issue will be in projects where un-amended standard form contracts are used unless this requirement is built into the technical documents which make up the contract. In the case of amended standard form contracts, it is relatively common to see additional conditions/requirements to practical completion being imposed so we do not see any barriers to the principle of adoption of a rigorous practical completion test.

The key issue for contractors of any tier is that their route to practical completion is fully transparent and all tests or requirements to get there are clearly defined so that they can fully understand what is being asked of them to achieve completion.

In many standard form contracts the requirements to achieve 'practical completion' are not stated. Looking, for example, at the SBCC Design and Build contract for use in Scotland 2011, practical completion is undefined and so in effect determination of when the works are complete in accordance with the contract is down to the professional judgement of the Employer's Agent. Often an unwritten 'rule of thumb' means that works are judged complete, for the purposes of achieving practical completion, if they are substantially complete and in a state in which the end user may enjoy beneficial use ignoring snagging items which don't prejudicially affect that occupation.

So called snagging lists are often appended to the practical completion certificate and whilst they are recognised by general usage in most standard forms they have no contractual status unless issued as a formal instruction which invariably they are not.

We propose that one of the simplest ways to ensure a more rigorous practical completion test is to include a list of criteria that will be required to be met in order to achieve practical completion. This rigorous list could be included in the Employer's Requirements or Specification so that it can be used in the case of both amended and not amended standard form contracts. However, to ensure the practical completion test is an absolute requirement to achieving practical completion under any contract, we would strongly recommend that reference to this is included in the contract terms and

conditions. A pro forma list could be produced with a check-box system to allow the parties to select the appropriate practical completion requirements by simply ticking them.

An amendment needs to be made to the practical completion provisions in any contract which makes practical completion conditional on satisfaction of everything noted in the practical completion list contained in the technical documents. Proposed drafting:

"It shall be a condition to practical completion in accordance with clause [●] of this [Contract] that all of the practical completion requirements contained in the [Employer's Requirements/Specification] have been met and fully satisfied by the [Contractor]."

A.5. Formal valuation at practical completion of incomplete work or work subject to snagging.

Although this is a formal valuation of the actual incomplete work at practical completion, it could be viewed by the contractor as effectively a form of cash retention unless there are detailed provisions governing how the outstanding work/snagging is to be valued.

Relevant amendments to the standard form building contracts would need to be introduced to provide for a formal valuation process at completion and some amendments may be required both to the terms and conditions and scope of services agreed with relevant professional team members involved in that certification process e.g. Architect, Quantity Surveyor, Contract Administrator or Employer's Agent. Sample drafting:

"1.1 At [practical completion], minor items of incomplete work and/or minor defects, shrinkages or other faults, the existence, completion or rectification of which in the opinion of the [Contract Administrator] would not prevent or interfere with the use and enjoyment of the completed [Works] shall be valued as follows:

1.1.1 consistent with values of work of similar character to that set out in the Contract, making due allowance for any change in the conditions under which such work is carried out; or

1.1.2 where no comparison can be made to the works carried out under the Contract in accordance with clause 1.1.1, a fair valuation shall be made"

A.6. Introduction of a 1% Project Specification Performance Payment (PSPP), payable at the end of the defects liability period, and linked to a range of tests of performance.

The policy approach to PSPP's needs to be carefully managed, to avoid the perception that this regime amounts to no more than a bonus for works which should be contractually done in any event. Having specified clearly defined requirements to achieve the PSPP will prevent the risk of this perception.

It is envisaged the 1% PSPP will form part of the amounts payable under the building contract and to avoid the inference that it is an additional performance related sum (a bonus) it should form part of the contract sum but be paid subject to separate payment provisions, which will closely mirror the provisions related to interim payments. Sample drafting:

"1.1 The Contractor shall satisfy the [PSPP Tests] in all respects as soon as reasonably practicable following the [Date of Completion] and in any event not later than expiry of the [Rectification Period] in return for the [PSPP]. Not later than [●] month[s] after the end of the [Rectification Period] in respect of the [Works] the [Contract Administrator] shall issue the [PSPP Certificate] which shall state (i) whether or not the [PSPP] is due to be paid to the Contractor (if it is due, it shall state the PSPP, and, if it is not due, it shall state zero) and (ii) whether the Contractor has complied sufficiently with clause [●] i.e. the basis on which that sum is calculated. The due date for payment of the [PSPP] shall be the date of issue of the [PSPP Certificate], or if the [PSPP Certificate] is not issued within the timescale noted above, the last date of that period and, subject to clause [●] the final date for payment shall be 28 days from the due date.

1.2 If the Employer intends to pay zero, contrary to what is stated in the [PSPP Certificate], he or any other person so authorised shall not later than 5 days before the final date for payment give the [Contractor] a pay less notice which shall specify that he considers zero to be due at the date the notice is given and the basis on which that sum has been calculated. If such a pay less notice is given the payment to be made on or before the final date for payment shall be zero.

1.3 If the [PSPP Certificate] is not issued in accordance with clause [●] above:

1.3.1 the [Contractor] may at any time after expiry of the [●] month[s] period above give notice to the [Employer] with a copy to the [Contract Administrator] stating that the [Contractor] considers the [PSPP] to be due to him under this [Contract], stating that sum and the basis on which the sum has been calculated and, subject to any pay less notice issued in accordance with clause [●] below, the final payment shall be the [PSPP];

1.3.2 if the [Contractor] gives notice in accordance with clause [●] above, the final date for payment of the sum specified in it shall be for all purposes be regarded as postponed by the same number of days as the number of days after expiry of the 2 month period that such notice is given;

1.3.3 following the [Contractor's] notice in accordance with clause [●] above, the [Employer] may not later than 5 days before the final date for payment give a pay less notice in

accordance with clause [●] above and, if he gives such notice, the provisions of clause [●] above shall apply."

"PSPP means [●] [1% of tendered sum] which may be payable to the Contractor in accordance with clause [●]"

"PSPP Certificate means the certificate to be issued by the [Contract Administrator] following expiry of the [Rectification Period] in relation to payment of the PSPP [●]]"

"PSPP Tests means [●]""

Annex B

SAMPLE FORM OF PERFORMANCE BOND

THE GUARANTEE BOND is **BETWEEN** the following parties whose names and [registered office] addresses are set out in the schedule to this Bond (the "Schedule"):

The "Contractor" as principal

The "Guarantor" as guarantor, and

The "Employer"

WHEREAS

By a contract (the "Contract") entered into or to be entered into between the Employer and the Contractor particulars of which are set out in the Schedule the Contractor has agreed with the Employer to execute works (the "Works") upon and subject to the terms and conditions therein set out.

The Guarantor has agreed with the Employer at the request of the Contractor to guarantee the performance of the obligations of the Contractor under the Contract upon the terms and conditions of this Guarantee Bond subject to the limitation set out in clause 1.

NOW IT IS AGREED as follows:

1. The Guarantor guarantees to the Employer that in the event of a breach of the Contract by the Contractor and/or the Contractor becoming Insolvent (as defined in the Schedule), the Guarantor shall subject to the provisions of this Guarantee Bond satisfy and discharge the damages sustained by the Employer as established and ascertained pursuant to and in accordance with the provisions of or by reference to the Contract and taking into account all sums due or to become due to the Contractor. Save where the Contractor has become Insolvent (as defined in the Schedule), a certified copy decision of an Adjudicator duly appointed in accordance with the Contract, in favour of the Employer, in respect of such event of breach of the Contract or failure by the Contractor to fulfil its obligations under and pursuant to the Contract, in the sum sought by the Employer in terms of this Guarantee Bond shall be sufficient evidence of establishment and ascertainment of any sum of money to be satisfied or paid in terms of this Guarantee Bond. Where the Contractor becomes Insolvent (as defined in the Schedule), it shall be sufficient for the Employer to serve on the Guarantor a certificate stating the extent of the losses and others suffered by the Employer as a result of the said insolvency.

2. The maximum aggregate liability of the Guarantor and the Contractor under this Guarantee Bond shall not exceed the sum set out the Schedule (the "Bond Amount") but subject to such

limitation and to clause 3 the liability of the Guarantor shall be co-extensive with the liability of the Contractor under the Contract.

3. The Guarantor shall not be discharged or released by any alteration of any of the terms, conditions and provisions of the Contract or in the extent or nature of the Works and no allowance of time by the Employer under or in respect of the Contract or the Works shall in any way release, reduce or affect the liability of the Guarantor under this Guarantee Bond.

4. Whether or not this Guarantee Bond shall be returned to the Guarantor the obligations of the Guarantor under this Guarantee Bond shall be released and discharged absolutely upon Expiry (as defined in the Schedule) save in respect of any breach of the Contract which has occurred and in respect of which a claim in writing containing particulars of such breach has been made upon the Guarantor before Expiry.

5. The Contractor having requested the execution of this Guarantee Bond by the Guarantor undertakes to the Guarantor (without limitation of any other rights and remedies of the Employer or the Guarantor against the Contractor) to perform and discharge the obligations on its part set out in the Contract.

6. This Guarantee Bond and the benefits thereof shall not be assigned without the prior written consent of the Guarantor and the Contractor.

7. Save where expressly stated otherwise in this Guarantee Bond, nothing in this Guarantee Bond shall confer or purport to confer on any third party any benefit or right to enforce any term of this Guarantee Bond.

8. This Guarantee Bond shall be governed by and construed in accordance with the laws of Scotland and only the courts of Scotland shall have jurisdiction hereunder, and the parties hereto consent to registration hereof for preservation and execution.

IN WITNESS WHEREOF these presents consisting of this and the preceding page together with the Schedule annexed hereto are executed as follows:

[*Insert signature block for Contractor, Employer and Guarantor*]

This is the Schedule referred to in the foregoing Guarantee Bond between [ ], [ ] and [ ].

The Contractor: [ ] whose [address] [registered office address] is [ ].

The Guarantor: [ ] whose registered office address is [ ].

The Employer: [ ] whose [address] [registered office address] is [ ].

The Contract: A contract [dated the [ ] day of [ ]] [*to be entered into*] between the Employer and the Contractor in the form known as [ ] for the construction of works comprising [ ] for the original contract sum of [ ] pounds (£[ ]).

The Bond Amount: The sum of £[ ] pounds sterling (£[ ]).

Expiry: [*Insert details of the event agreed between the parties*] which shall be conclusive for the purposes of this Guarantee Bond.

Insolvent: [*Insert a definition of "Insolvent" by reference to the contract provisions or by reference to the Companies Acts*]

Federation of Master Builders (FMB) response to the Economy, Infrastructure and Skills Committee consultation on Retention payments in the construction sector

October 2019

About the FMB

The Federation of Master Builders (FMB) is the largest trade association in both Wales and the UK construction industry. With over 8,000 member companies, it is the recognised voice of small and medium-sized (SME) construction firms. Established in 1941 to protect the interests of construction SMEs, the FMB is independent and non-profit-making, lobbying continuously for members' interests at national (Wales), UK and local level.

Response

There are positives and negatives to the use of retentions in the construction industry.

Benefits of retentions:

- no construction project is defect-free
- Security of contractor having to return to site to remedy defects
- Some insurance against the risks of downstream insolvency (subcontractors going bust and having to be replaced)

Problems with retentions:

- (In)security of retention payment in the event of upstream (contractor) insolvency
- Prompt release of retention monies when due

Impact of upstream insolvency:

The collapse of Carillion is a case in point. When Carillion went into liquidation in January 2018, one FMB member lost over £200,000 in unpaid contracts and one member had to put their company into liquidation.

The case of Carillion highlighted structural issues associated with contracts and payment practices within the supply chain.

When smaller firms work for a larger contractor like Carillion they are essentially investing in their business and projects because they invest significant resources upfront.

Impact of late payment:

Late payment disproportionately affects SMEs because they must use scarce resources chasing late payment. Where possible, SMEs do not work with businesses that pay late, but in many cases they'll have no choice. Furthermore, SMEs cannot charge interest on late payment because any future relationship with that business would be seriously damaged. This imbalance of power in the industry is the main cause of long payment terms.

Results from a 2014 industry survey of members of the NSCC (now part of BuildUK) and of the FMB found that 12.5% of retentions were written off as bad debt.

Alternatives to the use of retentions:

A Statutory abolition of retentions as a practice

This would require the development of the market for providing alternative forms of surety.

- Options are either a ban, or a ban with some form of mandated alternative – e.g. bonds, or insurance that would act as a guarantees of contractor performance.

- For a ban on retentions, the key question is whether the market for alternative products would expand, or whether clients/high tier contractors would accept no form of surety for work. It is likely some firms would not be able to obtain or afford the market alternatives.

- The cost of market forms of surety would be disproportionately higher for firms lower down in the supply chain.

- Mandating alternative forms of surety is the approach followed in other countries.

- It may not stop all abuses and may trigger the substitution of other forms of bad payment practice.

Statutory retention deposit scheme (RDS)

Retention monies to be held in an independently operated deposit scheme or an insurance policy held covering retentions.

Introduces a requirement to place withheld monies in an independent scheme or hold insurance policy.

Pluses:

- It would provide security against insolvency and protection against poor retention payment practices.

Minuses:

- A custodial RDS design would lock money out of the supply chain and so potentially increase cost pressures for those further up the supply chain/the client.

- This option may entrench the practice of cash retentions – would be an obstacle to the aim of abolition.

- It may not stop all abuses and may trigger the substitution in other forms of bad payment practices.

- Nature and complexity of supply chain creates potentially complicated and costly RDS design.

CIOB
THE CHARTERED INSTITUTE OF BUILDING

Briefing note on Retentions payments in the construction sector for the Finance Committee and the Economy, Infrastructure, Skills and Finance Committee of the National Assembly for Wales by the Chartered Institute of Building (CIOB)

Summary

The provision of credit by suppliers to customers is an established feature of business transactions and essential for the efficient operation of economy. However, the provision of goods and services ahead of payment means that suppliers can be vulnerable to payment delays. For this reason, it is crucial that businesses have sound credit management skills as otherwise late payments, and worse still bad debts, will eat into profits.

Introduction and General Comments

Late payment is an issue that matters hugely to businesses, particularly small businesses. A 2014 YouGov poll stated that 85% of small businesses say they have experienced late payment in the last two years, and according to government statistics they are owed around a total of £26.8 billion. In a separate Basware and YouGov poll in May 2018, over 2,000 small businesses with less than 250 staff found that more than half support a change in the law around late payments – with six-in-ten backing the introduction of a 45-day minimum payment term.[1]

In tough economic times the problem is heighted as cash retention becomes a greater priority for businesses.

The construction industry is often highlighted for its issue with late payment and it continues to pose a serious threat to the competitiveness of the sector. For example, for a project to finish on time, on budget and to the highest standards of quality, prompt payment must be made to ensure progress is not delayed to cash flow issues.

For context, construction in the UK is characterised by complex supply chains; this is a result of each building or piece of infrastructure being unique in some way. Main contractors with a direct commercial relationship with a client are termed tier 1. Sub-contractors and suppliers with a direct contract with the tier 1 main contractor are termed tier 2. Sub-contractors and suppliers working for sub-contractors are termed tier 3. Tier 3 sub-contractors also employ their own suppliers and sub-contractors, so in many cases there will be a fourth, fifth etc. tier involved in construction delivery.

A widely held view is that clients and tier 1 contractors retain money for as long as possible, for example to bolster their balance sheet, whereas sub-contractors wish to obtain their money as soon as possible. Longer payment periods, in turn, have a knock-on effect down the supply chain and those further down the chain may become cash starved, forcing greater reliance on borrowing and potentially risk insolvency. However, the counterargument is that retentions are held as a form of surety against defects which may be outlined in contract terms and conditions.

Some statistics that highlight the scale of the issue can be seen below.

[1] Basware & YouGov, *New poll shows 61% of small businesses want legislation around late payments*, May 2018

- The construction and real estate sector are particularly adversely affected by long waits for payment. Waits for payment have increased by 22% in the last five years to 107 days, from 88 days in 2008.[2]

- The squeezing of sub-contractors and suppliers is commonly seen as an accepted practice. In a survey of over 200 subcontractors it was found nine in ten (89%) are waiting over 30 days to receive payment from main contractors on private sector contracts. In the public sector, 92% of respondents who had worked in the sector reported that they were paid in 30 days or more.[3]

- A joint survey in 2015 from Constructing Excellence and Construction News found that, as a result of late payment, many subcontractors respond by inflating their tender prices to cover the costs (financing shortfall, administration involved in recovering costs etc.) they incur when their customers pay late. The survey suggests, on average, 4% is added to the tender price to cover late payment, which creates an additional hidden layer of cost to project delivery. The survey suggested that if main contractors paid promptly (i.e. in under 30 days) subcontractors would discount their prices by an average of 2.35%. In short, construction cost savings and improved margins could be achieved by quicker payment.[4]

UK legislation

Fair and transparent payment practices are essential to the achievement of successful integrated working on construction projects. Successive governments have tried numerous different approaches to tackle late payment. Some of the more well-known legislative approaches can be seen below:

- **The Housing Grants, Construction and Regeneration Act 1996:** Intended to ensure that payments are made promptly throughout the supply chain and that disputes are resolved swiftly. Provisions include:

    - The right to be paid in interim, periodic or stage payments
    - The right to be informed of the amount due, or any amounts to be withheld
    - The right to suspend performance for non-payment
    - The right to adjudication
    - Disallowing pay when paid clauses

The Act applies to all contracts for 'construction operations' (including construction contracts and consultants' appointments). If contracts fail to comply with the act, then the Scheme for Construction Contracts applies[5].

[2] Asset Based Finance Association (ABFA), *Late Payment: An analysis by sector*, May 2015
[3] Building, *Nine in ten subcontractors wait over 30 days for payment*, October 2014
[4] Constructing Excellence, *Late Payment: Digitising the Supply Chain*, September 2015
[5] The Scheme for Construction Contracts is a scheme which applies when construction contracts do not comply with the Housing Grants, Construction and Regeneration Act. Part 1 of the Scheme makes provision for adjudication where the contract does not comply with the Act. Part 2 of the Scheme replaces those provisions in relation to payment that do not comply with the Act.

The Act was amended in October 2011 to close loopholes within its provisions and it now applies to construction contracts including those that are not in writing. Adjudication clauses must still be in writing; otherwise the scheme for construction applies.

The Late Payment of Commercial Debts (Interest) Act 1998, Late Payment of Commercial Debts Regulations 2002 and 2013: These give businesses the statutory right to claim interest on late payments from other businesses. Statutory interest starts to accrue, if payment has not been received, on the day after the 'Relevant Day' and is calculated as 8% above the Bank of England base rate. New regulations amended

To supplement existing legislation measures, there have been several charters and voluntary measures such as the cross-industry Fair Payment Charter, the Prompt Payment Code and Construction Supply Chain Charter in recent years to try and improve the industries payment performance.

Reform and other measures to improve payment in the construction industry

In October 2017, the Government published the Pye Tait review; Retentions in the Construction Industry, BEIS Research Paper 17. The review sought to assess the costs and benefits of retentions and alternative mechanisms. It found that the average retention was 4.8%.

The report found that reasons for non-payment or late payment of retentions included:

- Disputes over defects.
- Contractors becoming insolvent.
- Non-payment in a higher tier of the supply chain.
- Contractors not asking for their retention money, with some Tier 3 companies pricing work to offset the retention costs, and others keen to maintain good relationships with their main contractor.
- This can result in higher overheads, poor relationships, constraints in growth and in some cases, insolvency.

Following the review, the government launched a consultation into 'the practice of cash retention under construction contracts'. In January 2018, following the collapse of Carillion, several main contractors backed a call to put an end to retention payments. Build UK, the Civil Engineering Contractors Association and the Construction Products Association provided a joint submission to the ongoing government consultation, stating that; 'The industry is fully committed to achieving zero cash retention and we believe that government must introduce legislation to ensure there is zero cash retention within the industry by no later than 2025.'

Despite this, the preference for the industry seems to still be focused on voluntary measures. In April 2019 it was found a host of companies – primarily tier one contractors – such as Balfour Beatty, Costain, Interserve and Laing O'Rourke had their membership of the Prompt Payment Code suspended for consistently missing payment targets.[6]

Other alternatives

[6] The Construction Index, *Late-paying construction companies suspended from Prompt Payment Code,* April 2019

Project Bank Accounts (PBA): One prominent solution, currently being adopted, is the use of project bank accounts, whereby the contractor and named members of the supply chain are paid out of a single account. In December 2017, the Welsh government announced that it would use project bank accounts on all building projects over £2m procured by government bodies from 1st January 2018.[7] And in February 2019, the Scottish Government announced that from 19 March, its thresholds would be reduced so that public bodies would have to include project bank accounts in tender documents for building contracts worth £2m or more and civil engineering projects worth £5m or more.[8] However, project bank accounts are rarely used outside the public sector and there are concerns as to their suitability on smaller projects (for example administration costs, gaps in knowledge, etc.)

Digitising Payment: The construction industry is currently in the process of digitising, optimising and integrating collaborative design, construction and maintenance processes through the adoption of Building Information Modelling (BIM) and data solutions. One thing that BIM has the potential to do is to digitise construction procurement and payment, which is still very much an analogue process. The government's Digital Built Britain strategy recognises the role digital payment has in improving productivity, driving out waste and encouraging more collaborative models of working, primarily as it provides transparency and trust.[9]

CIOB's position

We agree that whilst measures such as the Prompt Payment Code, Construction Supply Chain Payment Charter and Project Bank Accounts (PBA) have had a positive influence in improving payment practices, the number of construction contracts using these voluntary measures remain low. One of the primary reasons for this is could be a lack of support to adopt the above schemes which could be bureaucratic, particularly at SME contractor level.

We support the Build UK, Civil Engineering Contractors Association (CECA) and Construction Products Association (CPA) ambition to move towards zero cash retentions by the year 2025. There are clearly several significant benefits for the culture of the industry, its clients and stakeholders, which could be realised by removing retention, these are:

- Improved quality of completed works on construction projects, and increased assurance that any defects that do occur will be rectified appropriately, without the threat of unfair payment.
- An increase in working capital within the supply chain to support investment, productivity and growth.
- Increased collaboration and transparency in the construction industry, ensuring that any forms of security used against defects are appropriate and proportionate.

In light of this, we believe a legislative solution to abolish the practice of retention offers a game-changing opportunity for the industry. The joint Build UK, CECA and CPA response calls on the Government to legislate for zero cash retention by no later than 2025. The response also sets out an

[7] The Construction Index, *Welsh government mandates project bank accounts*, December 2017
[8] Scottish Government, *CPN 1/2019: Project Bank Accounts – Revised Thresholds and Procedures*, February 2019
[9] HM Government, *Digital Built Britain Level 3 Building Information Modelling - Strategic Plan*, February 2015

industry-led roadmap to assist the construction supply chain move towards a zero cash retentions system. Further information can be accessed here: https://builduk.org/priorities/improving-business-performance/retentions/

Scottish Government - Contribution to the National Assembly Of Wales Economy, Infrastructure and Skills Committee and the Finance Committee Inquiry into Retention Practices in the Welsh Construction Sector

Introduction

1. Scottish Government (SG) is pleased to be invited to contribute to the work of the National Assembly Of Wales (NAW) to carry out research into the use of cash retention in the Welsh construction sector.

Background

2. SG has made a commitment to consult on the same issue in Scotland and expects to publish its formal consultation document in due course. Unfortunately this is unlikely to be during the proceedings of the current NAW inquiry. However SG is happy to provide an overview of current policy on the broad aspects of performance assurance mechanisms (PAMs), which include cash retentions, and recent research undertaken on behalf of SG to identify custom, culture and practice in respect of PAMs in Scotland.

Acknowledgement

3. SG notes that the Scottish Futures Trust has already made a separate submission, dated October 2019.

4. SG is responsible for setting official policy on PAMs in construction contracts for in-scope organisations, including cash retentions. "In-scope organisations" are those bodies for which the Scottish Public Finance Manual is applicable guidance (here, paragraph 7 et seq). Organisations which are out of SG's administrative scope include, for example: local authorities; the higher education sector; and housing associations. Such bodies are therefore free to implement their own requirement for PAMs, or indeed none, as they think appropriate.

Current Policy

5. SG's PAM policy is set out in the erstwhile Construction Procurement Manual and is noted at Annex A. In summary, it encourages contracting authorities to consider assurance methods, including the use of retentions, on a project-by-project basis. The use of retentions is not the default position.

6. The Manual is an e-document which was taken off-line in mid-2017 while a replacement was being drafted, pursuant to implementing the associated recommendation of the Review of Scottish Public Sector Procurement in Construction. The Manual is being supplanted by a series of topical handbooks which are publishing on an ongoing basis. It still however contains current policy on some elements of construction contract administration: PAMs, cash retention, is one such policy.

Research

7. SG officials considered that the limited formal information around the volume and rate of retention use in Scotland required research. After a competitive tendering

process, Pye Tait were awarded the contract to carry out that research. NAW will no doubt be aware that they completed similar research for the UK Government (BEIS) on use of retentions in England.

8. SG’s project commenced in December 2018 and a final report was received at the end of April 2019. It followed a similar methodology to BEIS and aimed to provide a qualitative and, where possible, quantitative assessment of the costs and benefits of the contractual practice of holding retentions, and of alternative mechanisms, in construction contracts in Scotland.

9. While SG cannot go into too much detail in advance of formally publishing the outcome of the research, it did not provide a firm policy recommendation. In broad terms it found that there are a range of views across Scotland’s construction sector about the current use of retentions and whether action is required to change the method of assurance used in the construction sector. These findings were comparable with the BEIS research and their consultation on the use of retentions in the construction sector held towards the end of 2017.

10. In Scotland, as across the rest of the UK, the retention amount held is typically 5% of the contract value and the defects liability period is normally 12 months after practical completion. A higher proportion of contractors in Scotland may be avoiding the practice of retentions for a variety of reasons including what they regard as risk, previous bad experiences, and the perceived abuse of the system by higher tier contractors. It is suggested that this is reducing competition for contracts where a retention is required.

Consultation

11. SG has committed to a public consultation on the use of retentions in the construction industry in Scotland. The structure of the consultation is currently being developed along broadly neutral lines in which views will be sought on the following (subject to possible change):

    - elements of traditional PAMs
    - more recent innovations such as a Retention Deposit Scheme
    - legislation to regulate or indeed ban certain practices.

12. The consultation may also seek views on matters including the following:

    - effectiveness of existing prompt and fair payment measures for retentions
    - late and non-payment of retentions
    - effectiveness of existing alternative mechanisms to retentions
    - costs and benefits of holding retentions in a retention deposit scheme or trust account.

13. While an exact release date for the consultation is not possible to provide as yet, SG aims to publish as soon as practicable.

Scottish Government
10 October 2019

Annex A

Current Scottish Government Policy on Performance Assurance Mechanisms in Public Works Contracts

Need for assurance

Realistically, defects occur in most construction works and project owners therefore need to be assured by measures designed to protect the public purse from becoming liable for defective or sub-standard work and to ensure their projects are completed as contractually-specified. An evaluation of the options among available assurance mechanisms should be conducted in respect of strategic factors, including the specific nature of a project's value, procurement method and market conditions.

Assessment of assurance

Scottish Government does not prescribe particular assurance processes. Decisions should be project-based and processes should be proportionate to the specific circumstances of the project. Wherever possible, they should also be applied consistently along the supply chain. In most cases, professional advice and specialist input will be required to help fully inform decisions. Cash retentions or other traditional means of assurance should not prevail purely by default or without adequate analysis. "Custom and practice" is not of itself adequate justification for the implementation of any performance assurance mechanism. Hence, Scottish Government does not prescribe the use of cash retentions.

Cash retentions - principles

Project assurance mechanisms which utilise cash retention are permissible where an evaluation of options identifies them as offering the best overall value for money (rather than a retention bond or parent company guarantee, for example). Clients should ensure they receive advice from professionals, having regard to project circumstances. Whilst Scottish Government does not prescribe the proportion, or amount, of cash to be held, it should be reasonable and commensurate with strategic project factors, as should the triggers for its release.

Any costs associated with properly establishing and monitoring the retention fund should be compared with the benefits of minimising scope for abuse along the supply chain. Retention monies should not be unjustifiably withheld at any point along the supply chain on Scottish Government projects, those holding monies should observe the associated fiduciary duties (where applicable) and the relevant clauses in conditions of contract should be adhered to at all times.

Alternatives to cash retentions

Alternatives include the following:

Retention bonds - under a typical retention bond, the contractor's performance of its obligations to complete the works as contractually-specified is guaranteed by a third party, or surety, which undertakes to pay damages sustained by the employer in the event of any default on the part of the contractor. Normal practice is to provide conditional retention bonds that increase in value as payments are made (in full i.e. no cash retentions applied) in accordance with the contract. The surety's liability is limited to the sum which would otherwise have been held by the employer by way of cash

retention at the time of any breach and is automatically reduced by half upon issue of the certificate of practical completion.

Performance bonds - the contractor may be able to give a "default" (or "on default") bond to the public authority. This type of bond is conditional on performance of the contract or payment of damages by the bondsman if the contractor defaults. This bond is a guarantee because the bondsman assumes a secondary obligation to pay if the contractor fails to perform. The amount of the bondsman's liability is proportional to the damages sustained by the employer. Another type of performance bond is an "unconditional on demand" bond: however, it is Government policy not to use these. "Maintenance" bonds are also available, which provide limited security for performance of the contractor's obligations during the defects liability period. These can be of use where there has been a performance bond which has expired on practical completion or the works comprise a specialist installation demanding a high level of care after practical completion.

Parent company guarantees - This form of guarantee is given by a parent company (or holding company) to guarantee the proper performance of a contract by one of its subsidiaries (the contractor), and can only be given where the contractor is owned by a parent company or is the subsidiary of a larger group. Because the financial strength of the parent company may be linked to that of the contractor, a parent company guarantee will be acceptable only if the parent company (or holding company) is financially strong and its financial resources are largely independent of those of the contractor.

Such a guarantee is free of cost to the client, but may give less certainty of redress than a bond because it is not supplied by an independent third party. However, whilst accepting less independence, parent company guarantees for the proper performance of the contract can be more advantageous than bonds. The conditions of a parent company guarantee will usually give the parent company the opportunity to remedy any default within a period of notice before the guarantee is called. Rather than the client receiving a fixed amount in compensation, the parent company is obliged to complete the contract. The way in which this is done can, to some extent, be at the discretion of the parent company. Costs for completion are borne by the parent company - and these costs may be significantly more than the compensation provided for in a bond.

Assurance drivers and constraints

Contracting authorities should seek appropriate professional advice when considering the use of bonds and guarantees on public works contracts, to clarify their practicalities, technicalities and legalities, and also their overall value for money compared with other performance assurance mechanisms. The use of bonds transfers some of the project financing cost from the contractor to the public client and will pass cashflow benefits to the contractors. Their use should result in a lower overall cost to the client if the contractor is prepared to reduce its tender price accordingly. Only one type of performance assurance mechanism should be deployed by the client at any time on a single project: for example, retention bonds should not be supplemented by the withholding of cash retentions. There can be greater scope for implementing alternatives to cash retentions on longer term contracts, framework agreements or

serial contracts in which teambuilding and collaborative working practices can be more readily introduced.

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