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.