Procurement Guidance Note

PGN 05/16

The Use of Retention in Construction Works Contracts

Issued: 22 December 2016

PROCUREMENT GUIDANCE NOTES

Northern Ireland Public Procurement Policy (NIPPP) was approved by the Northern Ireland Executive in 2002. In approving the policy, the Executive took the decision that legislation was not necessary to ensure Departments, their Agencies, Non-Departmental Public Bodies and Public Corporations comply with the policy. Instead, it considered that compliance could be achieved by means of administrative direction.

Procurement Guidance Notes (PGNs) are the administrative means by which Departments are advised of procurement policy and best practice developments. They apply to those bodies subject to NIPPP and also provide useful guidance for other public sector bodies.

PGNs are developed by the Central Procurement Directorate (CPD), in consultation with the Centres of Procurement Expertise (CoPEs), and are subject to the approval of the Procurement Board.

Once endorsed by the Procurement Board, PGNs are issued to the Departments for implementation and copied to CoPEs who, if necessary, develop underpinning procedures supporting the implementation of the guidance in their particular sector. PGNs are published on the Department of Finance (DoF) website.

This PGN was endorsed by the Procurement Board with effect from 22 December 2016 for use by those bodies subject to NIPPP.

Revision History

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Definition of Terminology

In the preparation of this guide, the term **contractor/supplier** has been used to denote an organisation that contracts directly with a department, whether it is a supplier, a service provider or a construction contractor.

The term **department** has been used to refer to those bodies subject to Northern Ireland Public Procurement Policy including Departments, Non-Departmental Public Bodies and Public Corporations. A full list of such bodies is available in Annex A of the Northern Ireland Public Procurement Policy (NIPPP).

Glossary	
Defect	Is a part of the Works which is not in accordance with the Works Information or is a part of the Works designed by the Contractor which is not in accordance with the applicable law or the Contractor's design which the Project Manager has accepted. It also includes unfinished or omitted parts of the Works.
Defects Certificate	Is either a list of defects that the Supervisor has notified before the Defects Date which the Contractor has not corrected or, if there are no such defects, a statement that there are none. It Is issued either on the Defects Date or at the end of the last Defect Correction Period, whichever is the later. Its issue signifies the end of the contract.
Defect Correction Period	A specified length of time, identified in the contract, within which a notified defect must be corrected. There may be different periods for different categories of defect.
Defects Date	Is a date, identified in the contract, until which the contractor is liable to rectify any defects. It is a duration from Completion, rather than a specific day, typically 26 or 52 weeks from the completion date.
Defects Liability Period	A length of time, identified in the contract, after the completion of the whole of the Works within which the making good of defects is the responsibility of the contractor, usually 12 months.
Retention	Money held by the Employer from money due to the Contractor for work undertaken as security against any defects in that work that become apparent before the end of the contract Defects Liability Period.
Retention-free Amount	Is a portion of the Price for Work Done to Date to which no retention is applied.

Retention Percentage	A rate of retention, identified in the contract, which is applied to the excess of the Price for Work Done to Date above any retention-free amount.
Supervisor	Appointed by the Employer to check that the Works are constructed in accordance with the contract. The Supervisor issues the Defects Certificate.

LIST OF ABBREVIATIONS

NI Northern Ireland

PGN Procurement Guidance Note

1. GENERAL

1.1 Introduction

1.1.1 Retention is a contractual requirement in construction works contracts that enables the employer to retain a proportion of the monies due to a Contractor for the work undertaken to date. It is held as security against any defects in the Works that become apparent before the end of the contract Defects Liability Period.

1.1.2 Retention has traditionally been applied in both public and private sector construction works contracts. While it continues to be an important tool in managing Government contracts, it is important that it is applied in a consistent yet proportionate manner.

1.1.3 This guidance brings together best practice in relation to the application of Retention in public sector construction works contracts. It highlights relevant legal and policy requirements together with their application to the use of Retention.

1.1.4 This guidance is written from the perspective that Government's preferred standard construction form of contract is the NEC3 suite of contracts. The principles within this guidance may, however, be applied to other forms of construction works contracts.

1.2 Background

1.2.1 Most of the work in public sector construction projects in Northern Ireland is undertaken by subcontractors. They account for the vast majority of the workforce within the local construction industry

1.2.2 The eradication of poor payment practices, particularly between main contractors and subcontractors, remains a key focus for the Executive in its construction contracts. This is because these practices lead to increased disputes and costs across the industry and can expose small and medium sized firms to the risk of insolvency.

1.2.3 This is particularly relevant to the management of Retention, where the failure by the Contractor to release Retention monies to subcontractors on time, or at all, can pose real financial risks to these firms.

2. THE PURPOSE OF RETENTION

2.1.1 The main benefit of Retention arises from the incentive it provides to encourage the Contractor to rectify minor defects. Specifically those that do not justify the Employer suing the Contractor due to the small costs involved.

2.1.2 There can be confusion regarding the purpose of holding Retention. Often the reason for holding Retention is cited as protection against the Contractor's insolvency or to remedy major defects which become manifest in elements after work has been completed.

2.1.3 However, in the case of a Contractor's insolvency 1½%, 3% or even 5% Retention may not fully compensate the Employer for the additional costs that are generally incurred procuring a new Contractor and having the Works completed. In private sector contracts, an insurance bond of 10% of the contract value is normally requested to cover such an eventuality, but bonds are not recommended in Government contracts due to their cost across the Programme for Government.

2.1.4 It should be noted that Retention can only be retained by the Employer in relation to a defect for which it can demonstrate that the Contractor is liable. The cost to remedy a significant defect would, in general, exceed the amount of Retention held. However, the costs involved would normally be sufficient to justify the Employer commencing litigation against the Contractor, except, of course, where the Contractor accepts liability and rectifies the defect.

2.1.5 In the event that minor defects materialise after practical completion, and where the Contractor has refused to return and rectify them, the Retention provides a sum of money to have the defects attended to without impacting upon the Employer's revenue or maintenance budgets.

3. THE EFFECTS OF RETENTION

3.1 Financial impact

3.1.1 Departments should be aware that the application of Retention in a construction project can have a material financial impact on the Contractor and its supply chain. The impact is dependent on:

- the ratio between the anticipated cost of rectifying defects and the amount of Retention held;
- the ratio between final profit and the amount of Retention held;
- the ratio between the length of the contract period and the Defects Liability Period;
- the number and value of subcontracts; and
- the potential for insolvency of a higher tier Contractor or Subcontractor in the supply chain.

3.1.2 In addition, Retention can represent a significant part of a Contractor's profit from a construction project. This means that the realisation of a Contractor's profit may be delayed for a year after its work is completed.

3.1.3 The imposition of excessive Retention or failure to release the Retention fund at the appropriate time can have a significant affect on the profitability and solvency of Contractors and their supply chains.

3.1.4 Furthermore, the improper withholding of Retention can lead to unnecessary disputes across the supply chain. These disputes can ultimately impact upon the delivery of the project, adversely affecting the timeliness, cost and quality of the finished product.

3.2 Withholding Retention and/or reduction in Retention payable

3.2.1 While it is important that Departments are aware of the financial impact of Retention on the Contractor and its supply chain, there are instances in which it is appropriate to withhold or reduce the Retention payable.

For example, the release of Retention monies may justifiably be reduced or permanently withheld where a Contractor or Subcontractor has failed to rectify defects in its Works. This also applies where the amount owed to the contractor has been reduced as a result of delays or other costs incurred as a result of actions by the Contractor or Subcontractor.

4. LEGAL REQUIREMENTS WHEN MANAGING RETENTION

4.1 The Construction Contracts Order (NI) 1997

4.1.1 Under the Construction Contracts Order (NI) 1997 a Contractor is legally obliged to pay Retention to its subcontractors when it becomes due. This is regardless of when, or if, the Contractor has been paid its Retention by the Employer or higher tier Contractor. The practice commonly known as *'pay when paid'* was outlawed in construction contracts following the introduction of the Order.

4.1.2 Under the Order and the Construction Contracts (Amendment) Act (NI) 2011 non payment of sums due, or a dispute regarding the amount due, in a construction contract can be referred by either party to adjudication, generally within 7 days. If an adjudicator makes an award (which normally happens within 28 days) in respect of one party this can be enforced against the other as a debt.

5. POLICY REQUIREMENTS WHEN MANAGING RETENTION

5.1 Good practice in the management of Retention

5.1.1 Having taken account of the intended use of Retention and the potential impacts resulting from their application, the following Principles represent good practice in their management. They should be applied by Departments in the delivery of their construction projects.

5.2 Principle 1 - Use Retention only when required

5.2.1 Retention should not be used in contracts where the Contractor's performance, in relation to defects, can be incentivised by alternative means.

5.2.2 For example, Retention should not be applied in contracts awarded under Frameworks, Measured Term Contracts and Term Service Contracts where the Contractor is expected to be retained to undertake subsequent Works/contracts. This is because the opportunity for future work can be used to incentivise the Contractor to remedy defects in previous Works/contracts.

5.2.3 If it is not certain that the Contractor will be retained to undertake subsequent Works/contracts, such as within the last year of a framework agreement, then Retention may be applied.

5.3 Principle 2 - Apply Retention at a proportionate level

5.3.1 There should be consistency in the application of Retention across Government. Therefore, Retention should be applied at a standard rate of 3% in Government construction contracts. This should reduce to 1.5% upon completion of the Works / practical completion.

5.3.2 Release of the remaining 1.5% Retention is at the end of the contract Defects Liability Period which should not exceed 12 months from the completion of the Works / practical completion.

5.3.3 As Government policy requires that 'no worse' terms are passed on to the supply chain it is important that the Retention applied to first tier subcontracts, by the Contractor, reflects that included in the main contract.

5.4 Principle 3 - Release Retention promptly

5.4.1 Retention should be released promptly when due. For example, a Subcontractor's Retention must be released at the end of the subcontract Defects Liability Period and not held until end of the main contract Defects Liability Period. Similarly subcontract Retention should be reduced by half on completion of the subcontract Works as opposed to completion of the main contract Works.

5.5 Principle 4 - Application of a Retention-free amount

5.5.1 The NEC3 form of contract makes provision for an amount of the contract sum to be excluded from Retention, known as a Retention-free amount. This is intended to assist the Contractor's cash flow in the early stages of the contract.

5.5.2 Departments should consider applying an appropriate Retention-free sum when there are any high cost, early installed items for which Retention is not suitable. For example, this may include the provision of expensive equipment by specialist manufacturers where the risk of minor defects is low.

5.5.3 The Retention-free amount should be set out in the tender documentation. It is calculated and deducted at the start of the contract. Once the contractor has invoiced to the sum of the Retention-free amount, Retention is then applied for the remainder of the contract.

5.6 Principle 5 - Monitor the use of Retention to detect abuses within the supply chain

5.6.1 Northern Ireland Public Procurement Policy requires Contractors to report monthly on the application of fair payment practices in

Government construction contracts. Fair payment is monitored in these contracts by the Project Manager.

5.6.2 Monitoring of fair payment should, where practical, be extended to the application and release of Retention to first tier subcontractors whose subcontract has a value in excess of either 1% of the main contract sum or £10,000 (whichever is the greater). This is to ensure that Retention is released promptly within the contract and across the supply chain.

6. OTHER POLICY REQUIREMENTS RELEVANT TO RETENTION

6.1 Code of Practice for Government Clients and their Supply Chains

6.1.1 One of the economic objectives of the Construction Industry Forum for Northern Ireland's Sustainability Task Group's proposals is to encourage prompt payment and fair dealing.

6.1.2 As part of the *Code of Practice for Government Clients and their Supply Chains* (see PGN 06/12 section 4.3), the model *Fair Payment Charter* commits all parties to '*replicate any client arrangements for Retention on the same contract terms throughout the supply chain*'. Departments and contractors are required to sign up to, and comply with the Code.

6.1.3 This means that Retention conditions should be applied to the date the Subcontractor's work is completed as opposed to the date that the main contract is completed. This is an important distinction which can result in the earlier release of Retention payments to the supply chain than the Contractor.

6.2 Passing on 'No Worse' terms to First Tier Subcontractors

6.2.1 PGN 06/12 - Helping Small and Medium-sized Enterprises Benefit from Subcontracting Opportunities in Government Contracts requires Contractors, through contract conditions, to ensure that particular terms and conditions included in the contract between them and the department (for example, warranties, insurance, liability, security, confidentiality, indemnities and termination arrangements) are directly reflected in the terms agreed between the contractor and its first tier subcontractors.

6.2.2 This means that the subcontract Defects Liability Period and the Retention Percentage should not exceed that within the main contract.

6.2.3 The guidance also requires (see paragraph 3.1.6 of PGN 06/12):

- acceptance of subcontract terms by the Project Manager prior to the subcontract being entered into; and
- copies of all first tier subcontracts to be provided to the department where required.

This means that Government construction clients should ensure that subcontracts that have ‘worse’ terms than the main contact are not entered into by the Contractor.

6.3 Monitoring of payment to subcontractors

6.3.1 PGN 06/12 - Helping Small and Medium-sized Enterprises Benefit from Subcontracting Opportunities in Government Contracts also requires Departments to ensure prompt payment is actually applied to the first tier subcontractors and should require access to the contractor’s management information on the payment of first tier subcontractors so that it has visibility of payments made. This should take the form of a regular report by the contractor on payments to subcontractors with a contract share of more than one percent of the contract value or £10,000 (whichever is the greater). Departments should carry out periodic checks to ensure the accuracy of these reports.

6.4 Use of Project Bank Accounts

6.4.1 Where Project Bank Accounts are included in a Government contract they should be used to make payment of Retention to those first tier subcontractors that have access to it. Project Managers should monitor the application of this in relevant projects.

7. PROVISIONS FOR RETENTION IN CONSTRUCTION CONTRACTS

7.1 NEC3 Engineering and Construction Contracts

7.1.1 Government's preferred form of construction works contract, the NEC3 Engineering and Construction Contract (NEC ECC), makes provision for the application of Retention using secondary Option Clause X16. This option clause should be included in NEC ECC contracts where Retention is required.

7.1.2 The Retention Percentage stated in the NEC ECC Contract Data Part 1 should be 3%. The Defects Date in the NEC ECC Contract Data Part 1 should not exceed 52 weeks after completion but for short, straightforward contracts it may be 26 weeks or lower.

7.1.3 The first interim certificate issued after practical completion will result in the release of one-half of the Retention currently held by the Employer. The remainder will be released at the end of the Defects Liability Period upon the issue of the Defects Certificate.

7.1.4 If the Contractor produces substandard work, for example, a defect such as low quality brickwork, reinforced concrete or electrical installation, the Employer can take one of the following actions:

- Insist that the Contractor corrects the defect to provide the quality specified in the Works Information (NEC3 Clause 43.1);
- Accept the defect and also a quotation from the Contractor for reduced prices, an earlier completion date, or both, in return for a change to the Works Information (NEC3 Clause 44); or
- Recover the cost of having it corrected by another contractor if the Contractor fails to correct the defect within the Defect Correction Period (NEC3 Clause 45.1).

7.1.5 Where the latter is the case, Retention is used to recover costs. Where persistent poor performance exists, the procedures in PGN 01/12 –

Contract Management Procedures and Principles may be invoked. This can result in the issue of a Notice of Unsatisfactory Performance whereupon the Contractor may be excluded from all NI public procurement competitions covered for a period of up to 3 years. If the contract still has a significant period to run, or if performance is so poor that it cannot be allowed to continue, termination may be considered.

8. PERSISTENT FAILURE TO REMEDY DEFECTS

8.1 Managing performance

8.1.1 Procurement Guidance Note PGN 01/12: Contract Management Principles and Procedures explains the principles of contract management and contains the *Protocol for Managing Poor Contractor Performance* at Annex A therein.

8.1.2 Departments must ensure that they have effective contract management procedures in place and that they monitor payments to subcontractors and make use of the *Protocol for Managing Poor Contractor Performance* where there is persistent poor payment of first tier subcontractors.

9. FURTHER INFORMATION

Enquiries relating to this guide can be sent to:

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