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NEC4 Engineering and Construction Contract
Dealing with Retentions

16 January 2023

Steve Bratt ECA
Peter Higgins Chairman, NEC4 Contract Board
Andrew Croft Beale & Company Solicitors
Claire King, Fenwick Elliott

Agenda

- Background to work
- Introduction to guidance
- NEC approach to retentions
- How Option X16 works
- Alternative to X16
- Panel discussion

Introduction to guidance

- Retentions routinely used on construction contracts as security against unfinished or defective work
  - little thought as to true value, need
  - often misused
- Pressure for industry to move to zero retentions
- Guidance intended to
  - explain NEC approach to defective work and retentions and
  - set out when and why retentions may not be needed

NEC approach to retentions and defects

- Retention provided as optional clause
  - consider whether needed, not include “because we always do”
  - other options provide for security – should not duplicate
- Definition of Completion - Contractor has
  - done all the work the Scope states is to be done before Completion
  - corrected Defects that would prevent the Client’s use of works
- NEC approach is that there should be few remaining Defects at Completion
  - Defects arising after Completion must be corrected within a defined time

Defects and payment

- Priced Contract - payment for completed work
  - excludes work containing Defect the correction of which would delay following work
- Target/ Cost Reimbursable contract – payment of Defined Cost
  - Excludes cost of correcting Defects after Completion
  - limited other grounds for disallowing payment
    - Contractor shares cost of correcting through target share
- Uncorrected Defects following Completion
  - Contractor pays cost of correcting Defect not corrected in specified period
  - Contractor and Client may agree payment for not correcting Defect

Use of retention fund

- Security to cover cost of rectifying Defects after Completion
- Only of value if
  - significant Defects outstanding at Completion or
  - significant Defects arise following Completion
- and
  - Client believes Contractor unlikely to correct them.
- Alternative to retention fund
  - Use appropriate procurement and contract management procedures

How NEC Option X16 (Retention) works?

- An optional (rather than a core) clause.
- Security to cover Defects.
- *"…NEC promotes a high level of collaboration in project delivery, with a 'right first time' mantra applying from the outset.*

  The existence of non-compliant work at the end of an NEC project would imply the contract has not been managed properly, and any refusal to fix it would not accord with the collaborative ethos of the contracts…"

  Rudi Klein Retentions and their use with NEC contracts

How NEC Option X16 (Retention) works? (cont 1)

- Option X16 exists to recognise that sometimes only a retention will do. For example:
  - Contractor is unwilling to correct defects;
  - Contractor has solvency issues; or
  - Client cannot operate an effective quality management system during the Works.
- Included in construction contract/sub-contract. Not for use with Option F
- Under NEC4 option for retention bond

How Option X16 works? (Cont'd 2)

- When Option X16 is marked to apply (but not in the form of a X16.3 bond):
  - Client, via usual Project Manager certification process under clauses 50 and 51, is able to retain a proportion of the Price for Work Done to Date.
  - Contract Data should state:
    - *Retention percentage* - e.g. 5%
    - *Retention free amount* – if stated means retention only applies to sums above that.
- Impact on Contractor's cash-flow depends on the amount of work it subcontracts; there can be no double-deduction of retention as Defined Costs for Options C to E are calculated using the gross payments made to subcontractors (see clause 11.2(24) and item 41 of the Schedule of Cost Components for Options C to E).
- Release:
  - 50% of retention is released at the earlier of Completion or when the Client takes over the whole of the works.
  - Remainder is included in the final amount final amount due in accordance with clause 53.

How Option X16 works? (Cont'd 3)

- When Option X16 is marked to apply (and so is the X16.3 bond):
  - The Project Manager is tasked with the decision whether or not to accept the retention bond.
  - A valid reason for the Project Manager to not accept the bond is that the commercial position of the bank or insurer is not strong enough to carry the bond.
  - If any other reason for not accepting the bond is used by the Project Manager, a compensation event arises under clause 60.1(9) and should be notified by the Contractor as such pursuant to clause 63.1.

Alternatives to retention: Protection of funds (1)

- Project Bank Accounts:
  - Used for public contracts since 2007 and primarily used in that sector
  - Option Y(UK)1 – NEC4
  - Trust Deed required and monies held on trust subject to the rules governing the trust
  - Tier 1 contractors argued it increases costs (significantly): set up and administration costs, investing in accounting and finance systems, investing in training
  - Essential to deal with interest and who is entitled to it
  - Previous studies have concluded that unsuitable for sector-wide alternative to retentions

[Source: BEIS: Research paper 17: Pye Tait: Retentions in the construction industry (October 2017)]

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Alternatives to retention: Protection of funds (2)

- Trust accounts for retention funds
- Money is ring fenced and held in a separate fund
- 2017 BEIS research:
    - Hardly used over the last three years
    - BUT viable alternative relatively low cost way of protecting funds

Alternatives to retention: Security for performance (1)

- Performance Bond
  - Option X13 in NEC4
  - Protects an employer where a breach by the contractor results in losses
  - Can be on demand or contingent
- Provide protection from insolvency
- Cost of obtaining bonds has generally increased in recent years
- Widely used but generally in <u>addition</u> to retention in the industry

[2017 BEIS research]

Alternatives to retention: Security for performance (2)

- Retention Bond
  - Option X16.3 (NEC4)
  - Linked specifically to retention monies and for dealing with the same issues (e.g., Defects emerging after completion)
  - Procured as an alternative at the outset or during the project to get retention released
  - Up front cost but otherwise improved cash flow
  - Can be made payable on demand
  - Wording of the Retention Bond needs to ensure it is linked to the need for retention rather than wider breaches
    - Timescales for claiming, maximum amounts payable, how disputes are resolved
  - BEIS 2017 Report noted they were expensive for smaller contractors and subcontractors

Alternatives to retention: Security for performance (3)

- Parent Company Guarantee (“**PCG**”)
  - Option X4: “*Ultimate Holding Company Guarantee*”
  - Parent company “*guarantees*” to undertake its subsidiaries’ obligations / pay damages
  - Company needs to have a parent AND parent company needs to have assets!
  - Can take time to claim under a PCG
  - Exactly how long it takes to recover funds depends on the wording AND what form of dispute resolution is provided for

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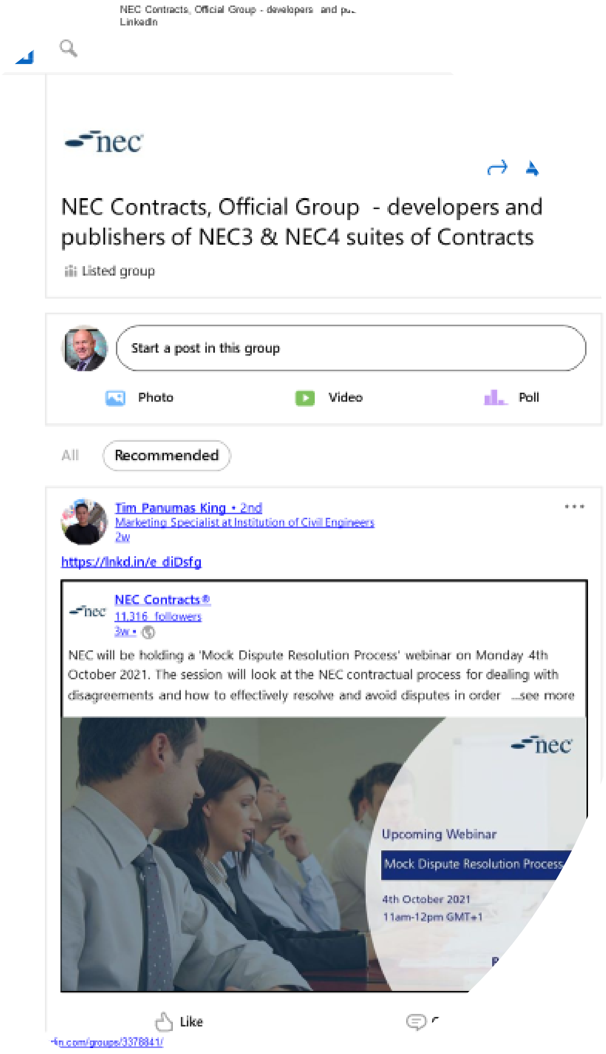

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- 30 hours of online learning and a one-day tutor-led consolidation session.
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- https://www.neccontract.com/products/training/nec4-ecc-project-manager-accreditation