



House of Commons

Trade and Industry Committee

Retaining Retentions?

**Comments on the Government's response to the
Committee's Report on the use of retentions in the
UK construction industry**

Fifteenth Report of Session 2002–03

*Report, together with formal minutes, oral and written
evidence*

*Ordered by The House of Commons
to be printed 9 September 2003*

HC 976

Published on 17 September 2003
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Trade and Industry Committee

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Footnotes

In the footnotes of this Report, references to oral evidence published with this Report are indicated by 'Q' followed by the question number; and references to oral evidence published with previous Reports are in the form 'HC 127 (2002-03), Q x'. References to written evidence published with this Report are indicated by 'App 1', and to written evidence published with previous Reports by 'HC 127 (2002-03), Ev x'.

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1 Background to this Report

1. “Retentions” is a term used to describe the practice whereby a client for construction work retains a proportion of the value of their contract as an incentive to the contractor to avoid or eliminate defects in construction work. The principal contractor spreads the impact of the retention by withholding the same proportion of his payments to sub-contractors who may, in turn, pass it on to sub-subcontractors. The exact amount of the retention is subject to contractual agreement and is typically 5 per cent of the total value of the contract, although it may be much more. Normally, the client holds the retention until the project is completed, when half of the retained sum is paid over to the primary contractor. The rest is paid at the end of what is called the defects liability period, once all of the defects identified at the project completion stage have been rectified. The primary contractor is responsible for the distribution of the retention among the sub-contractors and sub-subcontractors.

2. The retention system developed as a means of ensuring that contractors delivered work to the standard expected by the client, and its continuance is an indication of the degree of distrust between clients and the industry. It is also a very considerable burden upon the industry, especially the small and medium sized companies that make up the bulk of the construction sector. The Specialist Engineering Contractors Group (SEGC) has estimated that SMEs are funding £3.25 billion of cash retentions every year.¹ Furthermore, it is a burden on the taxpayer. The Construction Confederation suggested that sub-contractors routinely increased tender prices to provide a contingency against retentions. It estimated that the cost to the public purse of such a practice could be as much as £750 million a year.²

3. We held a brief inquiry last Autumn into the practice of retentions, its effect on the construction sector and the use of retentions in the public sector.³ We concluded that retention was an out-dated practice which should not be necessary in a modern industry which delivered a high quality product. We noted that the adoption of integrated supply chain management by major clients in partnership with their contractors, as recommended by the Strategic Forum for Construction, had resulted in higher productivity and greater client satisfaction. We recognised, however, that engineering the necessary change of attitude across the industry and the client base as a whole would be a long term process. We noted that the public sector was responsible for the procurement of more than 40 per cent by value of all construction work in the UK and felt that government departments and agencies should provide a lead to other clients and the industry by adopting the new procurement practices as quickly as possible and adopt a uniform approach to the phasing out of retentions.

4. We did not find the Government’s response to our Report entirely satisfactory.⁴ It seemed to us that, while the Government was content to accept any conclusion or

¹ App 1

² Trade and Industry Committee Second Report of Session 2002-03, *The Use of Retentions in the UK Construction Industry*, November 2002, HC 127, Ev 24

³ HC 127 (2002-03)

⁴ Trade and Industry Committee, Second Special Report of Session 2002-03, *Government Reply to the Second Report of Session 2002-03 : Retentions in the UK Construction Industry*, February 2003, HC 438

recommendation directed at third parties, it did not accept any which would require it to take specific action itself. In particular, it rejected the suggestion that a consistent approach to construction procurement could be taken by all government departments, on the grounds that differences in size and scope between them ruled this out. It also rejected the concept of a target date (of 2007) by which government departments should have removed the requirement for retentions from their procurement contracts.

5. While we were content to publish the response in order to put it into the public domain, we did not feel that the Government had provided an adequate explanation for its position on these issues. We decided, therefore, to seek further clarification on these points from Government officials.

6. We are grateful to Mr Mark Gibson, Director General, Business Group, and Mr Rodger Evans, Construction Sector Unit, from the DTI and their colleagues Mr John Oughton, Deputy Chief Executive, and Mr Arnold Butler, Director, Property and Construction Best Practice, of the Office of Government Commerce, for their further evidence to us, which we discuss briefly below. We are also grateful to the SECG for their further briefing on this subject.

2 Principal conclusions of our previous Report

Non-contentious issues

7. In our previous Report we found agreement between the industry and the DTI that construction clients, contractors and subcontractors did not trust each other to deliver defect-free work and that this was an endemic cultural problem. The SECG went further and said that the practice of retention encouraged this atmosphere of distrust.⁵ While construction clients told us that retentions afforded them at least some control over the rectification of defects, we received no evidence to enable us to gauge how effective an incentive the system was in practice. The industry did not feel that the system had any effect on the quality of the work delivered.⁶

8. The retentions system places a considerable financial burden on contractors and subcontractors. In practice, it is often very difficult for a company to retrieve the retention from the client or principal contractor, a fact which has been recognised by the Inland Revenue, which now allows companies to write off uncollected retentions for tax purposes.⁷ We did consider a suggestion from the industry that the retentions system might be removed by means of legislation, but we were not convinced this route would be appropriate given that the use of the system was essentially a contractual matter between two parties. We felt that the focus should be concentrated on the need to improve working relationships between clients and contractors in order to increase productivity and improve quality.⁸

9. To that end, we commended the work of the Strategic Forum for Construction in encouraging new working practices, including the development of integrated supply chains.⁹ We also supported initiatives such as the Clients Charter toolkit, which was developed by the Construction Clients Consortium and others to encourage the adoption of best practice in construction procurement.¹⁰

10. The Government was happy to agree with or acknowledge all of these points, which required it to do nothing or to provide continued support for initiatives already in place. It appears that it was not happy to accept the Report's principal recommendations for action which would involve changes in the construction procurement policies of government departments.

Retentions in Government procurement practice

11. The public sector represents the most significant group of clients for construction projects and accounts for an annual expenditure of more than £25 billion.¹¹ Furthermore, the Government expects to increase public investment in major public works, such as

⁵ HC 127 (2002-03), para 12

⁶ As above, para 15

⁷ App 1

⁸ HC 127 (2003-03), para 21

⁹ As above, para 31

¹⁰ As above, para 38

¹¹ HC 127 (2002-03), Ev 24

hospitals, schools, roads and railways.¹² We therefore thought that government departments would be in a good position to set an example to other construction clients in the development of better procurement practice.

12. Some public sector construction clients have already refined their procurement and project management practices to the point either that their contracts no longer include provision for a retention, or that they have a clear policy objective of phasing out that provision. Mr Oughton cited NHS Estates and the Defence Estates Organisation as good examples of clients developing their procurement practice in this direction,¹³ and we had received evidence from the DTI during our earlier inquiry that the Highways Agency and the Department of Work and Pensions were working towards an incentive-based approach to procurement which would replace the need for retentions.¹⁴ We were told that the Environment Agency had removed retentions from their contracts for large-scale works, as had the Home Office. However, both Departments had kept retentions provisions in their contracts for smaller projects.¹⁵ Others appeared to maintain retentions as a matter of policy.

13. Noting that policy with respect to retentions was not uniform across Whitehall, we wondered if such inconsistency applied to other procurement issues. We recommended that a consistent approach to construction procurement be adopted among government departments in order to reduce the scope for confusion among contractors and clients. We went on to recommend that the public sector should take the lead in adopting procurement policies which would render practices such as retentions redundant.¹⁶

14. In its response to our Report the Government sought to reassure us that it was taking a proactive role in the development of high-quality procurement practices across Whitehall. Action taken had included the launch of the *Achieving Excellence* programme in 1999, the work of the Government Construction Clients Panel and the Government Task Force on Construction. We were reminded that the Treasury guidelines for public construction, published in 2000, require the development of working practices which ensure an integrated supply chain, in line with the recommendations of the Strategic Forum for Construction. However, the Government felt that:

“Due to great differences in size and scope between different departments, it would not be appropriate to apply the same approach to procurement across all departments.”¹⁷

The Government used the same justification to reject our recommendation that it should take the lead in removing retentions from its procurement contracts.¹⁸

15. We sought clarification of this position. Mr Gibson assured us that the Government wanted to see the end of the retentions system.¹⁹ The difficulty appeared to be that while

¹² Trade and Industry Committee, Ninth Report of Session 2002-03, *UK Steel 2003*, HC 686, 27 June 2003, Ev 63 (DTI memorandum)

¹³ Q 2

¹⁴ HC 127 (2002-03), Ev 73

¹⁵ *Ibid*

¹⁶ HC 127 (2002-03), para 35

¹⁷ HC 438 (2002-03)

¹⁸ *Ibid*

¹⁹ Q 9

regular procurers of large-scale construction projects were able to adopt best procurement practice and so do without retentions, small departments or occasional clients often lacked the skills and experience that would allow them to do this, and they would continue to rely on retentions as an incentive to high quality work. However, it was made clear that the Government regarded retention as a symptom of the problems facing construction clients and contractors in their efforts to deliver defect-free projects, rather than a problem in itself, and preferred to address what it had identified as the problem rather than treat a symptom.²⁰

16. Mr Oughton sought to assure us that the OGC was committed to improve procurement practice across the board within government departments and their agencies, although he warned us that it might be a lengthy process:

“Our intention was to try and bring all government departments up to the level of performance of the best and clearly there is a range of capability and a range of experience across government for exactly the reason Mr Gibson has quoted. What we are trying to do is to put in place a range of measures which are all related to the need to develop better skills, better commercial awareness and better capability in departments to manage high-risk and mission-critical projects and also to deal with the generality of procurement of construction projects across the industry. So, we are taking a range of steps in all of the major departments to create centres of excellence, to embed best practice, to provide better guidance and to look at how we can develop the contractual terms and conditions that currently exist to reflect best practice across the piece.

“The Government successfully met their first target of creating those centres of excellence in June of this year and are now on track to develop plans for developing the capability of the centres of excellence support project by spring and summer of next year. In that way, we hope to move all clients in all departments to a position where they can contract with the industry in a more modern and a more sophisticated fashion using different methods of incentive rather than having to call on conventional traditional methods. Not everybody will be able to move at the same pace and not everybody will be dealing with the same circumstances. That is why we have said to the Committee that we believe we should retain a range of ways in which we can deal with the supply base at this point.”²¹

17. Mr Oughton also made clear that it was the OGC’s expectation that there would come a time when retentions would not be used in many cases, but pointed out that this would require improved performance by both clients and contractors. In 1999, when OGC had last reviewed performance, there had been difficulties with time, cost or quality in 60 per cent of contracts.²² The DTI’s most recent survey of the key performance indicators for the construction sector indicated that only 11 per cent of construction projects were completed defect-free.²³ Against that background, and to encourage the adoption of best procurement practice, the OGC had set an ambitious target for departments to achieve defect-free

²⁰ *Ibid*

²¹ Q 2

²² Q 6

²³ Q 14

completion of 70 per cent of all construction projects by March 2005.²⁴ Mr Gibson felt that achievement of this would:

“create the conditions which would allow [government departments] to move onto a regime that does not include retentions to the degree that it does now...”²⁵

However, the Government was not persuaded that achievement of that target would allow the Government to set a further target for the eventual removal of retentions from government contracts,²⁶ despite the fact that the Highways Agency, a major construction client, had previously indicated that this was a feasible objective.²⁷

18. Given the annual cost of retentions to the construction sector and to their public sector clients, it is obviously in the interest of all parties that they are phased out as soon as possible. The Government has insisted that this be done by the successful introduction of best procurement practice so that the retentions system is rendered obsolete, rather than by direct action to remove retentions provisions from government contracts. We do not accept that these actions are mutually exclusive, as the Government appears to believe, especially as some departments, such as the Highways Agency, have already indicated that removing retentions provisions would be feasible by 2007, as we had suggested. At the very least, the evaluation of the Government’s progress towards its target for defect-free construction work in 2005 should include an assessment of the possibility of the discontinuance of the use of retentions on a department-by-department basis.

19. We welcome the establishment of centres of excellence within those government departments which are major construction clients. Such organisations should be able to act as mentors to small and occasional clients which, the Government believes, cannot be expected to adopt best procurement practice as quickly. In some cases, there may be an argument for a centre of excellence to act as the agent for a small client and oversee the construction project on its behalf. An example of this “joined-up” approach might be the procurement of construction work by a major government department on behalf of one of its smaller non-departmental government bodies.

Retentions and PFI²⁸ contracts

20. In our earlier inquiry, we received conflicting evidence on the question of whether or not government PFI contracts include provisions for retentions. We suggested that the Government should insist that its principal PFI contractors should not require retentions from their construction contractors and sub-contractors.²⁹

21. In its reply to our Report, the Government flatly rejected our suggestion:

²⁴ Q 10

²⁵ Q 14

²⁶ Q 15

²⁷ HC 127 (2002-03), Ev 74

²⁸ PFI: Private Finance Initiative

²⁹ HC 127 (2002-03), para 37

“The public sector does not apply retentions in projects taken forward through the Private Finance Initiative as the payments are made subject to the successful provision of a service rather than on the satisfactory completion of a construction contract. We understand that retentions are however often applied internally by the private sector contractors in order to ensure that the contractors perform. The practice is essentially a contractual matter between private sector parties and it is inappropriate that the Government restrict private sector parties in the way that they choose to enforce the clearance of defects. Again, improving the construction process through *Rethinking Construction*³⁰ should provide a positive means for the supply team to avoid defects or remedy them.”³¹

22. In his further oral evidence to us Mr Oughton simply reiterated this position.³² However, he also told us that the OGC was establishing the capability to review PFI and other forms of government procurement contract and to see if better guidance could be given to government departments on best practice for contracting out of services.³³

23. We are not convinced of the validity of the Government’s argument that the issue of retentions is simply a contractual matter for the PFI principal contractor and its construction contractor. Even if the Government is unwilling to lay down specific requirements in PFI procurement contracts with regard to retentions, there is no reason why it should not require its principal contractor to be a ‘best practice construction client’ and to adopt procurement and project management methods of the type recommended by the Strategic Construction Forum. Such a requirement should obviate the need for a retention.

Other Issues

24. We took the opportunity to check progress on two other issues upon which we had commented in our earlier Report – the DTI’s *Constructionline* service, and the assessment of the impact of the integrated approach to project procurement on competition in the construction sector.³⁴

Constructionline

25. The *Constructionline* service is a public-private partnership project which had been intended as a single national database of construction companies vetted for their capacity and expertise on the basis of assessment standards used in the public sector. If successful, it would have offered advantages to construction clients in terms of savings in administration and assessment costs, and to construction firms in that it would have removed the necessity to prequalify for individual clients.³⁵ In our original inquiry, we had heard that this project had not been a success. Delays in delivery had reduced its attraction to construction clients and contractors alike. Some government departments or local

³⁰ *Rethinking Construction: Report of the Construction Task Force*, DETR Publications, July 1998

³¹ HC 486 (2002-03)

³² Q 16

³³ Q 22

³⁴ HC 127 (2002-03), paras 42 and 39 respectively

³⁵ As above, para 40

authority clients preferred to use their own prequalification database, or others which had been developed and marketed in the absence of *Constructionline*. This had a financial effect on contractors, who had to pay to qualify and register with several different databases in order to minimise the costs of pre-qualifying to tender for a range of potential clients.³⁶

26. Mr Gibson told us that the private partner in the project, Capita, was scoping the re-engineering of the project that would be necessary if *Constructionline* is to be developed into a useful tool for the industry and its clients.³⁷ From his comments, it would appear that Capita's past performance on the project had left something to be desired.³⁸ However, it appeared that the re-evaluation of the project would be completed in time for the DTI and Capita to come to a decision on the future of the database in the autumn.³⁹

The impact of the integrated approach to procurement on competition

27. In its response to our Report the DTI had informed us that it would set up a review of the research projects it has commissioned into partnering to identify any outcomes of partnering which affect competition.⁴⁰ In his evidence to us, Mr Gibson told us that the initial results of this review would be available in the autumn, at which time the Department would consider the need for further research.⁴¹

28. We look forward to receiving the results of the DTI's re-evaluation of the *Constructionline* project, and of its review of its research into the effects of partnering on competition, later this year.

³⁶ As above, para 41

³⁷ Q 25

³⁸ Q 29

³⁹ Q 26

⁴⁰ HC 486 (2002-03)

⁴¹ Qq 17,18

3 Conclusion

29. It remains our view that government departments should set an example to other public sector construction procurers and the private sector and work to eliminate the practice of retention as soon as possible.

30. We accept that the basis for the Government's reluctance to address the specific issue of retentions lies in its belief that the practice of retention is symptomatic of the inability of the construction industry to deliver projects to the standard expected by the client, and that the best way forward is to address the cause of the problem by encouraging the use of better methods of procurement and industrial practice. However, we do not accept that treatment of the symptom cannot be carried out in parallel to the treatment of the underlying problem. The objectives of defect-free construction procurement and the elimination of retentions are complementary, and should be pursued with equal enthusiasm.

31. We intend to monitor the Government's progress towards its target for defect-free public sector construction procurement and the impact that this has on the use of retentions in the public sector. We will also keep the development of the *Constructionline* project under close scrutiny.

Formal minutes

Tuesday 9 September 2003

Members present:

Mr Martin O'Neill, in the Chair

Mr Roger Berry

Mr Richard Burden

Mr Andrew Lansley

Mrs Linda Perham

Sir Robert Smith

The Committee deliberated.

Draft Report (Retaining Retentions?), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 31 read and agreed to.

Resolved, That the Report be the Fifteenth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

A Paper was ordered to be appended to the Minutes of Evidence.

Ordered, That the Appendix to the Minutes of Evidence taken before the Committee be reported to the House.

[Adjourned till Tuesday 16th September at Nine o'clock

Witnesses

Wednesday 9 July 2003

Page

Mark Gibson and **Rodger Evans**, Department of Trade and Industry, and

John Oughton and **Arnold Butler**, Office of Government Commerce.

Ev 1

List of written evidence

1 Specialist Engineering Contractors' Group

Ev 9