



Specialist Engineering Contractors' Group

A REPORT TO:

*Minister for Local and
Regional Government:
Office of the Deputy
Prime Minister*

*House of Commons
Committee on the
Office of the Deputy
Prime Minister*

*Parliamentary
Under-Secretary of
State for Construction,
Small Business and
Enterprise*

*House of Commons
Trade and Industry
Select Committee*

Scottish Executive

Welsh Assembly

*Northern Ireland (Dept
of the Environment)*

A photograph of a cityscape featuring St Paul's Cathedral in London, with several construction cranes and modern buildings in the background under a clear blue sky.

The Use of Retentions in Local Authority Construction Procurement

APRIL 2004

www.secgroup.org.uk

The Voice of the Specialist Engineering Contractor

THE USE OF RETENTIONS IN LOCAL AUTHORITY CONSTRUCTION PROCUREMENT



THE MEMBERS OF THE SEC GROUP ARE:

Association of Plumbing and Heating Contractors

British Constructional Steelwork Association

Electrical Contractors' Association

Heating and Ventilating Contractors' Association

Lift and Escalator Industry Association

SELECT (Electrical Contractors' Association of Scotland)

MISSION:

"The SEC Group exists to promote an efficient and profitable specialist engineering sector, comprising qualified firms and a skilled workforce, able to meet the business needs of its clients through delivering high-quality engineering systems, services, products and structures as part of integrated supply teams."

THE USE OF RETENTIONS IN LOCAL AUTHORITY CONSTRUCTION PROCUREMENT

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EXECUTIVE SUMMARY

- 1 This report is based upon a survey of UK local authorities carried out by the Specialist Engineering Contractors (SEC) Group during the second half of 2003. The aim of the survey was to establish the extent to which UK local authorities applied retentions in their construction contracts, the amounts of retentions withheld and the use made by local authorities of the withheld monies.
- 2 A total of 420 questionnaires were sent out and 77 councils responded. The questionnaire and a list of the councils that responded are included in appendices to this report. The estimated spend on construction works carried out by the total of respondents was almost £1.26bn.
- 3 All Scottish, Welsh and Northern Ireland local authorities responding to the survey were still committed to using retentions and were not likely to change this stance over the next two years. However, amongst English local authorities there is some progress. Out of the 62 English councils responding to the survey a total of 17 (just over 27%) councils either do not use retentions on **all** their contracts or will be phasing them out over the next two years on **some** of their contracts. A further 8 authorities will be eliminating retentions altogether over the next two years. These include Allerdale, Aylesbury Vale, Derwentside, Rushcliffe, Sunderland, Taunton, Tewkesbury and one unnamed authority.
- 4 The SEC Group survey reveals that many local authorities are justifying their use of retentions as being required by JCT/ICE forms of contract and/or by standing orders.
- 5 The vast majority of councils deducted the amounts of retention that were in accordance with the standard JCT and ICE contracts. However, 2 authorities - Tewkesbury Borough Council and Caradon District Council - admitted to deducting a 10% retention up to *practical completion*.
- 6 Local authorities were asked to indicate the use(s) made of the retention monies held. This sought to establish the whereabouts of the monies but many respondents understood this question to refer to the contractual justification for the use of retentions. The majority of respondents indicated that retention monies were used entirely for the benefit of the authority. The monies were either available for the council's general use or were put to some specific use such as financing capital programmes, investment or reducing borrowing and improving cash flow. Only 2 local authorities indicated that the retention monies were held in trust although one of these authorities - Warwickshire County Council - added that retained monies were ploughed back into the authority.
- 7 It is acknowledged that partnering relationships between local authorities and construction firms are more likely to provide the necessary basis for eliminating retentions and, therefore, it is vital that progress by local authorities in the development of such relationships is systematically monitored by the local government improvement agencies. The National Procurement Strategy for Local Government recommends that all local authorities in England should have in place during 2004 a strategy for partnering with firms delivering their construction needs.
- 8 All local authorities should revisit their standing orders to consider whether they need to be revised so that they are aimed at promoting best practice rather than perpetuating adversarial contractual arrangements that require the use of retentions. This is already a recommendation in the National Procurement Strategy for English local authorities. However, this exercise should also be carried out by all UK local authorities as part of their *Best Value* reviews of procurement processes.

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- 9 SEC Group urges local authorities to consider other measures that will help obviate the requirement for retentions. These include:
- placing greater emphasis on pre-qualification appointment procedures to ensure that appropriately qualified and reputable firms are used, and
 - where the contract is for building services a maintenance and servicing agreement should be part of the contract.
- 10 Where local authorities still insist on using retentions they should ensure that the retention fund is held separately in trust for the benefit of the **whole** of the supply chain. This will enable recovery of outstanding retentions by sub-contractors in the event of insolvency of first line contractors. Even where councils are not applying retentions to first line contractors, they should ensure that retentions are not being applied to the supply chain.
- 11 The practice of some local authorities in using retention funds for bolstering their reserves or for extraneous purposes such as financing their capital programmes or investment should not be tolerated. SEC Group intends to hold meetings with the audit authorities throughout the UK in order to determine appropriate measures for outlawing this practice.

1 BACKGROUND TO THIS REPORT

- 1.1 On 4 December 2002 the House of Commons Trade and Industry Select Committee published a report entitled *The Use of Retentions in the UK Construction Industry*¹. The view of the Select Committee was as follows:

“Given the doubtful benefits and clear disadvantages of retentions, it would obviously be in everyone’s interest for such an inefficient - and frequently harmful - practice to disappear.”

The Select Committee concluded that public sector clients - led by government procurers - should take steps to phase out this practice.

- 1.2 More recently a further report from the Select Committee entitled ‘*Retaining Retentions?*’ concluded:

*“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.”*²

- 1.3 The Select Committee considered that the practice of retentions constituted an enormous amount of waste for the construction industry, particularly small and medium-sized enterprises (SMEs) which - ultimately - have to fund an annual retention burden of £3.25bn. The Committee had not received any evidence of benefits that would have justified this massive outlay of funds. In the wake of the Committee’s report the Audit Commission has issued advice to appointed district auditors for England on the subject of retentions.

- 1.4 In May last year the Better Regulation Task Force and the Small Business Council published a review of the problems encountered by SMEs in seeking public sector contracts. The review, entitled *Government: Supporter and Customer?* refers to the practice of retentions in expressing concerns over poor payment practices being applied to SMEs within supply chains. The government has now accepted that all public sector procurers should ensure that payment practices down the supply chain are substantially improved.

¹ Trade and Industry Committee Second Report of Session 2002-03, HC127.

² Trade and Industry Committee Fifteenth Report of Session 2002-03, HC976 (published on 17 September 2003).

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- 1.5 Retentions constitute the vast majority of complaints by SMEs about poor payment practices. They are always at risk of being lost due to insolvencies up the supply chain since there are usually lengthy delays before sub-contractors are able to recover their retentions following satisfactory completion of their work.³ This is supported by a survey of specialist engineering firms carrying out local authority work that was carried out by the SEC Group over the period May to June 2003.⁴
- 1.6 In order to gauge the extent of the use of retentions by local authorities, the SEC Group carried out a survey amongst local authorities in the UK during the second half of 2003. The bulk of the responses were - not surprisingly - from England but there were also responses from Wales, Scotland, Northern Ireland and even the Isle of Man.⁵ The responses are analysed in this report which concludes with a number of recommendations proposed by the SEC Group.⁶
- 1.7 Overall they show that local authorities continue to use retentions for most of their construction work. We, therefore, urge all councils to reconsider their use of retentions within the context of their statutory duty of best value and the improvement agenda for construction.

*"The removal of the burden of funding retentions would enable SMEs to invest more in those resources, such as training and IT, that would help to improve the quality of their performance. **In its broadest sense Best Value should be concerned with promoting the health and performance of SMEs and not perpetuating practices that present an obstacle to achieving this aim.**"⁷*

Professor Rudi Klein

Chief Executive, SEC Group, April 2004

3 The insolvency of Ballast UK in 2003 left £14.9m worth of retentions owing to sub-contractors.
 4 The results of the survey were published in September 2003 in a report entitled; *Construction Procurement - Is Local Government Applying Best Value?* The report is available on the SEC Group website; www.secgroup.org.uk.
 5 Although the Isle of Man is not a UK local authority we have included its response in some of the statistics referred to in this report.
 6 Whilst much of this report makes references to current initiatives affecting English local authorities, the principles involved are also relevant to authorities in other parts of the UK.

Acknowledgements

SEC Group is grateful to all those local authorities which responded to the survey. The analysis of the responses was carried out by Marion Rich, Barrister and Director of Legal Affairs at the British Constructional Steelwork Association for which we wish to record our appreciation.

2 RESPONSE TO THE SEC GROUP SURVEY

- 2.1 Questionnaires were sent to every local authority in the UK and also to the Isle of Man Government.⁸ There were 84 returns out of a total of 420 questionnaires sent out but, discounting some duplication in the responses, 77 UK councils each provided a response.⁹

Region	No of Councils responding to survey
England	62
Scotland	7
Northern Ireland	5
Wales	3

The authorities that responded were responsible for procuring a wide range of construction works both in terms of the type of work procured and the value of work carried out.

- 2.2 The approximate annual expenditure on construction works carried out by the total of respondents was almost £1.26bn. This figure represents the current total maximum spend since there would, of course, be annual fluctuations in expenditure on construction works. The figure is likely to be conservative since some councils

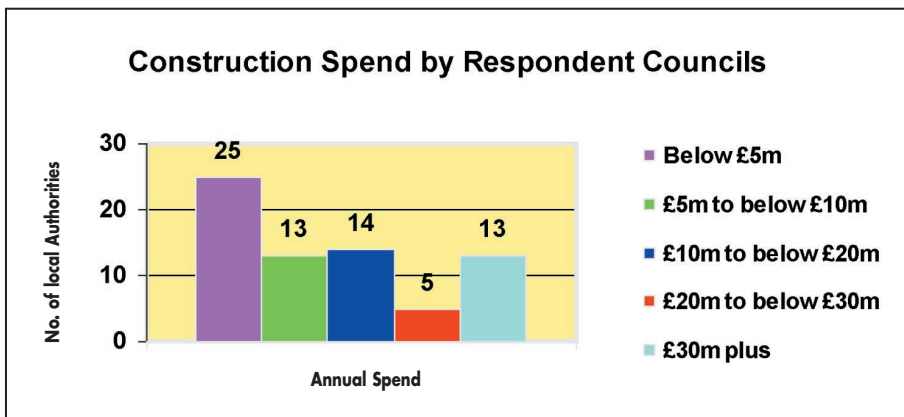
7 Para. 4.18 *Construction Procurement - Is Local Government Applying Best Value?*
 8 The questionnaire is attached at Appendix 1. In fact, two versions of the questionnaire were circulated and 6 councils responded to both versions. The councils were Aylesbury Vale, Rushcliffe, Tewkesbury, Allerdale, Scottish Borders and Moray. The reason for circulating the two versions is given at paragraph 6.1 in this report.
 9 The authorities responding are listed at Appendix 2. 5 councils were not named in their responses.

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reported that their estimates of expenditure did not necessarily include all items of expenditure incurred by individual departments and neither, for example, did they include expenditure on highways or housing maintenance and work carried under PFI arrangements.¹⁰

- Either the contracts were exclusively for maintenance work or a period of maintenance was tied into contracts for the installation of lifts and m&e systems.
- There were long-term relationships or partnering arrangements in place.

Fig 1



3.3 Tewkesbury did not deduct retentions on contracts under seal (where the limitation of liability period is 12 years from the date of breach of contract) whilst an unnamed English authority did not apply retentions to contracts under £20k. Lewes District Council reported that it had entered into a contract without retention for lift installation

2.3 The smallest construction spend was £50,000 per annum (Tewkesbury Borough Council). The largest spend of £100m was incurred by an unnamed English authority followed by Kent County Council with a spend of £70m. The Isle of Man government's annual spend was £250m (this is not included in fig. 1).

where the lift company belonged to an insurance scheme that would meet claims arising in the *defects liability period*.

3 HOW WIDESPREAD IS THE USE OF CASH RETENTIONS?

3.1 Every local authority responding to the survey admitted to holding cash retentions. The London Borough of Hammersmith and Fulham felt that the holding of retention was both a "standing order and audit requirement". However, 8 local authorities in England reported that they did not hold retentions on all their contracts but their reasons differed.

3.2 Their explanations can be grouped under three headings:

- An alternative to cash retentions was available such as an insurance-backed guarantee.

The Council has recently entered into some long-term contracts and on these retention is not being held.

(Borough Council of Kings Lynn and West Norfolk)

3.4 Unfortunately local authorities in Wales, Scotland, Northern Ireland and the Isle of Man Government currently withhold cash retentions on **all** their contracts. But, one authority - Moray Council in Scotland - did not require retentions on contracts entered into with its *direct labour organisation*.

3.5 From the responses and accompanying comments it appears the most local authorities rely on standing orders or their use of traditional contracts as justifying retentions. Standing orders, in fact, often insist on the use of such

¹⁰ 6 of the respondents failed to indicate their authority's approximate annual spend.

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contracts. But, Sir Ian Byatt's review of local government procurement in England recommended that local authorities should review their standing orders to ensure that they "positively" encouraged good practice.¹¹ This recommendation has now been carried over into the National Procurement Strategy for Local Government in England:

*"Councils shouldreview and revise their written procedures for procurement and contract management, including contract standing orders and financial regulations, to ensure theyembody best practices."*¹²

"No retention on DLO contracts and response maintenance".

(Moray Council)

3.6 The SEC Group survey asked councils to indicate whether they were a **beacon** local authority.¹³ 10 councils declared that they were a beacon authority but only one - Barnsley Metropolitan Borough Council - had secured beacon status by virtue of its commitment to the *Rethinking Construction* agenda. Nonetheless, Barnsley, with a construction spend of £25m, currently deducts cash retentions and is unlikely over the next two years to eliminate or reduce their use.

4 TO WHAT EXTENT WILL LOCAL AUTHORITIES BE ELIMINATING RETENTIONS OVER THE NEXT TWO YEARS?

4.1 All Scottish, Welsh and Northern Ireland local authorities - with the exception of the

respondent from Armagh District Council who expressed a "don't know" - indicated that they were **not** likely to eliminate retentions within the next two years. The Isle of Man Government also answered in the negative.

4.2 Out of the 62 English authorities responding to the questionnaire, an overwhelming number - 54 (87%) - indicated that they would not be eliminating retentions over the next two years. This figure includes eight qualified answers with one authority not responding on this point. The balance - 8 (13%) - answered in the positive. These authorities include Allerdale, Aylesbury Vale, Dewentside, Rushcliffe, Sunderland, Taunton, Tewkesbury and one unnamed authority.

4.3 An interesting qualified response was provided by Kings Lynn and West Norfolk Borough Council. Whilst this Council will not be eliminating retentions completely the Council states:

"We are now in the process of looking to using approved lists of contractors which could well affect the Council's views on holding retention."

The use of rigorous selection procedures that place emphasis on selecting firms that can provide the requisite quality (because they are technically proficient and well resourced) is a more positive approach than withholding retentions. The practice of retentions suggests a lack of trust in the firm(s) chosen to do the work.¹⁴

4.4 The other qualified answers were as follows:

- *"Quite likely"* (Surrey County Council)
- *"Moving that way but not completely"* (Buckinghamshire County Council)
- *"Under consideration"* (Coventry City Council)
- *"Unlikely for all"* (Lewes District Council)

¹¹ Recommendation 11, *Delivering Better Services for Citizens*, June 2001.

¹² Page 27, National Procurement Strategy for Local Government (in England) published by the Office of the Deputy Prime Minister in October 2003.

¹³ The Beacon Council Scheme was established by the Government in 1999 to identify councils in England which could act as centres of excellence and promote best practice to other authorities. Councils are selected by reference to various heads of service delivery such as street and highway works, homelessness and secondary education. A number of councils are now

achieving beacon status through promoting the *Rethinking Construction* principles.

¹⁴ This is not surprising in view of the fact that often the sole criteria for letting contracts is lowest price which is more likely to lead to compromises on quality. In the SEC Group report, *Construction Procurement - Is Local Government Applying Best Value?* it was stated that 88% of firms involved in work for local authorities indicated that most - if not all - of their contracts were let on lowest price alone.

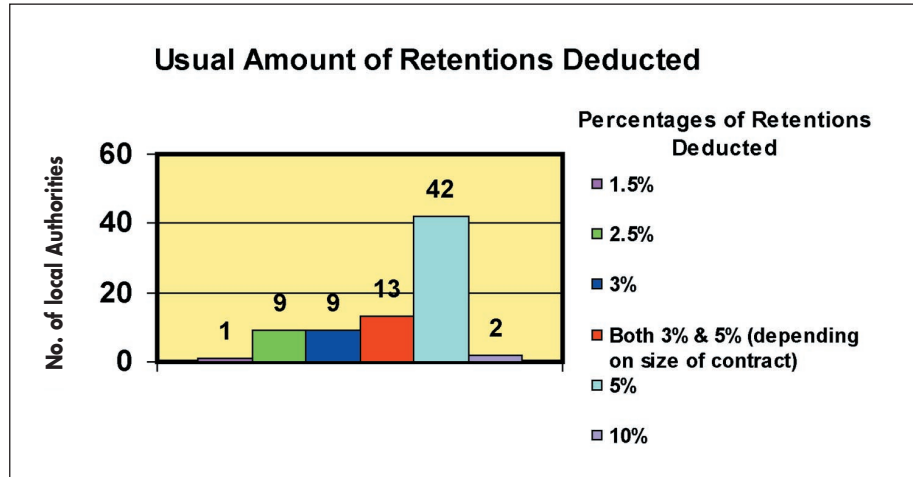
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- “Yes on partnering projects” (Cheshire County Council)
- “Yes if a long-term strategic relationship is developed” (North Lincolnshire Council)
- “Not completely but used less and less as more partnerships are created” (Fenland District Council)

9 councils deducted 3% (one council stating that this reduced to 1½% on practical completion) and another 9 councils deducted 2½%. It is likely that the majority of the latter actually deducted 5% up to practical completion. One authority did not answer this question.

Fig. 2

5 AMOUNT OF RETENTION WITHHELD BY LOCAL AUTHORITIES



- 5.1 It would appear that most local authorities follow the provisions in the JCT or ICE contracts. JCT contracts normally allow for the deduction of a 5% retention from interim payments up to *practical completion* whereupon half of the accumulated retention is released and the other half (2½%) is released on the expiry of the *defects liability period* or after the issue of a *certificate of completion on making good defects* whichever is later. In practice the second moiety of retention is unlikely to be released until payment of the final account. JCT contracts also allow for the retention percentage to be reduced to 3% for higher value projects estimated at tender stage to be £1/2m or over.
- 5.2 Under the ICE contract (7th Ed.) the recommended maximum retention percentage is 5% to be deducted from interim payments up to a maximum of 3% of the “tender total”. Half of the retention is released at *substantial completion* and the remaining half (1½%) is intended for release after the usual 12 month’s *defects correction period* (subject to deduction for any outstanding work).
- 5.3 Councils were asked to indicate the usual percentage they held by way of retention (see Fig. 2). The vast majority - 42 councils - deducted 5% with 7 councils indicating that this reduced to 2½% on practical completion.

- 5.4 13 councils declared that they deducted both 3% and 5% with many stating that the choice of percentage depended on the size of the contract. There were significant variations. For Sussex County Council the dividing line was £50k with work valued below this figure and above attracting a 5% and 3% retention respectively. For Derbyshire County Council the 3% did not “bite” until the value of the project exceeded £1/2m. For North East Lincolnshire Council the value of the project had to be over £1m to attract the 3% retention. This is double the figure of £1/2m advised in JCT contracts.
- 5.5 One authority deducted 1½% but it is likely that this figure referred to the amount retained after *practical* or *substantial completion*. Two authorities - Tewkesbury Borough Council and Caradon District Council - admitted to deducting retention of 10%. Tewkesbury reduced this to 5% and Caradon to 2½% on *practical completion*.
- 5.6 The table on the following page shows the total amount of retentions held per annum by the

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responding local authorities in each of the UK's regions expressed as a percentage of total annual construction spend. Out of the 62 English authorities responding to the survey, 15 did not indicate the total amount of retentions they held. On the other hand Salford County Council deducted £1.5m worth of retentions per year but did not indicate its annual construction spend. North Lincolnshire Council deducted £30m per annum by way of retention but this would appear to be an excessive figure. There is no figure for North Lincolnshire annual construction spend and therefore, a comparison cannot be made. Consequently, the table excludes 17 English authorities including Salford and North Lincolnshire.

Strabane. Neither is the Isle of Man included because a figure was not given for its total of retentions held.

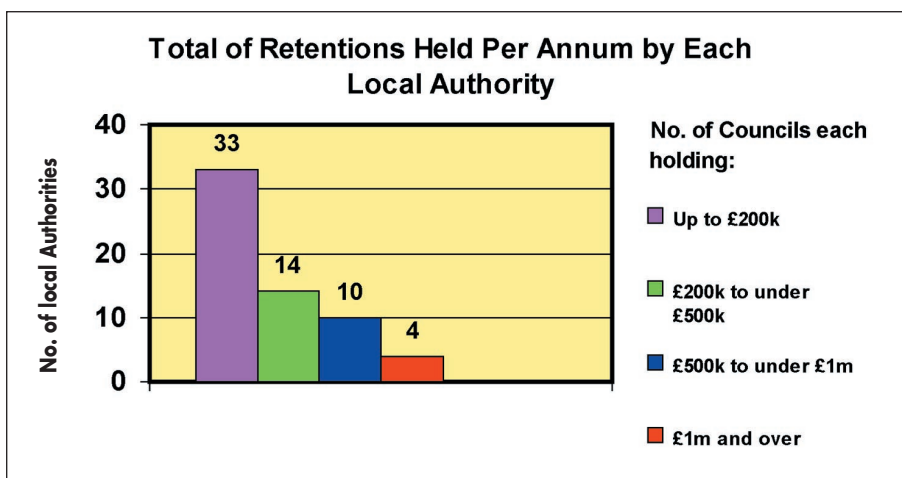
5.8 In total Welsh local authorities appear to hold a retention fund (expressed as a percentage of their total annual construction spend) that is double the amount each held by England and Northern Ireland. Some caution has to be exercised with regard to these statistics. There is a high probability that the figures declared by some respondents for the total of retentions held per year referred to the second moiety of retention (usually the 1 1/2% or 2 1/2% retained after *practical/*

substantial completion rather than the first moiety of 3% or 5% deducted up to *practical/* *substantial* completion). Fig. 3 shows the amounts of retention held by individual authorities.

Region	Total of Retentions held	Total Annual Spend	Retentions held as % of Annual Spend
England	£12,905m	£638,475m	Just over 2%
Scotland	£1,400m	£130m	Just over 1%
Wales	£1,200m	£31m	Almost 4%
N. Ireland	£465m	£21 1/2m	Just over 2%

5.7 All the Scottish, Welsh and Northern Ireland authorities provided figures for both their total of retentions held per annum and their annual spends with the exception of Strabane District Council which did not provide a figure for retentions held. The statistics in the table, therefore, exclude

Fig. 3



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Figure 3 represents figures supplied by a total of 61 councils. 16 councils did not provide a figure for the amount of retentions held and neither did the Isle of Man Government.

6 USES MADE OF RETENTION MONIES BY LOCAL AUTHORITIES

6.1 Local authorities were asked to indicate the use(s) made of the retention monies that they held. This question was aimed at establishing the whereabouts of the monies deducted as retentions. Unfortunately many respondents simply understood this to refer to the contractual justification for the use of retentions. A revised questionnaire was distributed on 6 October 2003 which asked authorities the same question but listed four specific options¹⁵:

- held in 'ring-fenced' account
- financing of capital schemes
- invested
- other

In total 55 authorities responded to version 1 whilst 29 authorities responded to version 2 that required a choice(s) to be made from the four options.¹⁶

snagging or defects. With regard to version 2 it was noteworthy that only one respondent - Derwentside District Council in Co. Durham - referred to the contractual justification for retentions; Derwentside holds retentions for one year against non-completion of defects after which they are released. Suffolk County Council also declared that retentions were an "incentive mechanism for completion of defects" but added that they had other uses. They were used for "interest bearing/avoidance" and "risk avoidance".

6.3 Some of the answers to this question were less than illuminating. Bolsover District Council, for example, stated that retentions were "held for payment" whilst Coventry City Council stated that: "Retentions are not 'used' but effectively delay contractual payments." A few other councils simply stated that retentions were "just held"; "held until release" or that retentions were not subject to any specific use. The only inference to be drawn from these answers was that retention monies were available for general use by the authorities concerned. In fact, the answers given by the majority of respondents to the question suggested that retention monies were used entirely for the benefit of the authority.

USE OF RETENTIONS

"To off-set the financial effect to the authority of contractors in liquidation or for non-performance for other reasons. To encourage contractors to make good defects."

(Wrexham County Borough Council)

USE OF RETENTIONS

"Retentions are not put to any 'use' as such. Budgets are allocated on the basis that retention will be deducted so, indirectly, retentions are used to finance capital schemes."

(Salford Council)

6.2 18 authorities responding to version 1 stated that the monies were used to ensure completion of the works or remedying of

6.4 We now turn to those local authorities which indicated a use for retentions other than simply stating their contractual use(s). Reference should

¹⁵ The first questionnaire was sent out on 5 August 2003.

¹⁶ 9 respondents did not answer this question on either version of the questionnaire.

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be made to Fig. 4 on page 13. Overall there were 32 - just over 38% - responses (in relation to both versions 1 and 2 of the questionnaire) where the authorities admitted that retention monies were either put to some specific use (eg to finance capital schemes, investment or to reduce borrowing and/or improve cash flow) or were available for the council's general use (eg the monies were kept in the council's bank account or some holding account).

USE OF RETENTIONS

"Reduces borrowing and aids cash flow."

(Aberdeenshire Council)

- 6.5 2 local authorities indicated that retention monies were held in trust but it is not clear whether this was for the benefit of contractors (and sub-contractors). One authority stating that the monies were held in trust was Warwickshire County Council but its response was contradictory. The retention monies were *"held in trust but.....usually released on completion of defects. Retained monies are ploughed back into the authority."*¹⁷ (emphasis added)
- 6.6 A further 10 responses indicated that retention monies were "ring-fenced". Unfortunately this term was not defined in version 2 of the questionnaire (where it was one of the listed options) and, therefore, those responses cannot be relied upon to suggest that the monies were held in trust for the benefit of contractors. It is possible that respondents simply interpreted this term to mean that the monies were held in a separate bank account or holding account. If so, the monies would be available for unfettered use by the authority.

¹⁷ The other authority that indicated that retentions were held in trust was Derbyshire County Council.

USE OF RETENTIONS

"Held in capital project accounts."

(Strabane District Council, Northern Ireland)

- 6.7 **The likelihood is that the majority of local authorities consider retention monies as their own funds to dispose of as they think fit.** This is contrary to a specific recommendation made by Sir Michael Latham in *Constructing the Team* almost 10 years ago that retentions should either be kept in a separate trust account for the benefit of contractors and sub-contractors or, alternatively, retention bonds should be accepted.
- 6.8 Also it ignores the requirements in JCT contracts that retentions should be kept in trust for the benefit of the main contractor and nominated sub-contractors (the latter being rarely appointed by local authorities). The requirement for the monies to be lodged in trust means that they should be kept in a separate account created for this purpose although such provision would not benefit domestic sub-contractors in the event of a main contractor's insolvency.

USE OF RETENTIONS

"Invested."

(Poole Borough Council)

- 6.9 In principle it is inappropriate that the industry - particularly SMEs saddled with the burden of retentions - should provide what is, in effect, a banking service to public authorities. This reinforces the perception generally held in the industry that the prime reason for the deduction of retentions is to improve the cash flow of the payer rather than their alleged or ostensible use as an incentive to remedy outstanding defects.¹⁸

¹⁸ In fact the standard forms of contract enable the retention fund to be used for satisfying all manner of outstanding claims.

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6.10 As the Trade and Industry Select Committee acknowledged, there is little evidence to suggest that retentions are actually used for this purpose. The Housing Forum has stated that:

"Holding retention is intended to incentivise contractors to repair defects in the defects liability period on traditional contracts. In reality there is little evidence to show it actually encourages contractors to produce defect-free properties. If anything holding retentions encourages contractors and sub-contractors to increase their prices accordingly because they will not necessarily receive their retention." ¹⁹

6.11 For sub-contractors cash retentions prove to be more of a disincentive than an incentive. The recovery of outstanding retentions is never contemporaneous with satisfactory completion of their work. Moreover 25% of retentions are never recovered and the balance of 75% are recovered late.²⁰ This is also reinforced by the Inland Revenue:

"Over 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 place for such monies never to get paid." ²¹

7 GENERAL COMMENTARY AND RECOMMENDATIONS

USE OF RETENTIONS

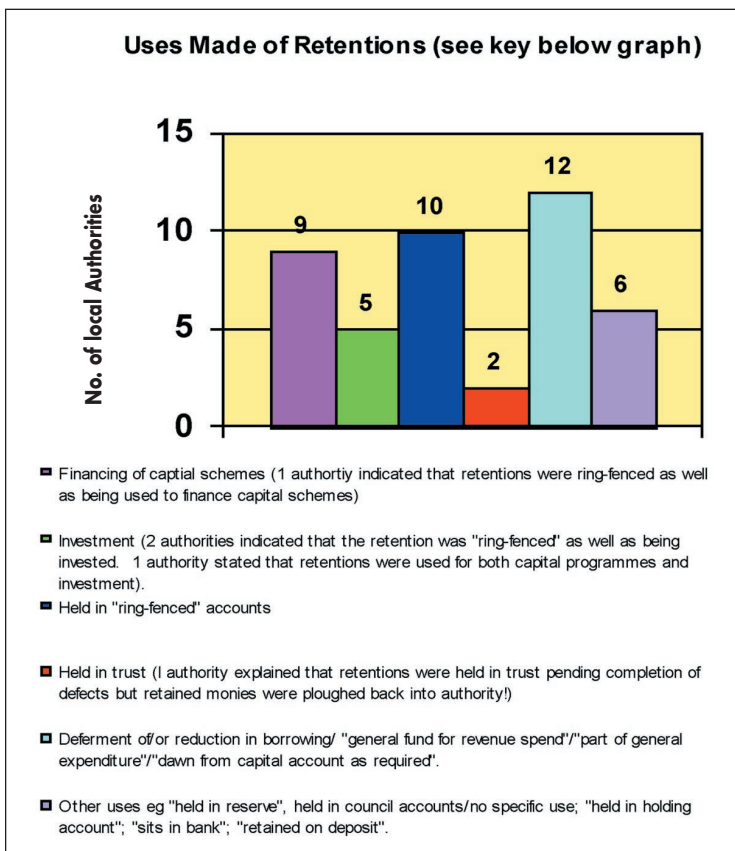
"Held in capital programme."

(Barrow Borough Council)

"Current retentions with Local Authorities/NHS £61k + overdue £9.4k."

(Extract from evidence to Trade & Industry Select Committee)

Fig. 4



7.1 In its submission to the House of Commons Trade & Industry Committee inquiry into retentions the SEC Group concluded.²²

"Retentions reflect a culture that has pervaded the industry for many years, that has been characterised by lowest price tendering, adversarialism and payment manipulation often erring on fraudulent behaviour. Retentions reflect relationships that are based upon all the worst features of contracting in the construction industry. Foremost amongst these has been the desire of many companies - particularly the larger organisations - to generate a positive cash flow by taking advantage of the opportunities for delaying and prolonging payment."

¹⁹ The Housing Forum Demonstration Projects Report, February 2002: *The Challenges Ahead*.

²⁰ Financial Protection in the UK Building Industry published by Reading Construction Forum, November 1998.

²¹ Inland Revenue Inspectors Manual No. 1943.

²² The Use of Retentions in the Construction Industry, SEC Group's submission to the Trade & Industry Select Committee, September 2002

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This may underlie the sentiment expressed in the response from Lincoln City Council that “retentions effectively delay contractual payment.” They are deducted from sums that are already admitted as due and, therefore, amount to involuntary lending.

- 7.2 In its submission to the Trade & Industry Select Committee inquiry SEC Group incorporated evidence received from firms within the specialist engineering sector. Some of that evidence concerned problems with retentions encountered on local authority projects. Extracts from the evidence are highlighted in this section of the report.

“Glasgow City Council, ten lifts put into service June 1998, full retention (£4,500) still being withheld due to a query on the test sheet for one of the lifts. The tests were witnessed by the client and accepted.”

(Extract from evidence to Trade & Industry Select Committee)

- 7.3 It is estimated that local authorities in the UK procure almost £20bn worth of construction work. In England alone the figure is £11bn for capital works. They can use their spending power, not only to enhance the services that they deliver, but also to help promote the commercial well-being of their suppliers which, in this virtuous circle, should further enhance service delivery.

“Our vision for local public services can only be realised if councils adopt world-class practices in procurement and the management of contracts and supplier relationships.”²³

- 7.4 The practice of retention is anathema to this vision. It is divisive. It applies to contractors only - not consultants or products/materials suppliers. It substantially harms the profitability and, therefore, competitiveness of SMEs. It gives rise to numerous disputes and the cost of recovering retentions is

exorbitant. Retentions absorb resources that can be better employed in helping firms improve their delivery of quality through additional training, employing more or better-skilled employees and investing in equipment, plant and IT.

“We undertook as a sub-contractor to replace suspended ceilings and light fittings [for a local authority]. Our contract value was in the region of £20,000 + VAT with retention of 2.5% lasting 12 months from completion which was in April 2001. Amount outstanding £625.47 incl. VAT. There have been no defects and we have been chasing the main contractor for retention. He says he is waiting for its release from [the Borough]. We have chased [the Borough] but to date we have not received the money. Time and effort in chasing the debt has probably cost half the outstanding monies so far. As we undertake regular works for this borough and for the relatively small contract value why have retentions?”

(Extract from evidence to Trade & Industry Select Committee)

- 7.5 Evidence is now accumulating that significant reductions in defects and improved quality can be obtained through teamworking, partnering arrangements and earlier involvement of the supply chain. Early involvement in the procurement process of key firms within the supply chain is more likely to help in achieving best value design solutions whilst eliminating or minimising defects. Indeed, such early involvement is an important recommendation in the National Procurement Strategy.²⁴
- 7.6 A striking example of the advantages gained through collaborative relationships was the Gosport Borough Council partnering trial recorded in the report of a working group of the Local Government Task Force.²⁵ The Gosport

²³ Page 11, National Procurement Strategy for Local Government (in England), October 2003.

²⁴ See page 18 in the National Strategy.

²⁵ Integrating Rethinking Construction with Best Value, April 2001.

THE USE OF RETENTIONS IN LOCAL AUTHORITY CONSTRUCTION PROCUREMENT

project compared defects arising on external improvements to a number of dwellings under traditional contracts with retentions and under contracts where there was a partnering relationship without retentions. Under the former a total of 107 defects was reported in respect of 56 dwellings - an average of 1.91 defects per dwelling. As regards the latter there was a total of 13 defects reported on 65 dwellings - an average of 0.2 defects per dwelling!

7.7 It is acknowledged that progress in developing partnering relationships with construction firms is more likely to provide the necessary basis for eliminating retentions. The National Procurement Strategy for Local Government recommends that all local authorities in England should have in place during 2004 a strategy for partnering with firms delivering their construction work. The SEC Group survey does, however, reveal that some progress is already being made. 9 English authorities have abolished retentions on **some of** their contracts and a further 8 councils will follow in their footsteps over the next two years. Over the next two years another 8 authorities in England will be eliminating retentions altogether. Some of these councils specifically stated that their increasing use of partnering has removed the need for retentions. **Where first line contractors are not required to provide retentions councils should ensure that retentions are eliminated throughout the supply chain.**

7.8 Progress towards the development of partnering and similar arrangements must be monitored by local government improvement agencies both as a means of providing support and calling to account those authorities that have not made the necessary progress. **The SEC Group survey suggests that councils in Scotland, Wales and Northern Ireland have not, as yet, made any significant progress towards developing collaborative relationships with construction firms.**

	Retention due date	Actual paid date
Brighton and Hove City Council	30.08.00	31.10.00
Brighton and Hove City Council	27.03.02	not paid
West Sussex County Council	30.11.00	27.03.01
West Sussex County Council	30.11.01	08.03.02
West Sussex County Council	19.01.02	27.03.02
West Sussex County Council	17.08.02	not paid

(Extract from evidence to Trade & Industry Select Committee)

7.9 Unfortunately too many local authorities are still wedded to the use of JCT forms of contract. These forms tend to reinforce the adversarial approach to contracting with an emphasis on negative mechanisms - such as retentions - to deal with failure of performance. Such mechanisms tend to be one-sided. For example, if retentions are regarded as a form of security for non-performance there is no equivalent fund or mechanism for ensuring compliance with payment obligations especially for firms further down the supply chain which are most at risk from late or non-payment.

7.10 SEC Group urges local authorities in England to revisit their standing orders to consider whether they need to be revised so that they are aimed at promoting best practice as recommended in the National Procurement Strategy for Local Government. This exercise

THE USE OF RETENTIONS IN LOCAL AUTHORITY CONSTRUCTION PROCUREMENT

could also be carried out by local authorities in the other regions of the UK as part of *Best Value* reviews of their procurement processes.

- 7.11 Local authorities should also consider other approaches that will help obviate the requirement for retentions. It is encouraging that the Borough Council of Kings Lynn and West Northfolk is considering the use of approved lists of contractors as an alternative to retentions. Other local authorities using approved lists for pre-qualification purposes should now consider whether these coupled with their appointment procedures are sufficient to identify appropriately qualified (and reputable) firms thus removing the need for retentions.
- 7.12 It is noteworthy that a few local authorities do not require retentions where maintenance of building services are required as part of a contract of installation. A contract that is inclusive of maintenance obviates the need for retentions. Any contractor-generated defects will have to be dealt with during maintenance at the contractor's cost. An alternative approach is simply for the contractor to provide an appropriate warranty. Qualification schemes offered by SEC Group associations already provide insurance-backed warranties in the event that firms do not address any outstanding problems with their work (or are not able to do so because of insolvency). Such arrangements could be put in place for both first line contractors and sub-contractors.
- 7.13 Where local authorities still insist on using retentions they should take appropriate measures to improve the security of the relevant monies especially for members of the supply chain. The retention fund should be held separately in trust for the benefit of the **whole** of the supply chain. Therefore the insolvency of the first line contractor would still

allow recovery of outstanding retentions by members of the supply chain. Where it is not possible for councils to hold the monies in trust firms should be given the option of providing a bond. Furthermore councils should insist that first line contractors ensure the return of retention monies to their sub-contractors on satisfactory completion of their respective works.

- 7.14 However, the practice of some local authorities in using retention funds for bolstering their reserves or for extraneous purposes such as financing their capital programmes or investment is conduct that is tantamount to fraudulent misuse of funds. This cannot continue to be tolerated. Accordingly, SEC Group will be holding meetings with the audit authorities throughout the UK with a view to bringing this practice to an end. Public sector authorities should not be operating their budgets on the basis that they will be receiving free loan facilities from the construction industry particularly SMEs.
- 7.15 In developing new procurement and contractual approaches, there is now available to local authorities a network of support and assistance from a variety of improvement agencies.²⁶ But, local authorities have much to gain from improved communication with firms throughout the supply chain. Such improved communication ultimately inspires better relationships and trust between both councils and suppliers. Moreover, the statutory best value regimes - now applying throughout the UK - provide greater opportunities for improving relationships between councils and their suppliers. Within this context it is to be hoped that councils will resort less and less to the use of retentions. SEC Group will, however, continue to monitor and keep under review progress by local authorities in achieving the aim of phasing out retentions on all their construction contracts.

²⁶ See, for example, the back of the National Procurement Strategy for Local Government (available at procurement@odpm.gsi.gov.uk).

THE USE OF RETENTIONS IN LOCAL AUTHORITY CONSTRUCTION PROCUREMENT

Appendix 1A

5 August 2003

Dear Sir/Madam

QUESTIONNAIRE FOR LOCAL AUTHORITIES ON RETENTIONS IN THE CONSTRUCTION INDUSTRY

The purpose of this letter is to try and establish the extent to which local authorities continue to use retentions. To help us achieve this objective I would be grateful if you would fill in the attached questionnaire, which should take no more than a couple of minutes.

The members of the Specialist Engineering Contractors Group are;

Association of Plumbing and Heating Contractors

British Constructional Steelwork Association

Electrical Contractors Association

Heating and Ventilating Contractors Association

Lift and Escalator Industry Association

SELECT (Electrical Contractors' Association of Scotland)

These organisations represent a total membership of 8,000 companies within the specialist-engineering sector. You may be aware of the report on *The Use of Retentions in the UK Construction Industry* published by the House of Commons Trade and Industry Committee on 4 December 2002. The report recommended that;

"Given the doubtful benefits and the clear disadvantages of retentions, it would obviously be in everyone's interest for such an inefficient - and frequently harmful - practice to disappear."

More recently, in May 2003 in a joint report to the Treasury, the Better Regulation Taskforce and Small Business Council highlighted the financial burden that the practice of retentions places on SMEs.

Against this background the SEC Group will continue to seek authorities to embrace procurement approaches that enable them to develop relationships of trust with contractors that are reputable and have demonstrated their ability to deliver the requisite performance. I very much appreciate your help in this matter.

A reply by the 8 September would be helpful.

Yours sincerely

Professor Rudi Klein

Chief Executive

THE USE OF RETENTIONS IN LOCAL AUTHORITY CONSTRUCTION PROCUREMENT

QUESTIONNAIRE FOR LOCAL AUTHORITIES ON RETENTIONS IN THE CONSTRUCTION INDUSTRY

Name

Position

Name of Local Authority

Address

.....

.....

1. Does your Authority use retentions? **YES/NO** *(delete whichever is appropriate)*
2. If the answer is YES please indicate whether your authority is likely to eliminate retentions within the next two years? **YES/NO** *(delete whichever is appropriate)*
3. If the answer to Question 1 was **YES** indicate the approximate amount held by your Authority per annum by way of retentions.
£
4. Please indicate the use(s) made of the retention monies held by the Authority.
 - a)
 - b)
 - c)
5. What is the usual amount of retention deducted? **3% 5% 7½% 10%** *(any other figure)*
(please circle the appropriate percentage)
6. What is the Authority's approximate annual spend on construction works and maintenance?
.....
7. Are you a Beacon Local Authority? **YES/NO** *(delete whichever is appropriate)*
8. Is your Authority in **England/Scotland/Wales/Northern Ireland?** *(delete whichever is appropriate).*

[We will understand if you do not wish to provide details about yourself or your Authority but we would appreciate if you could, at least, indicate whether the Authority is in England, Wales, Scotland or Northern Ireland]

PLEASE RETURN COMPLETED QUESTIONNAIRE TO:

John Nelson, Executive Secretary, SEC GROUP, 34, Palace Court, London, W2 4JG

Appendix 1B

6 October 2003

Dear Sir/Madam

A REMINDER TO COMPLETE THE QUESTIONNAIRE FOR LOCAL AUTHORITIES ON RETENTIONS IN THE CONSTRUCTION INDUSTRY

If you have not done so already I would be grateful if you would fill in the attached questionnaire, which should take no more than a couple of minutes.

The purpose of the questionnaire is to try and establish the extent to which local authorities continue to use retentions. The exercise is being co-ordinated by the Specialist Engineering Contractors Group. The members of the SEC Group are:

Association of Plumbing and Heating Contractors

British Constructional Steelwork Association

Electrical Contractors Association

Heating and Ventilating Contractors Association

Lift and Escalator Industry Association

SELECT (Electrical Contractors' Association of Scotland)

You may be aware of the report on *The Use of Retentions in the UK Construction Industry* published by the House of Commons Trade and Industry Committee on 4 December 2002. The report recommended that; *"Given the doubtful benefits and the clear disadvantages of retentions, it would obviously be in everyone's interest for such an inefficient - and frequently harmful - practice to disappear."*

More recently, a further report titled 'Retaining Retentions' published by the House of Commons Trade and Industry Committee on 17 September 2003 concluded that '***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.***'

Against this background the SEC Group will continue to seek authorities to embrace procurement approaches that enable them to develop relationships of trust with contractors that are reputable and have demonstrated their ability to deliver the requisite performance. I very much appreciate your help in this matter. **A reply by the 20 October would be helpful.**

Yours sincerely

John Nelson

Executive Secretary

THE USE OF RETENTIONS IN LOCAL AUTHORITY CONSTRUCTION PROCUREMENT

QUESTIONNAIRE FOR LOCAL AUTHORITIES ON RETENTIONS IN THE CONSTRUCTION INDUSTRY

Name

Position

Name of Local Authority

Address

.....

.....

1. Does your Authority use retentions? **YES/NO** *(delete whichever is appropriate)*
2. If the answer is YES please indicate whether your authority is likely to eliminate retentions within the next two years? **YES/NO** *(delete whichever is appropriate)*
3. If the answer to Question 1 was **YES** indicate the approximate amount held by your Authority per annum by way of retentions.

£

4. Please indicate the use(s) made of the retention monies held by the Authority.
 - a) Held in 'ring fenced' account **YES/NO**
 - b) Financing of capital schemes **YES/NO**
 - c) Invested **YES/NO**
 - d) Other

5. What is the usual amount of retention deducted? **3% 5% 7½% 10%** *(any other figure)*
(please circle the appropriate percentage)

6. What is the Authority's approximate annual spend on construction works and maintenance?
.....

7. Are you a Beacon Local Authority? **YES/NO** *(delete whichever is appropriate)*

8. Is your Authority in **England/Scotland/Wales/Northern Ireland?** *(delete whichever is appropriate).*

[We will understand if you do not wish to provide details about yourself or your Authority but we would appreciate if you could, at least, indicate whether the Authority is in England, Wales, Scotland or Northern Ireland]

**PLEASE RETURN COMPLETED QUESTIONNAIRE TO:
John Nelson, Executive Secretary, SEC GROUP, 34, Palace Court, London, W2 4JG**

Appendix II

NAMES OF LOCAL AUTHORITIES THAT RESPONDED TO THE SEC GROUP SURVEY

ENGLAND ²⁷

Allerdale Borough Council	Kerrier District Council
Aylesbury Vale District Council	Kings Lynn and West Norfolk Borough Council
Barnsley Metropolitan Borough Council	Lewes District Council
Barrow Borough Council	Lincoln City Council
Bolsover District Council	Mansfield District Council
Bolton Metropolitan Borough Council	Merton (London Borough)
Borough of Poole	North Devon District Council
Buckinghamshire County Council	North East Lincolnshire Council
Bury Metropolitan Borough Council	North Hertfordshire District Council
Caradon District Council	North Lincolnshire Council
Cherwell District Council	Northumberland County Council
Cheshire County Council	Peterborough City Council
Chiltern District Council	Rochford District Council
City of Sunderland	Rotherham Metropolitan Borough Council
Congleton Borough Council	Rushcliffe Borough Council
Coventry City Council	Salford Council
Derbyshire County Council	South Hampshire District Council
Derwentside District Council	South Kesteven District Council
Dudley Metropolitan Borough Council	South Staffordshire District Council
East Sussex County Council	Suffolk County Council
Eastleigh Borough Council	Surrey County Council
Fenland District Council	Taunton District Council
Greater Manchester Council	Test Valley Borough Council
Halton Borough Council	Tewkesbury Borough Council
Hambleton District Council	Tynedale District Council
Hammersmith and Fulham (London Borough)	Wansbeck District Council
Harlow Council	Warwickshire County Council
Kent County Council	West Oxford District Council
	Worcestershire County Council
	Wyre Borough Council

²⁷ Responses were also received from 4 unnamed English authorities.

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SCOTLAND

Aberdeenshire Council
East Ayrshire Council
Isle of Lewis Council
Moray Council
North Ayrshire Council
Scottish Borders Council
Shetland Islands Council

WALES

Caerphilly County Borough Council
Powis County Council
Wrexham County Borough Council

NORTHERN IRELAND ²⁸

Armagh District Council
Fermanagh District Council
North Eastern Education and Library Board
(Co. Antrim)
Strabane District Council

ISLE OF MAN GOVERNMENT

²⁸ A response was received from one unnamed Northern Ireland council.



THE WORK OF THE SEC GROUP

Would you like to know more about the work of the SEC Group or find out more about the specialist engineering sector? Why not first visit the SEC Group's website (www.secgroup.org.uk).

And if you want further information contact:

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Executive Secretary
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34 Palace Court
London
W2 4JG

Tel: 020 7313 4819

Fax: 020 7727 9268

Email: contact@secgroup.org.uk

Website: www.secgroup.org.uk

