Appendix 1

Regulatory Impact Statement
Retentions in construction contracts

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by the Construction Market Policy team in the Ministry of Business, Innovation and Employment (MBIE).

In construction projects there are often defects that need to be fixed. The Construction Contracts Act 2002 (CCA) allows for retentions to be held – a portion of the contract price that payers hold as an incentive for payees to fix defects in their work. The use of retentions creates issues, however, including transferring to payees risks relating to whether the payer will become insolvent.

This RIS assesses options for changing the CCA to better address the unintended consequences of retentions. The RIS assesses the effect of options against the objective of minimising risk, while minimising capital, transaction and administrative costs, and while continuing to ensure defects are fixed.

We have not been able to quantify all the effects, so some remain qualitative. To the extent the effects are qualitative, different conclusions might be drawn if different weightings were given to the objectives mentioned above.

There is considerable uncertainty surrounding the estimated effect of the options, due to:

- the availability and robustness of data, and the methodology used to arrive at estimates
- assumptions about how parties would respond to the changes described in each option, and the effects of those responses on the objectives.

This RIS notes where assumptions have been made, and also notes the degree of confidence we have in the data.

Despite the challenges confronting the analysis required for this RIS, and time constraints that limited the analysis and consultation that was possible, the Ministry is of the opinion that the conclusions provide a reasonable indication of the potential direction and significance of the effects of the options we have analysed. Overall, the Ministry is satisfied that the RIS provides a basis for Ministers to make decisions on the options.

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Context

1 The sector delivering commercial construction projects is characterised by cascading contracts: project owners contract with head contractors, who manage the project and subcontract the work to specialist trade contractors. Subcontractors sometimes further subcontract work. Most of the businesses doing construction work are small (over 95 per cent have fewer than ten employees).

2 In commercial construction contracts, payees undertake to deliver work for payers. Where payees do defective work, they are usually obliged by their contracts to fix the defects. Factors that contribute to defects include:

- commercial buildings tend to be bespoke projects with complex, integrated elements
- poor procurement and management practices, such as:
  - lowest cost tendering (where quality is not factored into the price)[1]
  - not engaging subcontractors early in the process where they could contribute to design and avoid subsequent variations and risks of defects
- the level of skill of those working in the construction sector.

3 For many years, both in New Zealand and overseas, commercial construction contracts have provided for payers to retain part of the contract price as a form of security, to use if the payee does not perform as required by the contract. The amounts retained by the payer are called 'retentions'.

4 In NZS 3910 – a standard contract developed by the industry – retentions are calculated as a fixed percentage of the contract price, and are payable if there are no outstanding defects following a 'defects liability period' after the substantive completion of the work.[2] The defects liability period often lasts for 12 months after the work has been completed.

5 Payers in the commercial construction sector use retentions because, despite payees being obliged to fix defects, payers can find it challenging to enforce this obligation. This can be due to:

- costs involved in pursuing payees to fix defects (the payees and their subcontractors may have all moved on to other projects)
- there is often no long-term relationship between the parties, limiting incentives for payees to fix defects to maintain good relationships and a good reputation
- the small size of payees – many payees are small businesses and some might have insufficient capacity to fulfil their obligation to fix defects
- a history of high rates of insolvency among commercial construction businesses.

6 Retentions are used less often in the residential, civil and infrastructure construction sectors because the above factors are different in those sectors (for example, many businesses in the infrastructure sector are larger than in the commercial construction sector).

7 We estimate there could be between $150 million and $250 million retentions held in the commercial construction sector.[3] We estimate 90 per cent of revenue earned in the sector has retentions held from it, and that half of revenue earned in the sector has over 5 per cent retentions held from it. Retentions come at a cost for payees – they must raise capital equivalent to the amount of retentions, to cover their cashflow for the period between the time they undertake the work and the time they ultimately receive retentions.

[1] Wolstenholme (2009).

[2] New Zealand Standard NZS 3910:2013.

[3] Based on MBIE survey of the commercial construction sector conducted in October 2014. Significant uncertainty surrounds the statistics due to issues with survey design and extrapolating from the survey result to the total sector.

8 The government does not specifically regulate retentions, although various statutes affect retentions. For example, retentions are a payment under a construction contract, so are subject to the prompt payment obligations of the Construction Contracts Act 2002 (CCA).

9 On 11 August 2014, Cabinet agreed in principle to amend the CCA to require retentions earned on a project to be held in trust for the benefit of the subcontractors on that project.[4] The amendments would be made by way of a Supplementary Order Paper to the Construction Contracts Amendment Bill.

Status quo

10 Although retentions are a form of security the payee has allowed the payer to hold, payers usually use the retentions as working capital – effectively treating retentions as an interest-free loan.

11 The use of retentions as working capital adds risk for payees, due to the chance that:

- payers becomes insolvent before paying retentions (a risk that payees have little influence over)
- payees cannot absorb the loss when they are not paid retentions, and become insolvent themselves.

12 When payers become insolvent, payees owed retentions are usually unsecured creditors. Unsecured creditors usually receive little from liquidations involving construction businesses.[5] We estimate that payees usually write off between $7 million and $16 million in retentions each year (either because the retentions are not worth pursuing, or the payer is insolvent). These write-offs are uneven: a third of payees do not usually write off retentions owed to them, whereas 40 per cent of payees write off an average of 5 per cent or more per year. In addition to these usual annual losses, large insolvencies can cause additional one-off losses.

13 The risk of not being paid retentions significantly affects business risk and profitability for subcontractors. It increases their cost of capital and limits their ability to invest (compared to a more certain payment environment). More than 30 per cent of subcontractors operate on margins of less than 10 per cent,[6] and for these payees, losing 5 per cent of retentions annually would be a significant portion of their profit. These risks to payees are likely to be reflected in higher prices (otherwise payees could not operate profitably).[7]

14 The use of retentions as working capital adds risk for projects due to:

- payees becoming insolvent could disrupt the progress of project
- lack of transparency about payers' ability to fund the project: payers are paying less than full price (and by using retentions to keep operating even though they might be having financial issues)
- adversarial relationships and disputes arising from the incentives for payers to hold retentions beyond what is reasonable given the risk of defects.

15 Payees can sometimes avoid allowing payers to use retentions as working capital by negotiating contracts that do not involve retentions, or agreeing to provide alternative security such as on-demand bonds.[8] These alternatives are feasible for payees with bargaining power, a track record for quality, and good working relationships.

[4] CAB Min (14) 27/9.

[5] Ramachandra (2013).

[6] Page and Curtis (2011), Figure 8.

[7] Australian Institute of Quantity Surveyors, quoted in Collins (2012) at page 109. Also, Bausman (2004).

[8] On-demand bonds are products offered by banks (and other sureties). A person holding a bond can convert it to cash by presenting it to the bank.

16 Owners and banks sometimes take steps that reduce the risks associated with using retentions as working capital, such as taking more direct control over payments through the construction supply chain,[9] or building high-trust relationships (e.g. using partnering agreements) reducing the need for retentions.[10]

17 Retentions continue to be widely used as working capital, however, because:

- it gives payers a readily-available source of interest-free capital (even though retentions are a form of security)
- it enables payers to transfer a portion of the risk of projects to payees (even though payees have little control over the success or failure of the project)
- some payees have insufficient financial strength, reputation and/or bargaining position to negotiate alternative arrangements
- alternatives arrangements are costly (for example, obtaining bonds is expensive for payees that lack a strong reputation or financial position).

Problem definition

18 The problem considered by this RIS is inefficient allocation of risk when payers use retentions as working capital. By using retentions as working capital, payers are transferring some of their business risk to payees. Payees (in particular, subcontractors) are often in a poor position to manage their payers' business risk. Payees often have insufficient bargaining position, finances or reputation to negotiate alternative arrangements to avoid this risk. Payers have strong incentives to negotiate contracts that allow them to use retentions as working capital because it gives them significant cashflow benefits.

[9] Collins (2012) page 176. Also House of Commons (UK) (2008) paragraphs 138-143.

[10] Whitley and Mbachu (2014), Table 2.

Objectives

19 This RIS assesses options to address the problem described in paragraph 18. The overall objective is to enhance the efficiency and productivity of the construction sector by ensuring that mechanisms used to get defects fixed do not unduly expose payees to risk. Options that achieve this objective would need to have benefits that exceed costs, relative to the status quo.

20 The primary objective for this RIS is therefore to address the inefficient allocation of risks currently created by payers using retentions as working capital. The other objectives relate to minimising costs created by the options – additional capital required, transaction costs to the parties, and administrative costs to the government. A final objective is to ensure that original purpose of retentions continues to be achieved – of getting defects fixed.

21 The table describes these objectives:

Objective	Description	Weighting
Risk of defects	Retentions aim to ensure that any defects are fixed.	**High weighting:** Getting defects fixed is the purpose of retentions. The options do not aim to affect the fixing of defects, but we wish to ensure this purpose is not negatively affected by the options.
Risk created by using retentions as working capital	Minimise payees' exposure to risk of payer being unable to pay retentions used as working capital. Allocate risk of the project to parties best-placed to manage it.	**High weighting:** addressing an inefficient allocation of risk could generate savings, reduce the cost of capital, and enhance productivity.
Capital requirement	Minimise the net requirement for capital.	**Medium weighting**: options that increase the amount of capital required impose a cost and reduce profitability.
Transaction costs and other costs to the parties	Minimise costs of operating the mechanisms envisaged by the options.	**Medium weighting**: transactions and other costs offset the benefit of the options.
Administrative costs to the government	Minimise cost to the government of administering the regime, including providing information to the sector and enforcing breaches.	**Low weighting:** These costs are expected to be small relative to the other costs described above (the options are expected to be largely self-enforcing).

22 The RIS assesses the options, relative to the status quo, using the following scale:

Scale	Likely effect
✓✓	Significant improvement
✓	Some improvement
No significant change	No change, or minor change
×	Some deterioration
××	Significant deterioration

Options to address the problem

23 Cabinet has agreed in principle to the option of requiring retentions earned on a project to be held in trust for the benefit of the subcontractors on that project. The RIS assesses variations on that option, as well as exploring other feasible options.

24 This RIS assesses the following options:

1 Cash retained must be held in trust by each payer (Cabinet agreed in principle)

2 Cash retained must be held in trust by an independent party

3 Amount equivalent to net retentions must be held in trust

4 Require security to be a bond.

25 For all options, 'retentions' means 'money retained by a payer out of money payable by the payer to a payee under a commercial construction contract, as security for the performance of obligations of the payee under the contract to the standard specified in the contract'.

Options for changing the status quo

1 Cash retained must be held in trust by each payer (Cabinet agreed in principle)

Description

The CCA would require retentions to be held in trust. The trust would apply to cash retained: if the payer is using debt to fund the work, the payer would not need to borrow cash to the equivalent of retentions and hold it in trust. The payer can keep any interest earned on the trust money, but the payer cannot charge any costs of administration against the trust money.

Comment

This Option effectively means that the trust obligation would not apply to owners' retentions, where owners are funding their projects from debt. Each payer lower in the supply chain would be holding retentions in trust, where they are receiving cash for work and retaining some of that cash from their payees. We assume that the parties would craft their contracts in ways that avoid parties in the supply chain holding duplicate amounts in trust, in respect of a single amount ultimately owed to a specialist trade contractor.

The amounts held in trust are illustrated in the following table:

Retentions related to retentions ultimately owed to the specialist trade contractor

	Owner	Head contractor	Intermediate contractor	Specialist trade contractor
Retentions retained	A	B	C	-
Retentions owed	-	A	B	C
Example of how parties might agree to hold cash in trust	-	B	C-B	-

An example of jurisdictions requiring head contractors and intermediate contractors to hold retentions in trust – but not owners – is Michigan.[11]

2 Cash retained must be held in trust by an independent party

Description

The CCA would require the retentions referred to in Option 1 to be held by an independent third party (such as an escrow agent).

Comment

An example of a jurisdiction that will require retentions to be held by a third party is New South Wales (legislation has been passed, but regulations are still to be made).[12]

[11] Mastrangel (2006).

[12] NSW Department of Finance & Services (2013).

Options for changing the status quo

3 Amount equivalent to net retentions must be held in trust

Description

The CCA would require all cash the payer holds or receives (up to the amount of retentions) to be held in trust, except to the extent the payee is already a beneficiary of retentions held in trust in relation to the work specified in the contract. The payer can keep any interest earned on the trust money, but the payer cannot charge any costs of administration against the trust money.

Comment

An example of amounts held in trust are illustrated in the following table:

Retentions related to retentions ultimately owed to the specialist trade contractor

	Owner	Head contractor	Intermediate contractor	Specialist trade contractor
Retentions retained	A	B	C	-
Retentions owed	-	A	B	C
To hold in trust	A	B-A	C-B	-

Key differences between Option 1 and Option 3 is that, under Option 3:

- all owners would hold retentions in trust: owners with less cash than the retentions would have all cash they hold or receive held on trust (whether earned on the project or otherwise)
- head contractors would hold less in trust than in Option 1, where the owner is holding retentions in trust (this is illustrated in the table above by the head contractor holding 'B-A' in trust).

An example of jurisdictions requiring owners to hold amounts equivalent to retentions in trust is Ontario.[13]

4 Require security to be a bond

Description

The CCA would provide that, where security is required for the performance by the payee, that the payee must provide an on-demand bond (or similar product that is not equivalent to a cash security).

Comment

This option would effectively prohibit retentions. An example of a jurisdiction that has prohibited retentions is New Mexico.[14]

26 Variations on the trust proposals are possible, as are other options aside from trusts, but this RIS does not assess them because they do not address the problem.

Option not assessed	Comment on the variation
A trust arrangement where the interest follows the principal, and the payer may deduct amounts from the trust fund to cover the cost of administering those funds.	This variation to the trust proposals is the usual approach for money held in trust. It would remove an incentive for payers of holding retentions other than as security against defects. This RIS does not assess this variation because it does not address the problem in paragraph 18. The problem would be addressed by the trust arrangement, and questions about interest and costs of administering the trust are second-order issues unrelated to the problem. The variation would add minor administrative cost: keeping track of the interest earned on each retention amount, and identifying the administrative costs associated with managing the trust funds.
Providing new civil and criminal remedies for breaches of trust	This variation to the trust proposals seeks to strengthen existing remedies for breach of trust, including providing civil remedies. This RIS does not assess this variation because it does not address the problem in paragraph 18 any further than the trust arrangements already proposed. The trust arrangements would rely on existing criminal remedies for breach of trust and theft, deterring people from breaching the trust. Payees would continue to have remedies under the CCA if they are not paid retentions.

[13] Section 7 Construction Lien Act RSO 1990 (Ontario).

[14] New Mexico Statute 57-28-5.

Option not assessed	Comment on the variation
In addition to requiring payers to hold retentions in trust, requiring payers to release those retentions if payees provide a bond	This variation to the trust proposals would allow payees – at any time – to provide a bond and demand the payer releases the retentions that are held in trust. This variation reflects a proposal by the Specialist Trade Contractors Federation. This RIS does not assess this variation because it does not address the problem in paragraph 18 any further than the trust arrangements. This variation would not benefit the key target group for this RIS – payees with insufficient bargaining position, finances and reputation to negotiate alternatives. Such payees are unlikely to be able to obtain bonds at a reasonable price, so this variation would not benefit them.
Do not require retentions to be held in trust, but limit the amount of retentions that can be held	This option would provide that retentions can only be held where there is a credible risk of defects, with a maximum withholding of 10 per cent of progress payments, reduced to 5 per cent upon completion of the work by the payee. Upon completion of the work by the payee, the payer must give written notice of amount, time period and reason for any continuing holding of retentions. Some jurisdictions limit the size and duration of retentions.[15] This RIS does not assess this option because it does not address the problem in paragraph 18. This option prevents payers holding more retentions than is reasonable, but continues to allow them to be used as working capital.

[15] For example, Massachusetts Gen. Laws Chapter 149, Section 29F.

Analysis of the options against the objectives

27 The following pages assess the effect of the options relative to the status quo. A summary of the effects is shown on page 17.

Option 1 – Cash retained must be held in trust by each payer (Cabinet agreed in principle)

Effect of Option 1
The CCA would require retentions to be held in trust. The trust would apply to cash retained: if the payer is using debt to fund the work, the payer would not need to borrow cash to the equivalent of retentions and hold it in trust. The payer can keep any interest earned on the trust money, but the payer cannot charge any costs of administration against the trust money.
Summary of effects The main benefits of Option 1 are: • less risk that payers cannot pay retentions (except retentions held from head contractors where the owner is using debt to fund the project) – estimated at between $7 million and $16 million savings to subcontractors • less risk to the project as a whole (a positive knock-on effect of less retentions being held and more certain payment of retentions to payees) – this benefit has not been quantified, but if this led to (say) 0.25% lower costs across the project it would represent a further $10 million savings per year. Option 1 has costs: • it requires additional capital in order to hold retentions in trust – estimated at between $15 and $20 million cost to payers who currently use retentions as working capital (because interest earned on the trust money would be less than payers' cost of capital) • transaction costs in performing trustee responsibilities (expected to be a minimal cost, over and above good accounting practice).
Defects fixed **No significant change** We expect Option 1 will create incentives that lead to a small reduction in defects, but that the change will not be significant. Reduced risk to payees' business and risk across the project should help to reduce the risk of defects. Removing an adversarial factor in the relationship between payers and payees could also help (a more cooperative relationship is likely to help the parties to avoid and fix defects).

Effect of Option 1

Risk created by the payer using retentions as working capital ✓✓

We expect Option 1 to reduce the risk that payers cannot pay retentions. Retentions would not be part of assets in insolvencies because they are held for the beneficiaries. There would be incentives for payers to pay retentions when they are due rather than continuing to hold them in trust. There are strong safeguards against breach of trust – people breaching the trust commit a criminal offence, and could incur a debt that they cannot discharge through bankruptcy.

Payees who contract directly with owners of debt-funded projects would continue to face the risk of not receiving those retentions. The number of owners going into liquidation is in the same order as the number of head contractors.[16] However, the payees most affected by the insolvency of owners are head contractors, who are not the target group for the problem in this RIS. The target group (payees with insufficient bargaining position, finances and reputation to negotiate alternatives) would have their retentions protected by the proposal, because their payer (e.g. head contractors) must hold in trust retentions they hold from subcontractors.

We estimate close to 100 per cent of retentions owed to subcontractors would be paid, saving subcontractors an estimated $7 million to $16 million per year.

Aside from directly reducing the risk to payees' retentions, Option 1 would reduce risks across the overall project:

- reduced risk of payee insolvency means less risk of knock-on effects for other businesses on the project
- reduced risk of payer insolvency (no longer relying on retentions, a volatile source of capital)
- earlier warning if payers are experiencing financial issues (they cannot use retentions and defer the issues)
- reduced risk for owners that subcontractors lose their retentions (it becomes an issue for owners when subcontractors are not paid).

We expect these reduced risks would be reflected in reduced cost of credit, and reduced prices across the project. We have not quantified savings from these reduced risks. However, we note that project bank accounts (PBAs – a mechanism that provides owners with more certainty and transparency of payments) are estimated to save projects up to 2.5 per cent of the project price. Retentions are a key payment issue for subcontractors, and if the flow-on reduction in risk to the project from Option 1 led to (say) 0.25% lower costs across the project, it would represent a further $10 million savings per year.

Although some overseas jurisdictions require retentions to be held in trust, we have not located quantitative evidence of the effectiveness of the regimes in reducing risk, although the tenor of commentary tends to indicate that the regimes are effective.[17]

Capital required for the project ××

Payers who currently use retentions as working capital would need to raise additional capital, equivalent to the amount of the retentions. There would be a cost (depending on the cost of capital to the business) offset by interest earned on the funds held in trust. We estimate the net cost of this additional capital would be between $15 million and $20 million. We expect these costs would be reflected in prices, so that the economic effect would ultimately be borne by owners.

Although some overseas jurisdictions require retentions to be held in trust, we have not located quantitative evidence of the effect of the regimes on the capital needed for projects.

Transaction costs and other costs to the parties **Net effect unclear**

The net effect of Option 1 on transaction costs is uncertain, but is expected to be small.

Payers would incur administrative costs associated with being a trustee. Option 1 does not specify how retentions should be held in trust. Payers might (say) open a bank account to hold trust money separately from their own money,[18] and have procedures for payments into and out of the account. We do not expect such arrangements to cost materially more than current good practice for managing accounts.[19]

We expect Option 1 would lead to fewer costs that payees currently incur pursuing unpaid retentions because payers would have incentives to pay them rather than keep holding them in trust. We do not expect Option 1 would introduce significant costs for the parties relating to disputes about holding retentions in trust. Payers who deliberately breach trust are also likely to breach the contract (so it does not necessarily change the number of disputes).

We do not consider there would be any significant economic distortion created by imposing the trust obligation on equity-funded projects but not debt-funded projects. Owners of equity-funded projects would have their financial position reduced by the amount of the funds held in trust, whereas debt-funded projects would be unaffected. We do not expect any significant economic distortion because most projects are debt-funded currently.

We do not consider there would be any significant economic distortion created by imposing the trust obligation on head contractors but not on owners (creating a small incentive for owners to contract directly with subcontractors). In jurisdictions that place trust obligations on contractors but not on owners (e.g. Michigan), we have not seen commentary raising issues about this aspect of the regime (which might suggest that the distortion is not significant).

[16] Ramachandra (2013) Table 5.1.

[17] For example, Collins (2012), Mastrangel (2006).

[18] Rayack Construction Ltd v Lampeter Meat Co Ltd (1979).

[19] Collins (2012) page 258, and Mellush J (Ferrier Hodgson) and Reynolds B (quoted in Collins (2012) at page 316).

Effect of Option 1	
Administrative costs to government	**No significant change**
The effect of Option 1 on administrative costs to the government is not expected to be significant. Payees will continue to be able to seek adjudication under the CCA (funded by the parties) for issues of non-payment of retentions. The government would incur administrative costs if the Crown (or payees) took prosecutions for breach of trust. This RIS assumes that cases would be few because people would avoid breaching trust (it is an imprisonable offence, and any associated debt cannot be discharged through bankruptcy).	

Option 2 – Cash retained must be held in trust by an independent party

Effect of Option 2 – Cash retained must be held in trust by an independent party
The CCA would require the retentions referred to in Option 1 to be held by an independent third party (such as an escrow agent).
Summary of effects The effects of Option 2 are similar to Option 1, except for higher transaction costs due to the requirement to engage a third party to administer the trust. The main effects of Option 2 (as with Option 1) include less risk faced by payees and less risk across the project, but increased capital required (to hold retentions in trust). The key additional effects of Option 2 are: • increased transaction costs for the parties interacting with the third party holding the retention trust account • small increase in monitoring and enforcing compliance.
Defects fixed — **No significant change** In the same way as Option 1, we expect Option 2 will have no significant effect on defects.
Risk created by the payer using retentions as working capital — ✓✓ We do not expect Option 2 to reduce risk significantly beyond that described in Option 1. Option 2 seeks to reduce the risk of breaches of trust (by a third party holding the funds in trust rather than the payer). We do not expect this arrangement would significantly affect risk, however, because where jurisdictions impose a trust obligation on the payer, commentary indicates that the obligation is effective.[20]
Capital required for the project — ×× The capital required for Option 2 is the same as for Option 1. Retentions held in trust are not available to payers to use as working capital, and those payers would need to raise additional capital.
Transaction costs and other costs to the parties — ×× We expect Option 2 to have transaction costs for the parties in excess of that described in Option 1, because it involves a third party as trustee. Under Option 1, the costs of payers being trustees are not expected to be material where payers already have good accounting practices,[21] but payers could decide to engage a third party as trustee if they preferred. Under Option 2, however, there is no discretion and all payers must engage a third party.
Administrative costs to government — × Option 2 could potentially increase administrative costs to the government because non-compliance can be an issue if it is in the financial interest of the parties to enter into contracts without involving a third party. It could be difficult for the government to monitor and enforce compliance – the government relies on self-enforcement of construction contracts.

[20] For example, Mastrangel (2006).

[21] Collins (2012) page 258, and Mellush J (Ferrier Hodgson) and Reynolds B (quoted in Collins (2012) at page 316).

Option 3 – Amount equivalent to net retentions must be held in trust

Effect of Option 3 – Amount equivalent to net retentions must be held in trust

The CCA would require all cash the payer holds or receives (up to the amount of retentions) to be held in trust, except to the extent the payee is already a beneficiary of retentions held in trust in relation to the work specified in the contract. The payer can keep any interest earned on the trust money, but the payer cannot charge any costs of administration against the trust money.

Summary of effects

The main benefits of Option 3 are similar to Option 1:

- less risk of payees losing retentions – estimated at between $7 million and $16 million savings
- less risk to the project as a whole (a positive knock-on effect of less risk to payees) – if this led to (say) 0.25% lower costs across the project it would represent a further $10 million savings per year.

The main difference in the benefits for Option 3 (compared with Option 1) is that all retentions held by owners would be subject to the trust obligation. We do not assess this benefit as significant because it benefits head contractors, who are expected to be in a better position to negotiate alternatives than the target group for this RIS (payees with insufficient bargaining position, finances and reputation to negotiate alternatives).

Option 3 has costs (similar to Option 1):

- it requires additional capital in order to hold retentions in trust – estimated between $15 million and $20 million cost
- small increase in transaction costs, to perform trustee responsibilities.

Defects fixed — **No significant change**

In the same way as Option 1, we expect Option 3 will have no significant effect on defects.

Risk created by the payer using retentions as working capital — ✓✓

We expect the effect on risk of Option 3 (similar to Option 1) would be:

- less risk of payees losing retentions – estimated at between $7 million and $16 million savings
- less risk to the project as a whole (a positive knock-on effect of less risk to payees) – if this led to (say) 0.25% lower costs across the project it would represent a further $10 million savings per year.

The main difference in the benefits for Option 3 (compared with Option 1) is that all retentions held by owners would be subject to the trust obligation. Based on limited data, we estimate retentions head contractor write-offs could be in the region of $2 million per year. We do not assess the benefit of protecting these retentions as significant because head contractors are a group who we expect would be in a better position to negotiate alternatives than the target group for this RIS (payees with insufficient bargaining position, finances and reputation to negotiate alternatives).

Capital required for the project — ××

Option 3 would require payers who currently use retentions as working capital (and owners who use retentions to defer borrowing) to raise additional capital, equivalent to the amount of the retentions. We estimate this cost to be between $15 and $20 million. We expect these costs would be reflected in prices, so that the economic effect would ultimately be borne by owners.

Option 3 would require more capital than Option 1, in situations where the owner is retaining more from the head contractor than the head contractor is retaining from subcontractors. We understand that head contractors usually retain more from subcontractors than owners retain from head contractors, so overall we do not expect Option 3 would require significantly more capital to be raised than Option 1.

Transaction costs and other costs to the parties — **Net effect unclear**

In the same way as Option 1, Option 3 would impose small additional costs of administering trust money, but reduce costs of pursuing outstanding retentions. The net effect is unclear, and we do not expect the costs to be significant.

The transaction costs could be marginally higher than Option 1 because all owners would be required to hold retentions in trust, including owners who finance projects using debt.

Administrative costs to government — **No significant change**

In the same way as Option 1, we expect Option 3 will have no significant effect on administrative costs to the government.

Option 4 – Require security to be a bond

Effect of Option 4
The CCA would provide that, where security is required for the performance by the payee, that the payee must provide an on-demand bond (or similar product that is not equivalent to a cash security).
Summary of effects The main effects of Option 4 are: • less risk faced by payees who provide bonds (only a subset of all payees – payees who cannot provide bonds would exit the market) • increased capital required by payer (cannot use retentions as working capital), less capital required by payee (only if the surety does not require security) • price of the bond (which could be expensive for payees that lack a strong reputation and finances).
Defects fixed **No significant change** We expect Option 4, at the margin, to result in slightly more payers not requiring security for defects (in light of the cost of bonds). We do not expect this to be significant, however.
Risk created by the payer using retentions as working capital ✓ Payees would not be providing retentions (or cash security) and would not face any risks relating to using retentions as working capital. Some payees might engage in avoidance activities, making arrangements with a similar effect as retentions, and continuing to face the risks associated with retentions being used as working capital. Anecdotally, where retentions have been prohibited in New Mexico, contracts were changed to have a similar effect as retentions.[22]
Capital required for the project × Payers who currently use retentions as working capital would need to raise capital equivalent to the retentions. We estimate the cost would be between $15 million and $20 million. Although payees would have no retentions withheld, many payees would need to use an equivalent amount as security for bonds (so do not necessarily have the full use of those amounts).
Transaction costs and other costs to the parties ×× Payees would need to pay for the bond. Payees with a strong reputation would be able to obtain bonds at a reasonable price, but it would be expensive for other payees (which can be up to 15 per cent of the sum covered by the bond),[23] and some payees would be unable to obtain a bond at all. There are also administrative costs in arranging the bond. There would potentially be increased prices across projects as a result of reduced competition, when many subcontractors exit the market because they cannot obtain bonds at a reasonable price. We have not located quantitative analysis in New Mexico of the impact its regime on payee participation in the market.
Administrative costs to government × Option 4 could potentially increase administrative costs to the government. Non-compliance can be an issue because it would be in the financial interest of some payees to provide cash security. It could be difficult for the government to monitor and enforce compliance – the government relies on self-enforcement of construction contracts.

[22] Gregory D and Travers E (2013).

[23] Whitley and Mbachu (2014) page 9.

Summary analysis of options

28 The table on the next page contains a fuller summary of the effects of the options, relative to the status quo, as assessed against the objectives listed on page 6. The following table briefly summarises the significant benefits and costs of the options, relative to the status quo.

Change from status quo	Option 1	Option 2	Option 3	Option 4
Benefits				
Quantified benefits Fewer write-offs by subcontractors	$7-$16m per year.	$7-$16m per year.	$7-$16m per year.	$7-$16m per year.
Unquantified benefits Reduced risk across all projects involving retentions	$10 million per year is feasible.	$10 million per year is feasible.	$10 million per year is feasible.	-
Fewer write-offs by head contractors (not the target group for this RIS)	-	-	✓	✓
Costs				
Quantified costs Cost of raising additional capital where retentions were being used as working capital	$15-20m per year.	$15-20m per year.	$15-20m per year.	Up to $15-20m per year.
Unquantified costs Cost of managing trust funds (or obtaining a bond)	No significant change.	Significant administration cost.	No significant change.	Significant cost to obtain bond.
Cost of other economic effects	-	-	-	Many payees exit the market as they could not afford a bond.

Summary analysis of options (relative to the status quo) assessed against the objectives on page 6

	1 Cash retained must be held in trust by each payer (Cabinet agreed in principle)	2 Cash retained must be held in trust by an independent party	3 Amount equivalent to net retentions must be held in trust	4 Require security to be a bond
High weighting Defects fixed	**No significant change** We expect improved incentives to fix defects (but not significant) due to more certain payment of retentions and reduced incentive for adversarial relationships.	**No significant change** Similar effect as Option 1.	**No significant change** Similar effect as Option 1.	**No significant change** Might result in some payers (not expected to be many) deciding to proceed without security for defects if payees cannot obtain bonds.
High weighting Risk	✓✓ Less risk that payers cannot pay retentions. Estimated $7 million to $16 million savings. Lower risk to payees reduces risk across the project. Savings not estimated, but an additional $10 million per year is feasible.	✓✓ Similar effect as Option 1.	✓✓ Similar effect as Option 1, except head contractors would continue to be exposed to the risk of retentions for debt-fund projects (this aspect is not assessed as significant because head contractors are not the target group for the RIS).	✓ Avoids risks relating to retentions, but many payees would be unable to obtain bonds at a reasonable price. Payees might continue to be exposed to similar risks if they engage in avoidance activities.
Medium weighting Capital required	×× Additional capital is required to hold retentions in trust (this capital earns less than the project's cost of capital). Estimated between $15 million and $20 million cost.	×× Similar effect as Option 1.	×× Similar effect as Option 1 (although slightly more costs because it covers retentions of owners of debt-funded projects).	×× Up to $15 million to $20 million: payers would need to fund working capital currently funded by retentions, and many payees would need to provide an equivalent amount as security for bonds.
Medium weighting Transaction costs and other cost for the parties	**Net effect unclear** Trustee responsibility not expected to cost much more than good accounting practice. Reduced cost for payees trying to recover retentions.	×× Additional transaction costs involved in transacting with a third party.	**Net effect unclear** Similar effect as Option 1.	×× Significant cost of obtaining bonds (up to 15 per cent of the retentions covered). Possibly increased prices because many subcontractors could not obtain bonds and would exit the market.
Low weighting Administrative cost to the government	**No significant change** Effect on costs to government expected to be small because they only occur where disputes cannot be dealt with by adjudication.	× The government could face costs of monitoring and enforcing compliance in cases where it is not in the interest of either party to comply.	**No significant change** Similar effect as Option 1.	× The government could face costs of monitoring and enforcing compliance in cases where it is not in the interest of either party to comply.

Conclusion

29 The preferred option in this RIS is Option 1. The main benefits of this option, relative to the status quo, are:

- payers would be holding retentions in trust rather than using them for working capital, which is appropriate because retentions are security payees have allowed the payer to withhold to protect against non-performance by the payees
- less retentions likely to be held (improving payees' cashflow) because there is less incentive for payers to hold retentions
- less risk that payers cannot pay retentions – estimated savings to subcontractors of between $7 million and $16 million per year
- less risk to the project as a whole (a positive knock-on effect of less retentions being held and more certain payment of retentions to payees) – we have not quantified these savings, but as a feasible scenario, if the lower risk resulted in 0.25 per cent savings across all projects involving retentions, the savings would amount to $10 million per year.

30 Option 1 has costs, however:

- it requires additional capital in order to hold retentions in trust (this comes at a cost because the trust money would earn less interest than the project's cost of capital – estimated at between $15 and $20 million per year to payers who currently use retentions as working capital)
- transaction costs in performing trustee responsibilities (not expected to be significant over and above good accounting practice).

31 Taking the potential reduction in risk to projects as a whole into account, we consider the benefits of Option 1 (relative to the status quo) are likely to outweigh the costs.

32 The key groups affected by the proposal are:

- head contractors: they would need to compete on the basis of performance in project management rather than on their ability to retain cash from their supply chain
- subcontractors: they would have better cashflow and face less business risk, in particular subcontractors that currently have insufficient bargaining power, financial strength or reputation to negotiate for arrangements where retentions are not used as working capital
- end-users of services from commercial buildings: we expect on balance that the benefits exceed costs for projects overall – the effects on head contractors and subcontractors would be ultimately reflected in lower prices paid by end-users of the products and services provided from the commercial building projects.

33 Option 1 and Option 3 have similar costs and benefits. On balance, we favour Option 1 over Option 3 because it is more closely focused on the target group for the problem in this RIS (payees with poor bargaining power and limited financial strength and reputation). We expect Option 1 to have slightly lower overall benefits than Option 3, but the difference is due to benefits accruing to head contractors, not the target group for this RIS. We expect head contractors to be better placed than the target group to negotiate arrangements that adequately manage their risks. We expect Option 1 to have slightly lower costs than Option 3, but the difference is not significant. Under Option 1, owners of debt-funded projects would not hold retentions in trust. Under Option 3, all owners would hold retentions in trust, but head contractors would hold less in trust than under Option 1 because they would only hold retentions in trust to the extent that owners are not holding amounts in trust.

Consultation

34 MBIE has consulted with representatives of the construction sector and with banks. Consultation included face-to-face workshops in 2013 to identify issues and in 2014 to discuss possible options. Over 45 people attended at least one of the workshops, representing a range of project owners, head contractors and subcontractors.

35 We consulted the sector again after Cabinet agreed in principle to a proposal that retentions be held in trust (Option 1 above). The sector generally supported the proposal, although some expressed concern about the cost involved. The sector signalled that lead-time would be needed for businesses to adjust to the proposed arrangements. The sector highlighted matters of operational detail that MBIE has either incorporated into drafting instructions, or would consider when preparing regulations prescribing the detailed operation of the trust.

36 MBIE requested qualitative information from sector representative and banks about retentions practices, and invited sector representatives to ask their members to complete a brief on-line survey, providing data used to estimate the amount of retentions held, and the amount written off. The survey resulted in 125 usable responses, representing an estimated 13 per cent of the commercial construction market.

37 The following government departments and agencies were consulted on this RIS, and comments received were taken into account: Department of Corrections, Accident Compensation Corporation, Department of Conservation, Ministry for Primary Industries, Police, Ministry of Social Development, NZ Fire Service, Ministry of Justice, Office of the Privacy Commissioner, Reserve Bank, Inland Revenue and The Treasury.

Implementation

38 The changes proposed for retentions would be included in a Supplementary Order Paper to the Construction Contracts Amendment Bill currently before Parliament. The changes would come into effect after regulations are made prescribing the details of the trust requirements.

39 The Cabinet paper proposes that the changes would apply to contracts entered into after 31 March 2016. The main changes the sector will need to make are:

Change required to implement the proposal	Comment about the implementation costs
Subcontractors adjusting to an environment with better cashflow and less risk	For subcontractors, we expect the transition to be positive: receiving retentions sooner and with more certainty. This would reduce their need to raise capital to cover cashflow. It would also reduce risk to their business, enabling them to invest more. In a competitive market, both these factors would tend to result in subcontractors reducing prices.
Head contractors changing their business model to compete on project management rather than on using retentions for cashflow	The transition to operating without using retentions as working capital is likely to be difficult for some head contractors. Without access to retentions for capital, head contractors would need to compete on their ability to manage projects well, for example by having an integrated low-risk supply chain. This is the sort of transition currently being implemented in the UK by some of large construction contractors – sacrificing cashflow by making prompt payments (including phasing out retentions in some cases) but gaining the competitive advantages of a better-functioning supply chain.[24] The transition could be difficult for head contractors whose competitive advantage arises from their ability to retain cash from their supply chain. In consultation, head contractors and banks indicated that two years would be sufficient time to prepare for the changes. Shorter lead times could potentially increase the risk of highly-geared head contractors becoming insolvent, but we have been unable to quantify that risk. As the change to operating without using retentions as working capital affects the whole market, we expect there would be upward pressure on prices as head contractors seek to remain profitable. Some payers indicate that retentions are small relative to working capital, and these head contractors would constrain the upward pressure on prices. We expect overall project prices would decrease because of subcontractors' improved profitability (described above) and less flow-on risk across projects. There are some similarities in the effects of holding retentions in trust, and the effects of project bank accounts (PBA) – in both cases, it reduces the ability of head contractors to use payments or retentions as working capital, and it ensures more prompt and certain payment to subcontractors. Cabinet Office (UK) (2012) said, in relation to the impact on profitability of head contractors, 'The use of a PBA reduces risk of supply chain failure and supports suppliers' engagement in projects. It is accepted that Tier 1 [head contractors] may have to raise their prices marginally.'[25]
Payers ensuring their accounting practices are adequate for trustee obligations	Payers that use good accounting practices should face little change. MBIE would provide information on how payers can comply. Although payers would have flexibility about how to comply, some simple steps can help with compliance (such as separating trust money from other money).
Payees learning about their new rights and exercising them	MBIE would provide advice and information about how payees can exercise their rights. We do not expect full uptake of this advice, because payees do not always fully exercise their existing rights under the CCA.[26]

40 MBIE currently provides advice, information and education to the sector on an ongoing basis, and will be providing advice on changes that are made when the Construction Contracts Amendment Bill is passed. Advice relating to holding retentions in trust will be provided as part of that existing and planned advice.

[24] Department for Business, Innovation & Skills (2014) page 12.

[25] Cabinet Office (UK) (2012), page 5.

[26] Whitley and Mbachu (2014) table 1.

Monitoring and review

41 The policy proposals considered in this RIS would provide an updated legislative regime governing retentions in construction contracts. The proposals are based on advice and information provided by the sector and banks, as well as insights from overseas jurisdictions.

42 MBIE intends to monitor the regime on an exceptions basis – that is, if there are indications of issues. This could be achieved through ongoing liaison with the sector, and monitoring disputes (adjudications and court decisions) and insolvencies. This monitoring could provide information on how well the regime is operating, and help us decide (in the first instance) what ongoing advice and information is needed.

43 We would liaise with the sector and banks to help us understand the effect of the regime on the holding of retentions, non-payment of retentions, and transaction costs of the regime. If warranted, we could gather survey information.

Glossary

Term	Meaning of the word (as used in this RIS)
Bond	This RIS refers to on-demand bonds offered by banks (and other sureties). A person holding an on-demand bond can convert it to cash by presenting it to the bank.
CCA	Construction Contracts Act 2002
Defects liability period	Agreed period of time after practical completion of the work, during which retentions are held in case defects are identified.
Head contractor	A payee who enters into a construction contract with an owner.
MBIE	Ministry of Business, Innovation and Employment
Owner	Project owner – the party who owns the building being constructed.
Project Bank Account (PBA)	A mechanism that provides owners with more certainty and transparency of payments throughout the construction supply chain.
Retention	Parts of the contract price the payer withholds from paying to ensure the payee fixes any defective work.
RIS	Regulatory Impact Statement.
Subcontractor	A payee who enters into a construction contract with a payer (other than the owner).

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