

PERCEPTIONS OF THE RETENTION SYSTEM IN THE CONSTRUCTION INDUSTRY

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The retention system of withholding a portion of payment to contractors and subcontractors is a peculiar feature of the building industry. In the past decade or so there has been much discussion about the practice of retentions in the US and UK construction industries. Anecdotal evidence without concerted research suggests that problems exist within the practice in the New Zealand construction industry, which this study will address. Retention practice affects the whole construction supply chain, but the effect the practice has on each party varies significantly. Thirteen interviews were carried out with experienced construction industry professionals, including clients, contractors, subcontractors and consultants. An analysis of their recorded views and perceptions revealed diverse views. Most agreed that problems with retention are very serious, the worst affected being the subcontractors who do not have much control or say. However, they said, in the absence of any better alternative, the practice is working well in its current form. Further research will work out some alternatives to the traditional retention practice so as to create more balance and fairness for all the parties involved in the supply chain.

Keywords: Government client, Contractors, Subcontractors, New Zealand.

1 INTRODUCTION

The payment mechanism of construction projects is different from other industries. For every payment made to a contractor or subcontractor, a sum of cash money varying from 2% to 10% is held back. This practice of withholding money is known as retention, and most construction contracts are subject to it (Hughes *et al.* 1998). Retention serves as a regular means of protection for construction clients from contractor's insolvency, and also provides the client with a form of insurance that contractors will complete their work on a job (*ibid*).

There has been considerable debate on the merits and demerits of retentions (*cf.* Fullerton 2000, Abeysekera 2002, Construction Manager 2002). Subcontractors are mainly of the opinion that retentions should not be charged, but the owners mainly disagree. This has created some polarity between the parties, and furious debates within the construction industry. Some countries such as US (within some states) have abolished its use in public contracts, whereas in other countries such as UK they have unsuccessfully tried to have it abolished (House of Commons 2003, Bausman 2004).

2 LITERATURE REVIEW

The retention mechanism impacts the whole construction supply chain starting from the client/employer to the contractor, subcontractor, and the suppliers. Proponents argue that it acts as a form of financial protection for the owners and ensures performance while imposing minimal financial hardship on contractors. Due to the difficulty in getting contractors back on site to remedy defects, retention is a good practice since it keeps the contractors on their toes and focussed on the job in hand (Boyes Turner 2005). Opponents of the practice believe that retention reduces competition, increases project costs, provides a financial disincentive for timely completion of the work, and places a financial hardship upon contractors and subcontractors (Bausman 2004). Opponents also believe that the system is often abused by employers who withhold payment unreasonably.

According to Hughes *et al* (1998), the retention system has a significant negative impact on the efficiency of the construction industry. Uncertainty and risk are multiplied by non-payment or long delays of retention disbursement. The industry is thus deprived of funds that could have been put into better use. Unfortunately, late payment and refusal to pay remain a common means of securing additional short-term cash flow. An issue associated with subcontractors whose work gets completed at the early stages of the construction is that their retentions are usually held until the main contract is completed. In addition, there is exposure to the danger of late payment or non-payment. Uher (1991) observed that the practice of general contractors holding retentions on all subcontractors, regardless of the nature of their work, is unnecessary and unfair. The subcontractors therefore suffer most from the practice of retentions and are the main opponents, as opposed to clients or main contractors for whom retentions are a source of extra capital for other purposes, e.g., financing other projects.

3 RESEARCH OBJECTIVE

The collapse of Mainzeal (the third-largest builders after Fletchers and Hawkins in New Zealand) in February 2013 has sparked debate against retentions in New Zealand (NZ). Reports suggest millions of dollars' worth of subcontractor's money was being held up as retentions (Steeman 2013). Anecdotal evidence suggests that in NZ the problem of retentions is commonplace. However there has not been much research to identify where the actual problem lies and what solutions could be put in place. Before a proper appraisal could be made, the first step was to identify the pros and cons of retentions in the NZ construction industry.

3.1 Research Method

As per (Denzin and Lincoln 1994), qualitative description can provide a rich understanding of processes and meanings which cannot be measured in terms of quantity. This study therefore utilises an inductive process of theory building using a small sample of construction practitioners. Data has been collected by interviewing experienced construction industry practitioners using the interview method. Semi-structured interviews with open-ended questions were used to gather as much data as possible.

3.2 Profile of Experts (Research Participants)

Key persons, sectors, and subsectors of the NZ construction industry were considered in the selection of 13 participants (i.e., contractor, subcontractors, clients, and consultants). Face-to-face interviews were conducted in line with the research objective. All interviewees hold very high positions in their respective organizations with 20-plus years of experience working in the industry. For the purpose of anonymity, the interviewees have been assigned an ID, and in the findings their ID number is used as a reference. Table 1 below shows the profile of the experts:

Table 1. Profile of participants.

Interviewee ID	Representative organization	Profession/Position	Work experience in years
R1	Government client	Manager Project Management Office	20
R2	Government client	Senior Procurement Manager	22
R3	Large client organization	Director Property Services	40
R4	Contracting Federation	Executive Officer	40
R5	Contracting	Commercial Risk Manager	40
R6	Contracting	Commercial Manager (Infrastructure)	40
R7	Contracting	Managing Director	40
R8	Subcontracting	Managing Director	20
R9	Subcontracting	Managing Director	35
R10	Subcontracting	Executive Director	45
R11	Subcontracting	Director	20
R12	Construction Consulting	Chief Engineer (Construction Contracts)	40
R13	Dispute Resolution	Managing Director	40

3.3 Research findings and discussion

Keeping in mind the research objective, the first opinion sought was on the fairness of the practice and the adequacy of funds collected by way of retentions. Second, they were asked if there were any problems with the practice in NZ. Finally, their opinion was asked about NZ's unique sliding-retention regime, as per NZS 3910 (Standards New Zealand 2003).

Regarding the fairness of the practice, the clients felt that overall it is a fair practice. All of them did recognize the fact that it impairs the cash flow of the contractor significantly, which may deter his capability to tender for more work. R1 and R3 were of the opinion that contractors build the cost of retentions into their pricing. R3 highlighted the fact that from time to time the level of defects is well in excess of the retentions held, especially with the sliding scale, therefore the practice is not fair. Also that it would be much fairer and less risky for the contractor if the principal had to provide a principal's bond, or if the money had to be lodged in a trust account assuring the security of retention funds.

The opinion of the contractor group was mixed with regards to the fairness of the practice. R4 felt that retentions are not fair as they affect the contractor's cash flow, and that the practice is more a tradition than a rational system. R5 thought the retention practice has been there for centuries and not changed much. It is fair and only becomes

unfair when the clients insist on holding a bond as well. R6 was not sure, but said that the practice creates pressure on the subcontractor and thus is an imposition on them. R7 said that if the practice was scaled and done properly it was fair.

The subcontractor group generally felt retentions were not fair. R8 and R11 held that in principle it was fair if it worked properly, but it does not most of the time. R9 thought it unfair because holding, say, 10% of contract for a NZ\$1M job is \$100,000 withheld, which for a subcontractor is a lot of money. R10 held similar views, adding that the amount of money held is totally irrelevant in terms of the potential defects. Respondents R12 and R13 believed that having a security of performance is a very good idea and retentions are one way of achieving it. However, R12 thought that it is not the most efficient way of doing things, since it drains the contractor's cash flow. R13 described it "as a crude stick to assure performance".

Respondents held diverse views when asked whether there were any problems with retentions. Clients overall did not see any problem for obvious reasons, since they are at the top of the food chain holding on to the money. R1 stated that the impact on the cash flow for some contractors could be significant, whereas for others it did not matter. An interesting opinion from R1 was that there were issues with some principals managing retentions and holding them in their financing systems. In the absence of sophisticated financing systems, the tracking of retentions could be a significant issue. This can end up building up the cost of the entire program, not just one project. R3's opinion was that it was not a major problem within the industry and there are other problems that supersede it.

Three out of the four contractors agreed that there is a problem around the practice. R5 felt that it was hard on the subcontractors, particularly on the early trades, since their money is held for long periods of time. R6 described retentions as a "tough nut".

The subcontractor group described the issue of retentions as a "major" or a "significant" problem in the industry. R8 described the main problem as them not being paid out on time, with subcontractors having to fight for reimbursement; with the low margins in the industry, significant money sits in retentions. R9's opinion was that the sub-trades in the industry act as unsecured creditors: When compiling construction contracts in financial terms, the rule of thumb is that the sub-trades are 80% and prime contractors are 20%. So \$80 out of every \$100 is unsecured credit.

Consultants R12 and R13 did not think that there was a real problem with the practice. However, R12 highlighted the fact that contractors do go into liquidation, and holding back a significant sum of money is perhaps a cause. R13 believed that the issue around retentions is not any worse than it has ever been.

In response to the last question, on NZ's unique retention regime, most of the respondents (except the subcontractor group) seemed to agree that NZ's sliding regime was fairer than a flat one used elsewhere. When asked about the history behind the sliding regime, only R12 seemed to know why NZ used a sliding retention regime. According to R12, the NZ Parliament in 1908 had passed the Wages Protection and Contractor's Liens Act for the protection of the workmen and subcontractors. That act was repealed in 1989. Nothing replaced the 1908 Act until the Construction Contracts Act came along in 2002. But people hung on to the familiar scale of 10%, 5%, 2.5%, 1%. R12 described it as an anachronism. R4 said that the practice was traditional, but also recognized the fact that the amount withheld became unreasonably larger as the

projects increased in scale. R4 said that the client groups recognize that there is probably no need to have as large an amount of money held as retention. R6 held that the unique regime could exist because the industry was fairly small, and for, say, a NZ\$50,000 contract there was a need for a security of more than 2%. R7 said the sliding regime was best, and should be made mandatory for all construction-related contracts.

The perspective of subcontractors was different with regards to the sliding regime. R8 said that the level of retentions could vary completely even if a subcontractor signs a contract under 3910. R9's opinion was that it is not fair since a good portion of their contracts are valued under NZ\$200,000. In the roofing industry, the roofing aspect of contracts is 10%, so having a NZ\$2M contract with a 10% regime up to \$200,000, and then 5% and 1% retentions create a positive cash flow for the main contractor and unsecured creditor status shakier. R12 thought that from an international perspective, a retention of 10% was an unusual practice, but for smaller-scale operations it may make some sense if other securities, such as a performance bond, were not involved. R13 thought the sliding scale was better than a flat one unless there is a flat percentage with a cap. R13 thought that a flat rate of 10% on a million-dollar contract was ridiculous, and said that a lot of subcontractors would inadvertently sign them off. In R13's opinion, it was important to look around and see what the international best practice is.

4 CONCLUSION

This paper sought the views of industry experts on the retention practice in the NZ construction industry. With regards to the current practice, clients and contractors seem to be comfortable with the practice since they are on the receiving end and do not have much to lose. They do agree that the system is not perfect and has issues especially with regards to cash flow. However, in the absence of a better system to protect their investments, the practice seems to be working well for them. The subcontractors, however, find the retention system abusive. Problems seem to happen more for private clients and developers, less for government clients and large-scale contractors. However, the collapse of the Mainzeal, one of NZ's largest building corporations, called into question the efficacy of the system for large-scale contractors as well. Further research including a wider-cross section of the NZ construction industry professionals will help identify the issues around the practice and what better alternatives could be put in place.

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