Construction Leadership Group

Guidance on security for construction projects

Industry Discussion Paper
December 2018

NSW GOVERNMENT

INTRODUCTION

This Guidance has been prepared for the Construction Leadership Group (CLG) to assist procuring Agencies, when acting as Principal to a construction contract, to understand:

- why there is a need for security for construction projects;
- how to optimise the required types of security in a contract (i.e. the security package);
- how different factors can impact the effectiveness of each security type; and
- the implications that may arise from calling on security.

As a minimum, procuring Agencies are required to ensure that contractors provide adequate security before signing any construction contract to prevent and/or mitigate potential financial loss that may be suffered if the contractor defaults during construction and/or fails to fulfil its obligations.

This Guidance should be considered in respect of all construction projects.

This Guidance is limited to describing key forms of security that are commonly provided by contractors in New South Wales, being any (or a combination) of the following:

- parent company guarantee (PCG);
- unconditional undertakings (i.e. bank guarantees and insurance bonds); or
- cash retention.

A glossary of key terms used in this Guidance is set out in Appendix A.

REQUEST FOR FEEDBACK

The CLG invites interested parties (Respondents) to make a formal submission (Submission) to provide feedback and comments on this Guidance. Feedback and comments can be submitted to further develop this Guidance for use by Procuring Agencies as a "go-to" guide in relation to security packages.

Feedback and comments can be submitted to CLG@treasury.nsw.gov.au by no later than 28 February 2019.

The CLG is not obligated to incorporate all feedback and comments.

The CLG may follow-up with select Respondents.

The CLG may decide to publish the Submissions on the Infrastructure NSW website at the end of the consultation process. A Respondent must clearly identify any part of its Submission which contains confidential information. Automatically generated confidentiality statements in emails do not suffice for this purpose. Any confidential information should be marked as 'confidential' and be provided in a separate document. Respondents authorise the CLG to use, copy, adapt, modify and reproduce the whole or any portion of their Submission for the purposes of the development of the guidelines whether or not confidentiality is claimed with respect to the whole or any part of a Submission.

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OVERVIEW

Purpose of security

Security provided by a contractor for construction contracts is required to reduce a Principal's risk of financial loss that may be suffered if the contractor defaults during construction and/or fails to fulfil its obligations.

To ensure adequate performance of the construction contract by the contractor (and to mitigate the counterparty risk of the contracting entity), a Principal will seek to "secure" the contractor's contractual obligations by a variety of means, usually in the form of security.

There are several forms of security that can be provided by a contractor, each with varying:

» levels of comfort and support to a project;

» legal and commercial consequences; and

» costs.

It is important to understand how the nuances of each form of security may impact on its operation and utility. Key features of each common security type discussed in this Guidance are described in further detail in Appendix B.

Selecting security

Wherever possible, security should be bespoke to an individual project, balancing the appropriateness of the security against its effectiveness and cost. Across the project timeline, risk and complexity will change which will impact the value-for-money (VfM) outcome of security. Assessment of the project risk and complexity and the security's VfM offering should provide a guide to optimising the appropriate security package.

Minimum requirements

The security package selected by procuring Agencies must include the features listed below.

Duration	The security must cover both the project construction phase and defects liability phase.
Risk / complexity	The security should be appropriate for the risk and associated complexity of the project and sculpted to align with the project's timeline, risk profile, client objectives and key project milestones.
Satisfactory credit rating / financial capacity	The security must have a satisfactory credit rating, enabling the Principal to gain confidence on both the contractor's and its guarantor's financial capacity. Procuring Agencies should refer to the NSW Treasury Circular 14-01 (Acceptance of Performance Bonds or Unconditional Undertakings by Government Agencies) in the case of determining the creditworthiness of the guarantor of an unconditional undertakings or complete a thorough assessment of the proposed parent company in the case of PCGs.
Enforceability	The security must provide the Principal with enough confidence that it will be enforceable in the event that the contractor fails to fulfil its contractual obligations. Some key considerations which impact the enforceability of security are discussed in detail in Chapter 3 below.

Sufficiency of the amount	The security should provide the Principal with sufficient financial protection which aligns with the level of the potential losses the Principal may suffer. Procuring Agencies should assess their potential loss exposure as part of determining what will be a sufficient amount of security. Refer to Appendix B for the current market standards. The Principal should not reduce the security size if the remaining security in the package does not compensate adequately for the risk.

Further considerations: The overall security package provided by contractors should be sufficient to cover the contractor's liability under the contract. This is distinct from the contract value.

The contractor's liability will usually be capped at a fixed percentage of the contract value, subject to certain categories of liability which sit outside the liability cap.

It is important that the level of security provided by the Contractor is sized so that it takes into consideration the contractor may potentially be liable for some level of uncapped liability.

Calling on security

Security should be structured so that there are no restrictions and/or conditions that impede the Principal's right to call on security. However, calling on security is a strategic decision that needs to be considered against other options that may be available (i.e. set-off or termination).

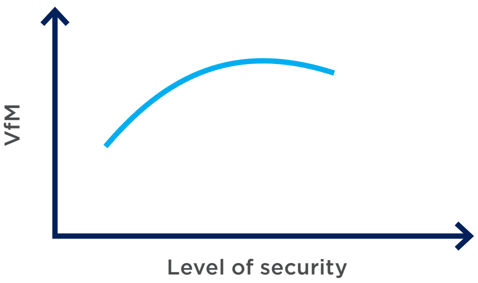
OPTIMISING SECURITY

When seeking to optimise security levels, the Principal should bear in mind that there is a balance between the:

- desired level of security;
- type of security;
- risk, complexity and size of the project;
- capacity of the contractor market to provide security; and additional cost to the project.

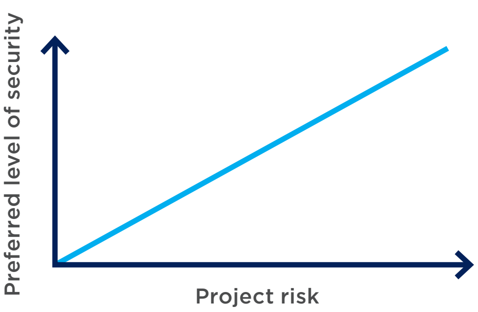
The graphs and descriptions below demonstrate key relationships to consider.

Figure 1 Level of security and VfM



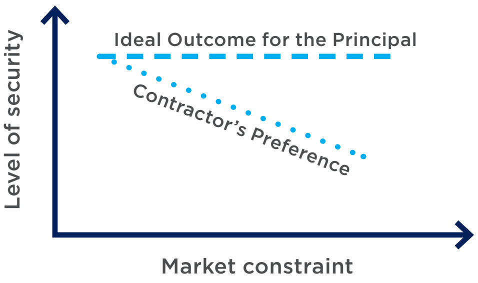
Requesting higher levels of security will often come at a cost (which will inevitably be priced into the contract). There will be a point where the extra cost of security outweighs the marginal benefit and value of the extra security. Additionally, there will be a point where extra security is no longer available from the contractor market (see Figure 3 below).

Figure 2 Project risk and preferred level of security



The preferred level of security increases for higher risk projects (e.g. low levels of security will not be suitable for a project where there is a high-level of risk). As project risk increases, it is often difficult to quantify the risk and thus, the desired level of security may be over or underestimated.

Figure 3 Market constraint and security



While there will be a desired level of security, market constraint may reduce the security achieved. Contractors prefer to provide less security than more.

CONSIDERATIONS WHEN SELECTING SECURITY

When selecting a security, consideration must be given to the effectiveness of each security type. The tables below outline key considerations impacting the effectiveness of each security type.
The different types of security are described in detail in Appendix B.

Parent Company Guarantee (PCG)

Financial vs performance guarantee	PCGs typically guarantee both financial and performance obligations of the contractor under the construction contract. It follows that a PCG can be useful as an alternative to termination and can require the guarantor to step-in to complete the contract. However, in many instances, the guarantor may not have the necessary capability or resources to complete the construction contract (as the contractor would have). Additional complications may arise when certain registrations or accreditations (e.g. construction licences) are required by the entity carrying out the works which the guarantor may not hold. Because of these risks, a parent company may seek to limit its guarantee in respect of the contractor's financial liabilities. In such instances, the Principal will not be able to compel the guarantor to complete the contract and the guarantor will only be responsible for the financial liability of the contractor.
Less protection when the guarantor is an intermediate entity	A PCG will only be as valuable as the credit quality of the guarantor. It must be considered whether the guarantor has the credit quality to meet its obligations under the security. There is an increased risk that the PCG does not provide sufficient protection when the contractor entity is a subsidiary of a complex company group structure as it can be unclear where the group's assets are held. Where an entity provides a PCG below the ultimate parent, the ultimate parent may be able to divest major assets of the intermediate entity, leaving very little in the way of assets to fund a claim. In a competitive market, contractors may be more willing to provide a guarantee from their ultimate parent. However, guarantees from an entity below the ultimate parent are becoming prevalent as the NSW market becomes constrained and less competitive. In these cases, it may be more appropriate to seek a higher level of security in the form of bank guarantees/insurance bonds or cash retentions, to compensate for the intermediate entity where assurance on its creditworthiness may not provide the same degree of confidence as that of the ultimate parent.

Enforcement associated with foreign guarantors	Enforcing a PCG with a foreign parent can be more difficult than a PCG with a local parent. This difficulty can dilute the protection offered by a PCG. Procuring Agencies should contact the Infrastructure & Structured Finance Unit of NSW Treasury to confirm the acceptability of any proposed foreign guarantor. It is important that an appropriate foreign legal option confirming the enforceability of the PCG is obtained in the case of any foreign parent. There are two key factors to consider when a guarantor is a foreign entity: **1.Enforcement** The ability to enforce a guarantee against a foreign company will depend on whether the relevant foreign court will enforce an Australian judgment or arbitrational award against the guarantor. It can often be the case that a foreign country is not under any obligation to recognise or enforce the judgments handed down by Australian courts. This is in contrast with arbitrational awards which will be enforceable where the parent company's domicile is a country that is a signatory to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards. **2. Repatriation of funds to Australia** There may be restrictions for repatriation of funds from the parent company's domicile country to Australia. For example, the requirements of the State Administration of Foreign Exchange (an administrative agency in China) may apply in relation to funds payable under a PCG from a Chinese parent company In this case, obtaining a PCG from the ultimate local parent may provide better confidence on enforceability.
Nil protection when construction contract becomes unenforceable, illegal or invalid	A PCG alone will not offer any protection where the obligations of the contractor under the contract become unenforceable, illegal or invalid. For this reason, it is important that the PCG includes an indemnity from the parent company in respect of the contractor's non-performance of its obligations. This indemnity creates a primary, independent obligation on the guarantor which will be separately enforceable.
Beneficiary of the claim on the PCG is an unsecured creditor	The Principal will be an unsecured creditor upon enforcement. Should the guarantor become insolvent, the Principal will stand in line with other unsecured creditors. The PCG will have limited value if the guarantor's assets are exhausted.
Smaller contractors	PCGs of smaller contractors may not be as worthwhile given the value of the assets behind the parent company. In such circumstances, it may be a better course of action to require alternative forms of security.
Impact on balance sheet	A parent's company's balance sheet will often be impacted by the guarantee (depending on the size of the contract) as it will be accounted for as a contingent liability. For this reason, a parent company will usually seek to limit its exposure under the guarantee. It is important that procuring Agencies ensure that the PCG will still provide sufficient financial protection which aligns with the level of the potential losses the Principal may suffer.

Further considerations: Assessment of parent companies consists of a front-end high-level financial assessment analysis by specialist advisors. If the analysis provides unsatisfactory or questionable results, a deep-dive analysis is recommended.

This deep-dive includes the guarantor's and contractor's credit history, financial statements, company's directors and any issues with ASIC.

Banks currently use this approach when assessing their clients even from a global perspective.

Unconditional undertakings – bank guarantees / insurance bonds

Form	Unconditional undertakings should be in a form "as good as cash" which means they are truly unconditional and payable on demand. This will be the case where the Principal has a primary right of action against the issuer and does not need to prove the Contractor's default or its right to claim under the construction contract. However, although bank guarantees, and insurance bonds may be described as "unconditional undertakings", contractors prefer to add conditionality such that the Principal is required to prove the contractor defaulted under the construction contract and caused loss before the security may be called. Such conditionality will impact the Principal's ability to enforce the guarantee. It is not standard practice across Government to accept such 'conditional" undertakings.
Contractual right only	Guarantees / bonds are contractual in nature and do not give the Principal an interest in any property i.e. physical entitlement.
Uncertainties associated with insurance bonds	There is a general perception that there are additional complexities and uncertainties associated with insurance bonds and that they are not an ideal form of security. Further, there are few practical examples of calling on an insurance bond to provide any insight on whether such complexity impacts on their callability.
Size and trigger events	Guarantees / bonds typically can be more successfully called upon if the purpose for providing security is clearly stated in the contract by reference to specific performance required of the contractor. This can be achieved by breaking-down the amounts for specific events as opposed to a lump-sum. For example, $10 million allocated for provision of final documentation.

Assurance on credit-worthiness	The Principal's assurance as to the credit-worthiness of the guarantor / issuer is based on the guarantor / issuer's credit rating. This may be determined by the credit rating agencies (guided by NSW TC14-01) or through independent analysis (by a suitably qualified adviser).
Sculpted across project risk and timeline	It is not uncommon to have lower levels of bonding during the design phase, a step-up during construction, and a step-down during the defects liability period. This structure may be acceptable depending on the risk profile of the project. Furthermore, requesting additional security from the contractor should be considered where there is a significant variation that substantially increases the construction contract's value.

Further considerations: The form of PCG and bank guarantee should be provided at the time of tender to ensure that contractors have sufficient time to engage with the relevant third-party providers. Late changes to the form or requirements of the security will often delay the signing of the contract as third parties (i.e. parent companies / banks / insurance companies) need to approve those changes.

Cash retentions

Structure to align with the project's risk profile and timeline	Fixing a blanket cash retention value across the project should be avoided. Rather, cash retentions will be most effective when structured to align with the project's timeline, risk profile, client objectives and key project milestones. However, if critical risk elements of the project are expected to occur in the early phases, then, cash retention may not be suitable because it requires build-up over time in order to provide sufficient protection against the level of risk.
Initial payments	Adequate cash reserves will take time to accumulate in the case of cash retention. Also, it is generally recommended that cash retentions are not applied in the first weeks of a project to allow the contractor to have sufficient funds to mobilise. It is important to note that cash retention alone does not provide the Principal with adequate security against any initial payments made to the contractor.
Legislative requirements	Additional legislative requirements may apply where cash retention is used as security, such as under the *Security of Payment Act 1999 (NSW)*. Procuring Agencies should seek legal advice to ensure their security structure and construction contract comply with any applicable legal requirements.

Further considerations: In October 2017, the UK government published a review on cash retentions in the construction industry. It found that, when due (typically at construction completion), contractors were not receiving their payment of the cash retained by the Principal, or this payment was late, due to: disputes over defects, contractors becoming insolvent, non-payment in a higher tier of the supply chain, and contractors not asking for their retention money, with some tier 3 companies pricing work to offset the retention costs, and others keen to maintain good relationships with their main contractor. Following the collapse of the top tier contractor, Carillion in 2018, there is a major push in the UK by major contractors on the government to end cash retention.

What other key factors should be considered when deciding on the security package?

Below are other key factors that the procuring Agency should consider when selecting a security package (ideally before issuing any tender).

What are the project risks across the project timeline?

The specific project risks should drive the structure of the security. For example, a project with a combination of infrastructure and operating systems that need to be fully integrated before the asset becomes operational, will require more security than a general surface road works project.

Requesting additional security from the contractor should also be considered where there is a significant variation that substantially increases the construction contract's value.

Further considerations: Contractors generally consider liability caps as the most significant risk exposure on their balance sheet and will often push back on the liability amount.

For example, while the market standard of 50% liability cap is generally viewed as reasonable, an alternative approach is to sculpt the liability cap across the project timeline to recognise the level of risk exposure to the Principal at the relevant time.

It may be worthwhile for a project to introduce step-changes to the liability cap in return for more stringent conditions around the security provided by the contractor.

Are there critical assets to the project?

Depending on the project type, certain vehicle or equipment may be critical to the progress of the project (e.g. tunnel boring machines). Such assets are generally needed at the inception of the project and are critical to the project start. However, often these assets are supplied or manufactured by a separate company (i.e. not the contractor) and it is difficult to enforce the timely supply of the asset with only security from the contractor. This may be achieved by requesting additional security over the contractor's manufacturing leases of the equipment.

Similarly, the contractor will often require payment for materials intended to be incorporated into the works (i.e. unfixed assets). The Principal should ensure that it is not obliged to pay for such materials until the contractor has provided additional security (i.e. unconditional undertaking) for an amount equal to the payment claimed for the materials (which remains in effect until the materials are incorporated into the works) and sufficient evidence that title in the materials will pass to the Principal on payment.

It is also important to consider whether the Principal has any security interests in such critical assets or materials. The Principal may only be a secured creditor in respect of those security interests if procedures set out in the Personal Property Securities Act 2009 are complied with. Compliance with this legislation may be particularly relevant if the contractor subsequently becomes insolvent.

Has the Contractor received a mobilisation payment?

Contractors will usually seek an initial mobilisation payment to assist with meeting the start-up costs associated with a project.

If the Principal chooses to provide the contractor with a first mobilisation payment, it is recommended that a matched i.e. equivalent level of unconditional undertaking is required to be given to provide the Principal with sufficient protection in respect of the payment it has had to make before starting any works. This security can be released when the mobilisation works have been completed or at the Principal's discretion.

Typically, the contractor will request to recover costs associated with providing this security as part of the initial mobilisation payments.

Cash retention is typically not adequate security for the early part of the project including for mobilisation payments.

What are the risks associated with the contractor's corporate structure?

The contractor's corporate structure often influences the effectiveness of various security types.

Parent Company Guarantee	**Corporate structure** The quality of a PCG is generally a function of the contractor's company structure. It is important to consider the broader corporate group's involvement in projects. For example, the value of a PCG may become diluted where the parent is already supporting a significant number of its subsidiaries on projects. The worth of a PCG must be scrutinised when there is evidence (both publicly available and across government) that a contractor has issues internally. These issues may be under-resourcing due to bidding on multiple projects, or delay issues across multiple projects etc and will may have cascading effects on the contractor's cash-flow, worsening the parent company's financial risk position. **Joint ventures (JVs)** For JVs, it is important to receive parent company guarantees from each parent of the joint venture members. Typically, JVs are joint and several. As such, it is then essential that each parent company guarantee of the subsidiary companies covers the full liability of the contractor (i.e. not just the subsidiary's potential individual liability).
Unconditional undertakings – bank guarantees / insurance bonds	Generally suitable when the parent company's financial strength is low or there is no parent company (particularly for smaller contractors). Consideration must be given to the ability of the contractor to obtain bonds from an appropriate financial institution. It may be difficult for non-Tier 1 contractors to have access to bank guarantees as banks may require a contractor to have sufficient cash reserves equal to the amount of the guarantee. The guarantee / bond issuer must be satisfied that a contractor can meet current and future obligations, has a good reputation, has experience meeting the requirements of the projects to be undertaken, and has (or can obtain) the equipment necessary to perform the work. Contractors challenge procuring Agencies as to whether they are receiving VfM from higher bonding levels as they try to reduce their exposure to third-party risks (e.g. banks) and to keep costs down. Furthermore, contractors want to retain their bonding capability (i.e. ability to issues bonds) to compete for future projects. In such instances, the Principal should ensure the amount (i.e. value of bonding) provides sufficient financial protection.
Cash retention	Cash retention affects a contractor's liquidity (i.e. cash flow) and can impact their ability to meet their project expenses (including paying subcontractors). For smaller projects or smaller contractors, cash retentions are common when the contractors do not have means to obtain bank guarantees / insurance bonds.

Does security impact the project's value-for-money?

A key distinguishing feature of the various forms of security is the cost. The costs incurred by the contractor to provide the security are subsequently passed on to the Principal when pricing the construction contract. These costs will increase as the duration that the security is required to be available for and the value increases (i.e. the higher the value and duration, the higher the cost.)

Procuring Agencies need to consider if the additional protection afforded by a selected security is worth the additional cost.

Potential savings can be realised from using certain forms of security or optimising the level of security which can impact the VfM assessment of a project. For example, there are potential costs savings that can be realised from using insurance bonds instead of bank guarantees on a project as insurance bonds are typically cheaper.

Similarly, sculpting security to align with the risk profile of the project can improve the VfM. For example, the last stage of a project may not be complex or high-risk (e.g. safety testing of pavements).

What alternative mechanisms are available that can improve the contractor's performance?

Alternative mechanisms are also available to influence the contractor's performance, including:

» liquidated damages;

» deductions/setting off/netting provisions;

» indemnities;

» fixed and floating charges;

» default triggers and cure plan requirements (e.g. look-forward tests); and

» personal guarantees from company directors (typically used for smaller projects and small family-run contractors and are usually limited to an agreed amount).

Whether any of these mechanisms are included should be considered as part of assessing the Principal's risk exposure on a project and the level of security that may be required to offset this risk.

CALLING SECURITY

What impacts the Principal's contractual right to call on security?

Ideally the construction contract should provide the Principal with the right to call on security for any claim under the contract. There should be limited restrictions and/or conditions (and ideally none) that impede the Principal's ability to do so. Some common conditions include:

- the Principal has a claim or entitlement against the contractor;
- the contractor has a debt due and payable to the Principal;
- the Principal gives notice to the contractor that it intends to make a call; or
- a notice period elapses before the Principal can call on the security.

What should the Principal consider when calling on security?

Calling on security can provide the Principal with immediate access to funds to protect itself against unexpected costs it incurs because of the contractor's breach or insolvency. These costs include payment of subcontractors in the event of contractor insolvency, costs associated with exercising step-in rights or engaging additional resources to manage the breach or retendering the contract and engaging a new contractor to complete the project.

Even though the Principal may have a right to call on security, before calling it is important to consider the following.

Court injunction to restrain calling security	A contractor may seek an injunction from the courts to restrain the call on security or prevent the Principal from using the associated funds where the contractor asserts that any contract requirements have not been complied with. In these instances, it will be for the courts to examine the underlying construction contract and terms of the security to determine if the Principal's call is permitted.
Financial distress or failure for a contractor	Calling on the security can potentially lead to financial distress or failure for a contractor, which can impact the delivery of the project
Insolvency or voluntary administration of a contractor	Where a contractor is insolvent or in voluntary administration, the involvement of a liquidator can further complicate the call process. In certain projects (particularly involving smaller contractors), a Principal may be required to quantify its losses before calling on the security. In recent experiences with JVs, the other JV members have stepped-in to complete the works before the security can be called upon, when a JV member became insolvent or under voluntary administration.
Not a reflection of final rights between parties	Although a Principal has the right to call on the security, the contractor may subsequently be entitled to recover the proceeds of the call where it is ultimately held that the contractor was not in default.
Consideration of other options	Calling security must be considered against other options. For example, it may be an easier course of action to rely on any set-off provisions available under the construction contract to withhold payment where work has not been performed in accordance with the construction contract.

APPENDIX A: GLOSSARY OF TERMS

Term	Definition
Agencies	NSW Governments entities engaged in all aspects associated with the procurement and delivery of construction projects.
Bonding	Bonding is a general term that refers to any of the unconditional undertakings provided by the contractor – either the bank guarantee or insurance bond.
Cash retention	Form of cash held by the Principal by retaining an agreed percentage from the progressive payments to the contractor until the amount of the retention held is equivalent to the total amount of security required.
Look-forward tests	Assessment of construction progress by an independent certifier to determine whether completion is likely to be achieved within a required timeframe. Failure to satisfy this test will trigger certain remedial rights for the Principal under the construction contract.
Parent Company Guarantee (PCG)	Promise by a parent company to guarantee its subsidiary's contractual obligations.
Principal	An entity that engages a contractor by entering into a construction contract. On government projects, this may be the procuring Agency but could also be another government entity depending on the project structure.
Sculpting security	Choosing different level of security over the life of the construction contract, to align with preferred levels which may change due to changing levels of risk over the contract.
Security	Provision by the contractor to secure the performance of its obligations.
Security type	Security type refers to an individual security. Cash retentions, bank guarantees, insurance bonds and parent company guarantees are examples of various security types.
Security package	Combination of one or more security types in a contract.
Unconditional undertakings – Bank guarantees and insurance bonds	Requirement of a bank or insurance company to make a payment on demand by the Principal, up to a stated amount where the contractor fails to perform under the construction contract.

APPENDIX B: TYPES OF SECURITY

	Parent Company Guarantee (PCG)	Unconditional undertakings – Bank guarantees and insurance bonds	Cash Retention
Features	**Identity of the guarantor**: Given by the ultimate parent company or a parent company with satisfactory credit rating, independence and liquidity. **Cost:** Parent company's overheads and risk premium are charged to the contractor, which are then typically priced into the contact sum and passed through to the Principal. It is generally viewed that a PCG is easier and less costly to obtain than other forms of security **Wholistic guarantee:** Typically guarantees both financial and performance obligations of the contractor under the construction contract. **Financial Enhancement:** Bolsters the financial credibility of contractors that are subsidiary companies.	**Identity of the bond issuer:** Issued by a bank or insurance company with acceptable creditworthiness, as guided by NSW TC14-01. **Cost:** The bank / insurance company will charge a fee for providing the bank guarantee / insurance bond. The associated fee structure will vary. As an example, banks typically charge fee of between 1.25% and 1.75% of the guaranteed amount. A separate fee will be payable if any amounts are paid out under the guarantee. **Amount:** Typically, a percentage of the contract value depending on the size and risk profile of the project. The market standard is typically 5-10% of the contract value. For projects over c.$1.5 billion, it may trend down towards 5% of the contract value. An alternative approach is to require an amount which is sufficient to cover the Principal's potential financial exposure by reference to how quickly the Principal can act to step in and terminate in the event of contractor default, in particular contractor insolvency.	**Separate bank account:** The retention may be required to be kept in a separate bank account. **Cost:** Contractors may need to fund the gap created by not receiving the full payment, in which case this will be priced in to the contract sum. **Interest:** The parties should agree who is entitled to any interest paid while the retention is held **Amount:** The agreed percentage varies according to individual contract and project. Interim payment certificates should make clear the amount of retention held by the Principal. **Value:** The value of cash retention improves over time as the amount of cash retained accumulates.

	Parent Company Guarantee (PCG)	Unconditional undertakings – Bank guarantees and insurance bonds	Cash Retention
Features		The Principal's key financial exposure is being able to pay the costs of all subcontractors working on the project. The Principal may seek to size the amount of security by modelling the projected cashflow over the project lifecycle to understand the maximum exposure for this specific risk. Under this approach, the Principal may still need to cashflow its other financial exposures as the security amount may not be sufficient. If the Principal is concerned about ensuring all its potential exposure is covered (i.e. kept "whole"), the amount of bonding may also be sized to cover the Principal's costs during the period it is implementing mitigation strategies (such as stepping-in, terminating the contract or engaging another contractor). For example: » if a D&C contract contemplates a remedial period of 2 months prior to termination; and » the Principal anticipates that engaging a new contractor will take an additional 3 months, the Principal should seek bonding which is for an amount equivalent to the estimated potential financial impacts over the cumulative 5-month period.	

	Parent Company Guarantee (PCG)	Unconditional undertakings – Bank guarantees and insurance bonds	Cash Retention
Process of Calling Security	Involves escalating enforcement actions generally start initially with written notifications by the Principal and discussions with the contractor. If an agreement is not reached, enforcement action against the guarantor can involve lengthy litigation and arbitration.	The indemnity structure of unconditional undertakings should allow a Principal to claim directly against the financial institution or insurance company without first having to pursue the contractor or prove the contractor's breach (noting such a decision must be carefully considered as detailed in Chapter 4 above). In these instances, the Principal's representative can notify the relevant institution of its claim directly. The bank / insurance company will subsequently seek to recoup any amounts paid out directly against the contractor.	The Principal will be able to access the cash where the contractor fails to perform under the construction contract. The administration of any cash retentions will be set out in the construction contract. The financial institution which holds the relevant bank account may have certain requirements.
Providing Security	Provided at the time the construction contract is signed for the entire construction period and the defects liability. Typically, a condition precedent to contractual close to ensure the availability of contractual remedies for the Principal against the contractor if it fails to provide the security.	Should adopt a similar approach to that for PCGs. The contractor should be required to provide replacement security where the bank / insurance company no longer retains the required credit rating; and well in advance of any expiration (if applicable).	Security is provided progressively as a retention from the progressive payments to the contractor until the amount of the retention held is equivalent to the total amount of security required.
Release of security	Should be released when the contractor no longer has any liability under the contract.	Progressively released by the Principal on a step-down basis, at designated stages (i.e. once the contractor satisfactorily completes the activities required of them or reaches agreed milestones).	Should adopt a similar approach to that for unconditional undertakings.

Further considerations: Although this subject is not within the remit of the Guidance, contractors are increasingly requesting security to be provided by private-sector Principals on projects. It will typically be requested in scenarios where the Principal is allocated a significant level of risk associated with an element of the project (e.g. contamination, utilities etc.). In such instances, a contractor will be seeking protection where the Principal fails to fulfil its obligations under the contract. However, it is not standard practice across Government to provide this type of security and this generally only happens when there is risk that the Principal might default.

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