



File No. DOIA 1617-0674

18 JAN 2017

Mr Tom Henderson
fyi-request-5016-e740c4ae@requests.fyi.org.nz

Dear Tom

Thank you for your email of 28 November 2016 requesting for the following information under the Official Information Act 1982 (the Act):

I have been told that PwC has been commissioned to write a report with suggestions as to possible regulations regarding the changes to the Construction Contracts Act. Access to this would be very helpful as at this stage I am having to guess at to the scope of the regulations.

On 10 December 2016, you clarified your request to note:

It may have been KPMG who has written the report. I just wanted to clear this up and emphasise that the information I am looking at is any reports concerning the upcoming regulations.

Please find enclosed the report 'Contract Retentions – Construction Contracts Amendment Act 2015' which was prepared by KPMG for the Ministry of Business, Innovation and Employment (the Ministry). Some information has been withheld under the following sections of the Act:

- | | |
|-------------|---|
| s9(2)(a) | to protect the privacy of natural persons. |
| s9(2)(g)(i) | to maintain the effective conduct of public affairs through the free and frank expression of opinions by or between or to Ministers of the Crown or members of an organisation or officers and employees of any department or organisation in the course of their duty. |
| s18(c)(ii) | the making available of the information requested would constitute contempt of the House of Representatives. |

The advice contained within the requested report is currently before Parliament's Commerce Select Committee (the Committee) for examination while it considers the Regulatory Systems (Commercial Matters) Amendment Bill (the Bill). Only the evidence the Committee has received or heard on the Bill is currently available publicly. All of the Committee's other proceedings, including any advice the Ministry has provided to the Committee, remains strictly confidential until the Committee reports back to the House of Representatives on its examination of the Bill. Standing Order 239 of the House makes it clear that the House may treat as a contempt divulging the proceedings of a select committee contrary to the Standing Orders.

In terms of section 9(1) of the Act, I am satisfied that, in the circumstances, the decision to withhold certain information is not outweighed by other considerations that render it desirable to make this information available in the public interest.

You have the right under section 28(3) of the Act to ask the Ombudsman to investigate and review my decision. The relevant contact details are:

The Ombudsman
Office of the Ombudsman
PO Box 10 162
WELLINGTON 6143

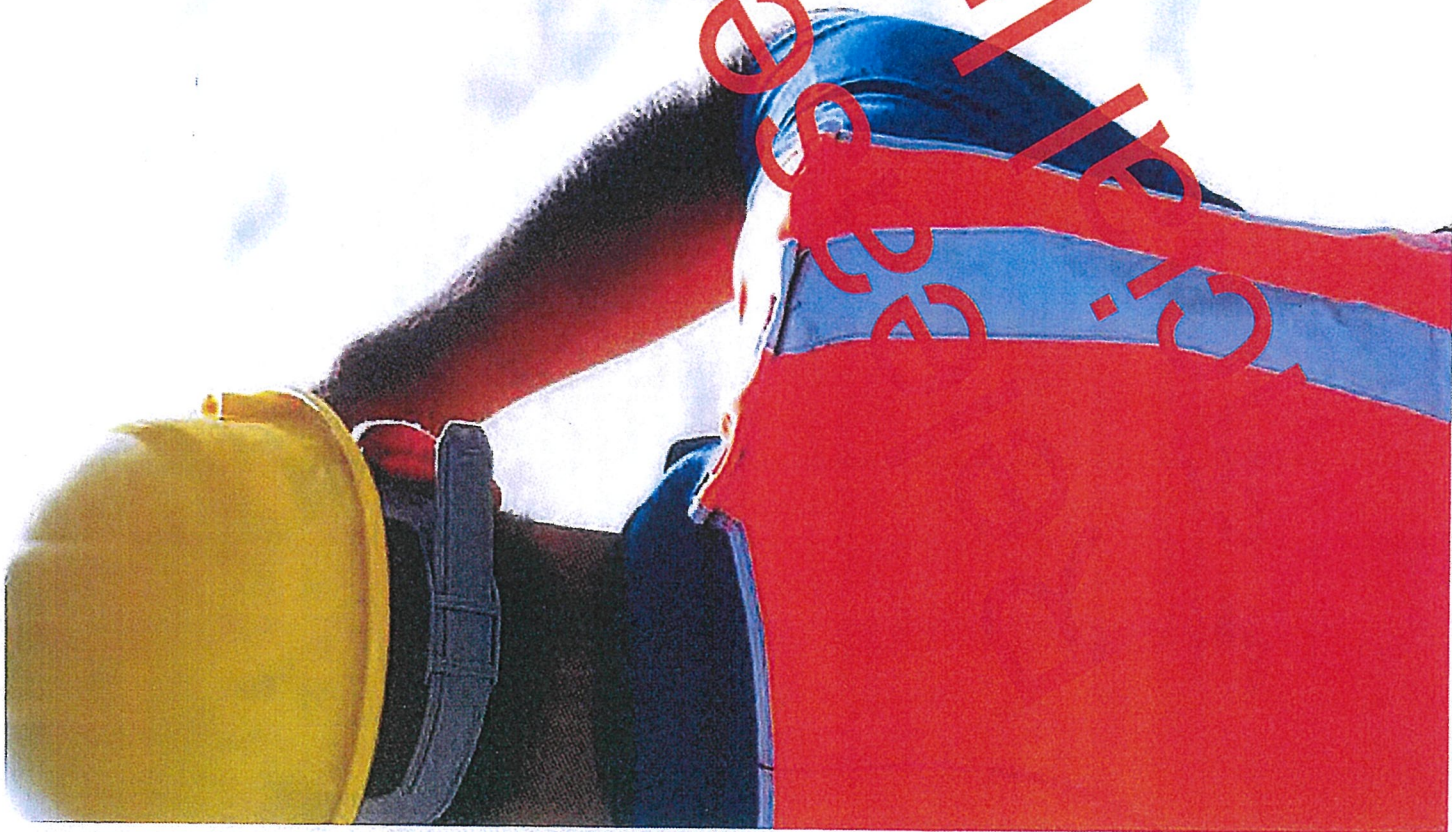
0800 802 602

www.ombudsman.parliament.nz

Yours sincerely

A handwritten signature in black ink that reads "Rachel Groves". The signature is written in a cursive, flowing style.

Rachel Groves
Manager, Building Policy Development
Building System Performance
Building, Resources and Markets



Contract Retentions

Construction Contracts Amendments Act 2015

10 October 2016

kpmg.com/nz



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Manager, Building Policy Development
Ministry of Business Development and Innovation
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10 October 2016

Dear Rachel

Contract retentions

In accordance with our consultancy services order dated 7 July 2016 and addendum dated 10 October 2016, we enclose our report in relation to the Construction Contracts Amendment Act 2015.

Our report is for the information of the Ministry of Business, Innovation and Employment ("MBIE") and we consent to it being made public if MBIE elects to publicise it on its website. The terms of reference for this report have been agreed by MBIE and we will not accept responsibility to any other party to whom the report may be shown or who may acquire a copy of the report.

If you have any questions regarding this report, please contact me.
Yours sincerely

s 9(2)(a)

Paul Herd
Partner

This report should not be regarded as suitable for use by any person other than by MBIE.

Our report was prepared solely for MBIE, in accordance with the specific terms of reference set out in our engagement letter with MBIE for no other purpose. Other than our responsibility to MBIE, KPMG (including its Partners, employees and agents) assumes no responsibility arising in any way from any claim, loss or damage caused by a third party on this report. Accordingly, KPMG expressly disclaims any and all liability for any loss or damage of whatever kind to any third party who chooses to act, or refrains from acting, in reliance on this report.

The information presented in this report is based on consultation with industry participants and publicly available information. We have indicated within the report the sources of the information provided. Unless otherwise stated, we have relied upon the truth, accuracy and completeness of any information provided, or made available to us, without independently verifying it. Accordingly, KPMG (including its Partners, employees and agents), accepts no responsibility for any such information being inaccurate, incomplete or unreliable or for any errors in the analysis, statements or opinions provided in this report based directly or indirectly on that information.

The report dated 10 October 2016 was prepared based on the information available at the time. KPMG have no obligation to update our report or revise the information contained therein due to events and transactions occurring subsequent to the date of the report.

Executive summary

Official
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Information
under the
Access to
Information Act

Background and methodology

Background and purpose of this report

- KPMG has been engaged to assist MBE to prepare advice to the Minister about what (if any) further methods of accounting for retention money should be prescribed in regulations, in order to reduce any uncertainty about ways of complying with the retention provisions of the Construction Contracts Amendment Act 2015 ("CCAA").
- The CCAA provides for the following key features in relation to retentions:
 - All money withheld by a party ("Party A") to a construction contract that is payable to another party ("Party B") as security for performance of Party A's obligations must be held on trust by Party A as trustee for the benefit of Party B;
 - Retention money may be held in the form of cash or other liquid assets that are readily converted into cash; and
 - Party A must keep proper accounting records of all retention money that correctly record all dealings and transactions, comply with the AP, and are readily and properly auditable.
- The advice is also intended to enable MBE to further understand the impact of the provisions on construction firms and other industry participants as set out in our scope below.

Sources and methodology

- Our engagement was of a limited nature and focused on ways to reduce uncertainty and compliance with the CCAA. In particular, we considered the following matters:
 - Compliance of industry feedback.
 - Messages set out in Appendix A for a detailed scope of the engagement.
 - Undertaking this engagement, we have sought views from a wide cross section of the industry, including construction companies (both head-contractors and sub-contractors), property developers, industry representative organisations, banks, law firms, accounting firms, and bonding and insurance companies.
 - Our report reflects a compilation of the feedback provided by industry participants, formal submissions provided to MBE, legal advice provided to KPMG by MBE and our views based on industry knowledge and research.
 - In this report, we have relied upon the truth, accuracy and completeness of any information provided by industry participants and other parties without independently verifying it. In particular, we have not undertaken any statistical or financial analysis regarding the estimated amount of retentions held, the economic impact of the CCAA or the ability of the industry to comply.

Contacts

The contact at KPMG in connection with this report is:

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Executive summary

Headlines

The industry was generally supportive of the intent of the CCAA, s 9(2)(g)(i), s 18(c)(ii)

s 9(2)(g)(i), s 18(c)(ii)

The legislation does not define liquid assets and provides no guidance or reference to s 9(2)(g), s 18(c)(ii)

Feedback provided suggests the industry believe that the intent of the CCAA has merit, but there is uncertainty regarding how the CCAA will apply in practice.

s 9(2)(g)(i), s 18(c)(ii)

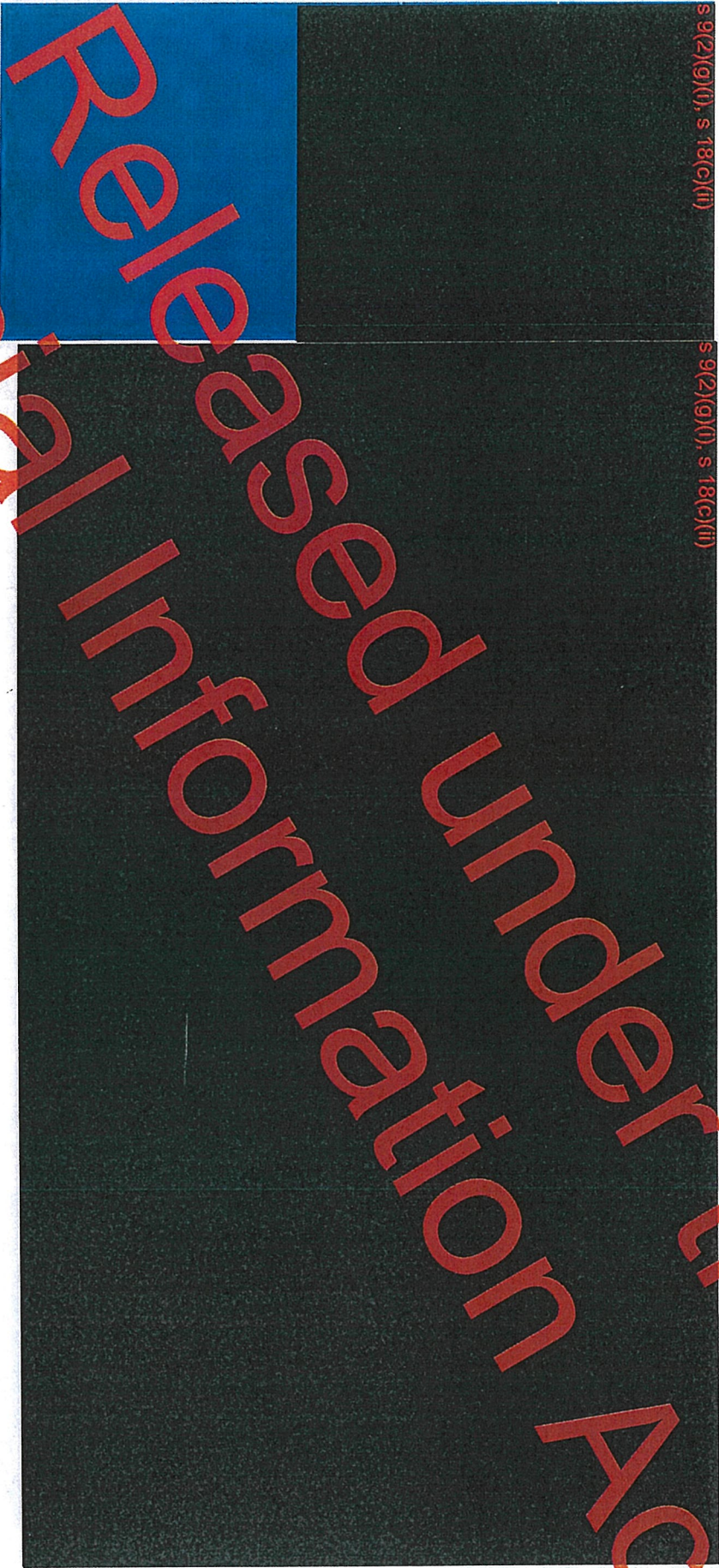
Official Information Act

Executive summary

Headlines

s 9(2)(g)(i), s 18(c)(ii)

s 9(2)(g)(i), s 18(c)(ii)



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Supporting analysis to key findings

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Background

Retentions are extensively used in the construction industry and are applied to most contracts.

- Retentions are used in the construction industry as a means to secure obligations under a construction contract. Retentions represent an amount deducted and withheld from each progress payment made to a contractor or subcontractor. The retention amount is typically calculated on a sliding scale and can represent as much as 10% of the total contract value (capped at specified levels). The retention is then released in two parts: 50% on practical completion; and 50% at the end of the defect liability period. In some instances, this may increase up to a two-year (or more) wait for the retention to be released. Retentions are prevalent throughout the construction industry and are applied to most contracts.
 - For contractors, there will typically be a difference between the value of upstream and downstream retentions, due to contract structuring and due to the extent of self-performance of the work of sub-contractors. Contractors indicated they received some working capital benefit from holding the net level of retentions, but this represents a small portion of their working capital funding. The primary purpose of retentions was to enforce performance obligations and ensure defects were remedied.
 - MBE estimates that the amount of retentions withheld in the industry could be between \$150 million and \$250 million. However, we note that PwC have estimated the amount as being as high as \$600 million. Based on retentions held by clients and contractors). We understand no statistical analysis has been undertaken to accurately quantify the amount of retentions held, so these amounts are high level estimates only.
 - Source: *Construction contracts, Regulatory Impact Statement No. 21, November 2014, "Retention rules come at a price", Lara Bennett (PwC), NZ Herald, 14 July 2016.*
- Legislative reform relating to the use of retentions was prompted by the collapse of the Mainzeal group of companies ("Mainzeal") in February 2013. At the date of collapse, Mainzeal owed creditors approximately \$169m of which \$18.3m (excl of GST) represented retentions. While there remains a prospect of a return to sub-contractors, at this stage we understand no payments have been made to sub-contractors towards their retention payments.
- Source: *Mainzeal Property and Construction Limited (in Receivership and Liquidation) and Mainzeal Living Limited (in Receivership and Liquidation), Receivers 1st and 5th report and Liquidators' reports.*

Supporting analysis to key findings

Background

Retentions are extensively used in the construction industry and are applied to most contracts.

- Retentions are a common and long-standing practice in the industry and the Mainzeal collapse highlighted a number of issues relating to their use. In particular:
 - The risks of non-payment to sub-contractors in the event of insolvency;
 - The high rate of insolvency in the construction market, which creates a high risk of loss of retentions for subcontractors impacting growth and productivity in the industry;
 - That retentions are used as working capital by some contractors enabling under capitalised businesses to tender for work they are not adequately capitalised to undertake and supporting other poor practices, such as low price tendering and
 - While the Construction Contracts Act 2003 ("the Act") banned the use of "pay when paid clauses", clients and head contractors often delay payment of retentions, which are not legally prohibited by the Act.
Source: Cabinet Paper, Legislative solutions to issues relating to the use of retentions in the construction market.
- On 22 October 2015, Parliament passed the CCAA, which will impose a trust obligation on retention money held in the construction industry. The legislation will require firms to ensure that clients and head contractors no longer use retention money as a means of transferring business risk to subcontractors.
Source: Cabinet Paper, Legislative solutions to issues relating to the use of retentions in the construction market.
- MySBE asked us to prepare advice on the basis that the CCAA will apply to all retention money withheld under a commercial construction contract from the commencement date regardless of when the retention money was withheld.

Summary of industry feedback

s 9(2)(g)(i), s 18(c)(ii)

What is the current state of the market?

- The construction industry is facing unprecedented levels of activity due to the Christchurch rebuild, increased levels of infrastructure investment, and residential and commercial building development in Auckland. This is putting significant strain on the industry's economic resources and capacity to deliver projects.

What is the level of support for the CCAA?

- Most industry participants were supportive of measures to provide greater security to contractors and sub-contractors in the event of insolvency.

s 9(2)(g)(i), s 18(c)(ii)

Source: Retentions in construction contracts regulatory impact statement, 21 November 2014, [Retentions in construction contracts regulatory impact statement](#), 21 November 2014.

- One of the features of the CCAA is the requirement for all parties to a Construction Contract (as defined by the Act) to hold retention monies on trust in the form of cash or other liquid assets. Accordingly, retention monies must be held on trust for each layer of contracting arrangements, even if the actual amount of retention money at risk through the project is considerably less. The industry may seek to adopt different models to mitigate

s 9(2)(g)(i), s 18(c)(ii)

Are there alternatives to the use of retentions?

- It was not seen as practicable or likely that retentions would cease to exist. There were varying views as to whether alternatives would be used i.e. performance bonds and funds in lieu of retentions. At present, bonds are typically used only until practical completion (for those companies who have sufficient capital) and not for the defects liability period. In addition, contracts will often utilise retentions as well as performance bonding. Please refer to page 20 for information regarding other options.

s 9(2)(g)(i), s 18(c)(ii)

Supporting analysis to key findings

Summary of industry feedback

s 9(2)(g)(i), s 18(c)(ii)

s 9(2)(g)(i), s 18(c)(ii)

noting that there is no specific enforcement regime and penalties provided for under the CCAA.

s 9(2)(g)(i), s 18(c)(ii)

Summary of industry feedback

The industry would benefit from greater clarity over a number of features of the CCAA.

s 9(2)(g)(i), s 18(c)(ii)

— There was a wide range of views and confusion from the industry regarding the interpretation and implementation of the CCAA. The industry would benefit from further clarity around a number of areas (refer to the headings section of the report). Some of the questions and areas of confusion regarding the CCAA, related to:

s 9(2)(g)(i), s 18(c)(ii)

- how liquid assets are placed 'to trust' and what legal documentation (if any) is required to put liquid assets on trust;
- what are the requirements of directors of companies with regard to compliance with the CCAA and administering the liquid assets on trust;
- what are the penalties and implications of non-compliance for directors of companies, particularly in the event of insolvency;
- the trust regime enforced by any independent body, or what it should be subject to the dispute resolution procedures under the Act;
- is there any requirement for the trust records to be audited; and
- who administers the trust in the event of insolvency, how would the insolvency practitioner be remunerated for administering the trust and what risks would the trust administrator face in doing so, and what requirements.

s 9(2)(g)(i), s 18(c)(ii)

Supporting analysis to key findings

Summary of industry feedback

s 18(c)(ii), s 9(2)(g)(i)

s 9(2)(g)(i), s 18(c)(ii)

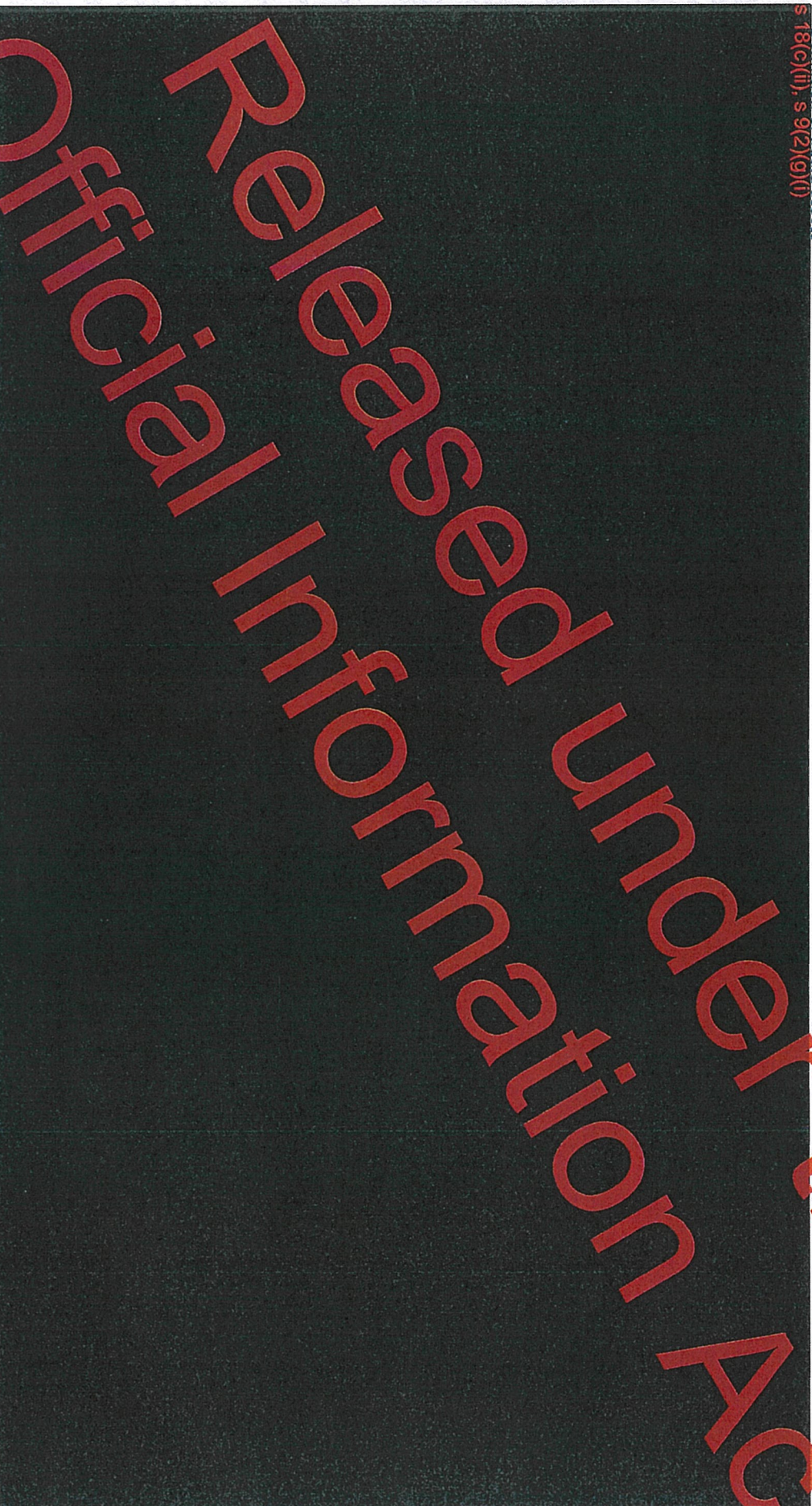
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Supporting analysis to key findings

Liquid assets

Definition of liquid assets
s 18(c)(ii), s 9(2)(g)(i)



Supporting analysis to key findings

Liquid assets

s 9(2)(g)(i), s 18(c)(ii)

s 9(2)(g)(i), s 18(c)(iii)

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Supporting analysis to key findings

Liquid assets

s 18(c)(iii), s 9(2)(g)(i)

s 18(c)(iii), s 9(2)(g)(i)

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Supporting analysis to key findings

Liquid assets

[Redacted content]

s 18(c)(ii), s 9(2)(g)(i)

s 9(2)(g)(i), s 18(c)(ii)

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Supporting analysis to key findings

Liquid assets

Further feedback was provided by industry participants regarding possible solutions to assist the industry comply with the CCAA.

s 18(9)(ii), s 9(2)(g)(i)

s 9(2)(g)

Accounting requirements

NZ GAAP is an accounting framework specifying a certain accounting policies.

s 9(2)(g)(i), s 18(c)(ii)

Applicability of NZ GAAP

— The Companies Act 1993 and Financial Reporting Act 2013 requires companies to meet specific criteria to prepare financial statements that comply with NZ GAAP. All other companies may prepare special purpose financial statements that comply with accounting policies determined by the directors or for the purposes of meeting tax compliance obligations or financing requirements. NZ GAAP is an accounting framework mandated by the External Reporting Board for profit, not-for-profit and public sector entities. Other entities such as trusts, incorporated societies and partnerships have varying financial reporting requirements; however, for simplicity, we have only commented on the regime for companies.

— The CCAA requires accounting records to be kept which comply with GAAP.

s 9(2)(g)(i), s 18(c)(ii)

— One further requirement of the CCAA is that records must be 'ready and properly auditable'.

s 9(2)(g)(i), s 18(c)(ii)

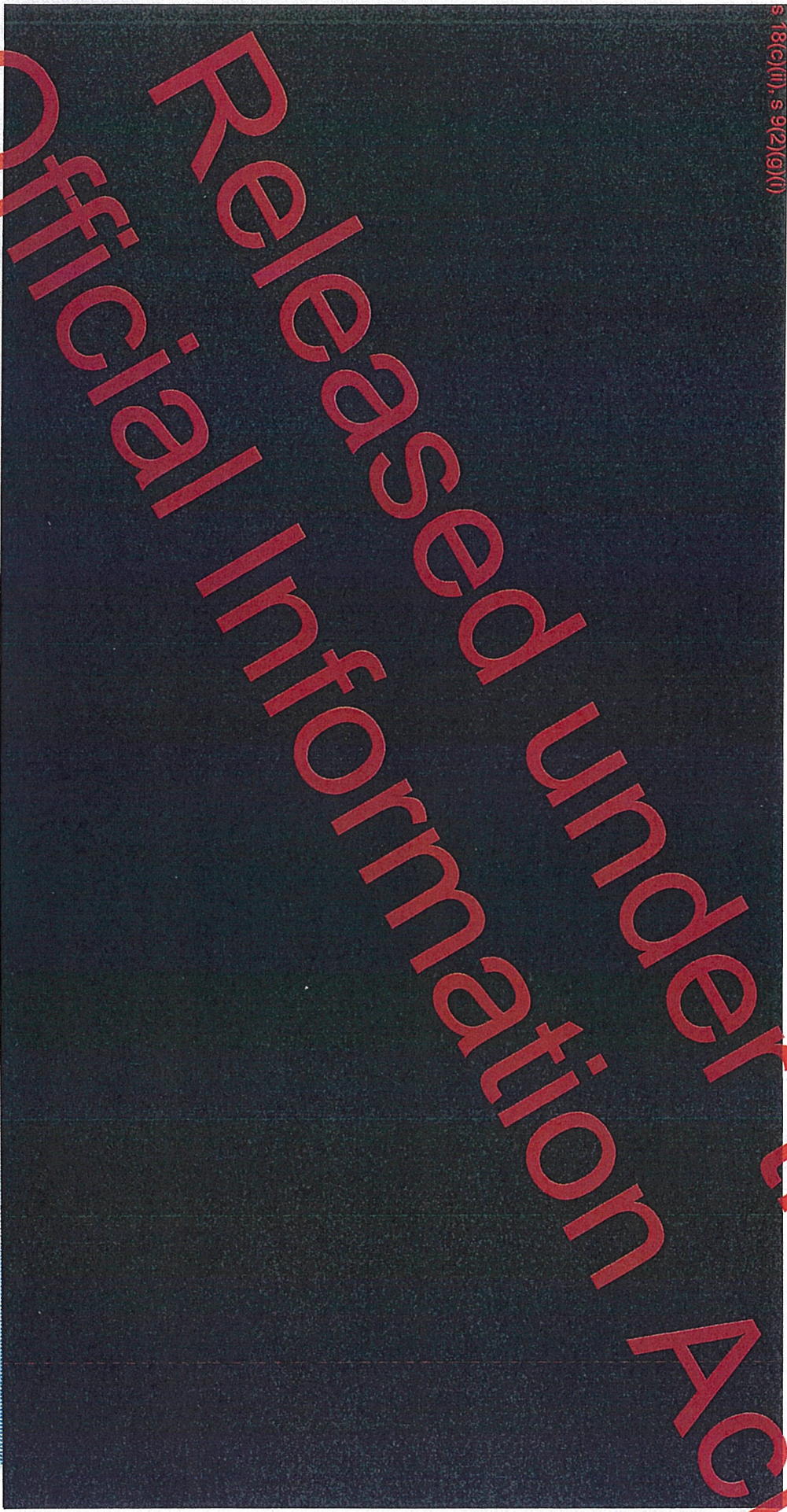
Reporting and inspection of records

Under the CCAA, parties must make accounting records relating to retention money available for inspection at all reasonable times.

s 9(2)(g)(i), s 18(c)(ii)

Supporting analysis to key findings
Reporting requirements

s 18(c)(ii), s 9(2)(g)(i)



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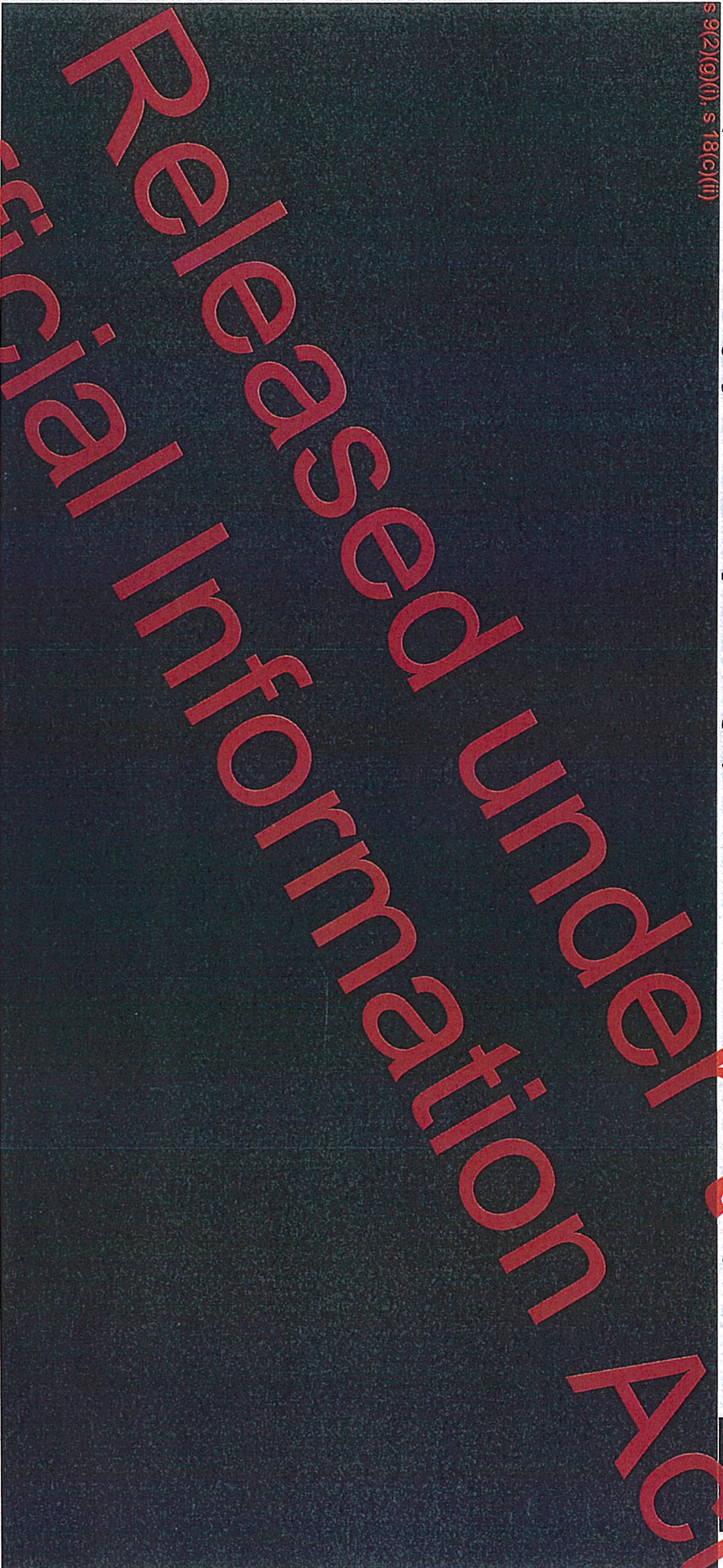
Appendix

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SCOPE

MBLE is responsible for introducing regulations concerning the accounting requirements, the de minimis amount, and the rate of penalty interest.

s 9(2)(g)(i); s 18(c)(ii)



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