A critical review of risk in the New Zealand construction market

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BELL GULLY

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Introduction

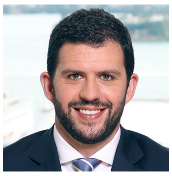
The need for fair risk allocation in commercial construction contracts has become a hot topic. The commonly applied theory that risk should be 'allocated to the party best placed to bear it' does not automatically create fair risk allocation in practice. To achieve objectively fair risk allocation it's necessary to allocate risk project-by-project in a realistic, transparent and informed way.

In the public debate there is a sharp focus on the part risk allocation has played in the current state of the construction industry. However, to pin the woes of the industry exclusively on unfair risk allocation in construction contracts is in itself illustrative of the actual fundamental problem: poor market behaviours characterised by adversarial dealings, short term self-interest and lack of self-accountability.

There are a number of options and initiatives for mitigating and allocating risk, both at an industry and project-specific level. These options must be carefully assessed to ensure reform and improvement is directed where it is most effective.

These ideas are explored in a series of three articles authored by Bell Gully construction expert Ian Becke alongside Glen Heath - CEO and general counsel at Mansons TCLM, David Jewell - owner/director of BondCM, Craig Wheatley - head of legal at HEB Construction, and Krista Payne - partner at law firm Ashurst.

The authors



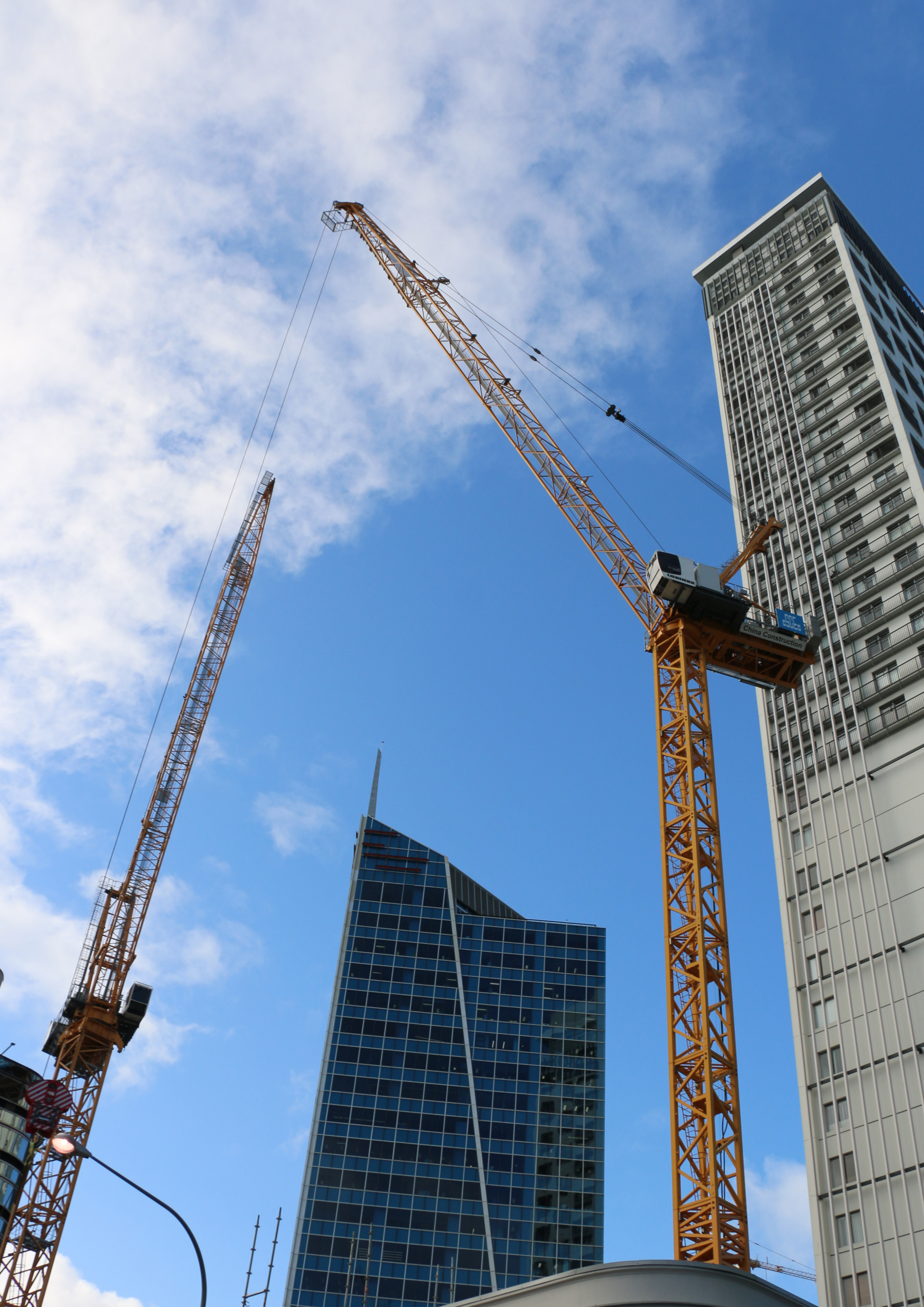
Ian Becke is a partner in Bell Gully's Projects and Real Estate team. He has acted for private and public sector clients, including all levels of government in both New Zealand and Australia, on a variety of major projects and real estate transactions since 2007. He advises on construction contracts, infrastructure projects and property development projects across a wide range of industry sectors. Having acted for many different project participants Ian thoroughly understands competing perspectives and context and is adept at finding best-for-project solutions.

Glen Heath is the CEO and general counsel of Mansons TCLM. Mansons is New Zealand's most pre-eminent commercial office developer, having successfully developed over NZ$1 billion of commercial office buildings in Auckland. Mansons is currently undertaking a number of premium grade office developments in Wynyard Quarter, Parnell and the Auckland CBD. Mansons performs the role of both developer and main contractor, providing Glen a unique perspective on the current contracting market.

David Jewell is an owner/director of BondCM. He and his team of senior professional engineers and quantity surveyors who have extensive construction contracting experience provide specialist advisory services to infrastructure owners on the commercial and contractual aspects of major projects. David has more than 35 years' of experience in construction contracting in New Zealand and Asia. Prior to joining BondCM, David was the general manager of infrastructure at Fletcher Construction.

Craig Wheatley is the head of legal at HEB Construction. HEB has been in the construction business in New Zealand for 35 years and is actively involved in some of New Zealand's largest infrastructure projects, including the Transmission Gully motorway, the new Manawatu Gorge replacement route and the construction of a new wharf at Napier Port. Prior to joining HEB, Craig was principal legal counsel at Downer where he advised on some of New Zealand's largest infrastructure projects including the Link Alliance's successful bid for the City Rail Link 'C3' alliance contract.

Krista Payne is a partner in the projects team at Ashurst with extensive infrastructure and construction experience in both the UK and Australia. While in London, she advised on the £4bn Thames Tideway Tunnel, Silvertown Tunnel Project (ongoing) and various waste-to-energy projects. She is currently working on some of the largest transport infrastructure projects in Australia, including the Sydney Metro City and Southwest Project and the Second Sydney Airport.


China Construction

The meaning and contestability of fair risk allocation

IN COMMERCIAL CONTRACTING

The need for fair risk allocation in commercial construction contracts has become a hot topic. High-profile contractor insolvencies and financial losses – and an apparent inability to properly capitalise on the construction 'bull market' – have led the construction industry to take a long, hard look at itself.

At the core of this introspection, a focus on contracting practices is emerging. Who is being asked to bear what risk under the contract and is this fair? Undeniably, principals have tended to shift as much risk as possible to contractors and up until recently a number of contractors have been willing to accept this. It would seem, for some contractors, the approach is to proceed on the basis that the risk can be scoped, priced and managed, and profits made, or they have not properly appraised the true nature and extent of the risk they are being asked to take on. In New Zealand's dynamic and varied contracting market, with differing approaches and risk appetites among contractors (at least until recently), the question of what constitutes fair risk allocation in the current market is not easily answered.

The theory of fair risk allocation

In the context of a construction project, a risk is an uncertain event or set of circumstances which, if it occurs, will have an effect on the achievement of one or more of the project's objectives. In other words, so long as there is uncertainty, there is risk. Common project risks include weather, ground conditions, labour markets, defective work or materials, inadequate design, incorrect estimating, incorrect programming and natural disasters. Inevitably, there are also additional project-specific risks. The consequences of such risks are realised in the contract works themselves (for example, through defects), the time for completion of the contract works and the amount payable for the contract works.

The current debate is about which party should bear responsibility for identifying, managing and mitigating such risks and which party should bear the consequences of those risks.

In 1973, internationally recognised construction law expert Max Abrahamson published what became known as the 'Abrahamson Principles'. The Abrahamson Principles state that to achieve a fair and equitable allocation of risk in a construction project, a risk should be allocated to a party if:

- the risk is within the party's control;
- the party can transfer the risk (for example, through insurance) and it is economical to deal with the risk in this way;
- the main economic benefit of controlling the risk accrues to the party;
- it is in the interests of efficiency to place the risk on the party; and/or

when the risk occurs, the loss falls on the party in the first instance and, applying the preceding principles, there is no basis to transfer the loss to the other party (or it is impractical to do so).

It is from these principles that the ubiquitous statement 'the risk should be borne by the party best placed to bear it' is derived. This statement is often held out as the barometer of fair risk allocation in a construction contract. Although many standard form construction contracts bear the hallmarks of the Abrahamson Principles, the Principles are only a theoretical framework which is not necessarily suited to each project or project participant. A party may be best placed to control and manage a risk, but this does not mean allocating the risk to that party is fair.

"This pure approach to risk allocation in relation to all risks in a contract can often be difficult in practice for contracting parties," says Krista Payne, partner at global law firm Ashurst. She notes "this difficulty can result from a variety of factors, including:

- the ability of parties to accurately price risk;
- questions regarding best value for money and how to achieve the best project outcomes;
- corporate policies regarding acceptable risk allocation;
- risk around setting market precedents;
- competition in procurements (or shortage of work) creating pressure to accept certain risks;
- the alignment between the scope or likelihood of the risks being taken and the pricing structure for a contract; and
- availability of expertise and capacity within principals to manage certain risks."

> " The current debate is about which party should bear responsibility for identifying, managing and mitigating such risks and which party should bear the consequences of those risks.

Achieving fair risk allocation in practice

Fairness is, by definition, an inherently personal concept. Glen Heath, CEO and general counsel of Mansons TCLM, says fairness is subjective and will mean different things to each party to the contract. "The only real, objective fairness is that each party considers that the contract is fair from their own respective perspective," he suggests. "Each party endeavours to achieve a balance of the various components of the contractual matrix that they consider is palatable and fair to them."

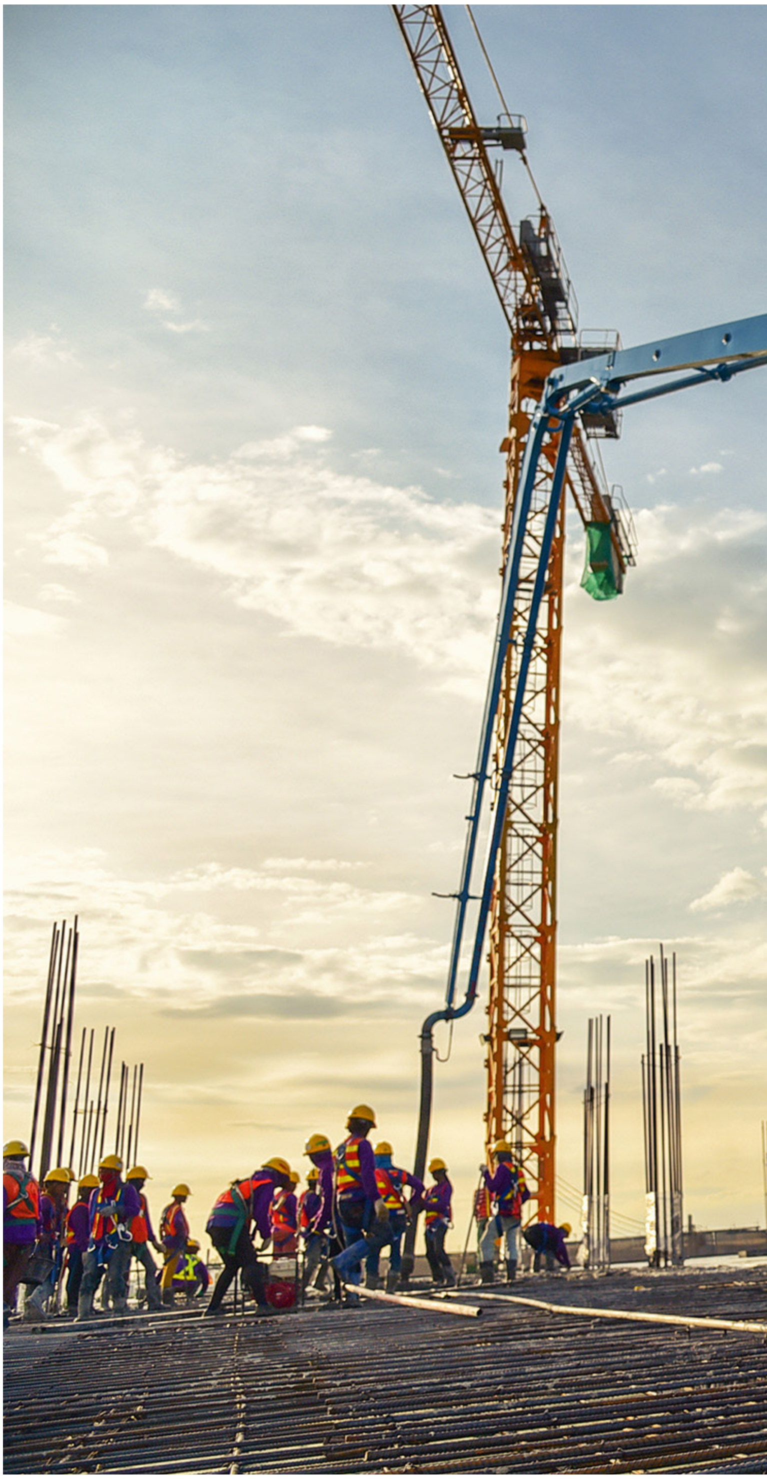
Glen makes the point that it is when the respective counterparty assessments of risk allocation are compatible that mutual benefits often flow. "The best outcomes are achieved when the parties' risk sensitivities are compatible, that is, each party places different levels of importance on different aspects, enabling them to each receive and provide what is important to them," he says. "For example, quality may be more important than price to the particular developer, and the contractor has confidence in its quality so is comfortable agreeing to more extensive warranties in return for higher margins."

Consistent with Glen's views, Craig Wheatley, head of legal at HEB Construction, believes that properly understanding the drivers and environment of the other party is key to achieving fair risk allocation. On the contractor side, this means recognising that the principal wants an asset built to a high-standard, on time and on budget, and so satisfying its stakeholders. On the principal side, this means recognising that the contractor is trying to make a reasonable profit. After all, deriving a fair profit in return for their services "is why construction companies exist", he points out.

So what does this realism look like in practice? According to Craig, it is predicated on not asking for more than what you know should be obtained. "If you're a principal, don't (for example) request 30-year guarantees on certain items when those are only given in certain niche markets overseas," he offers. "On the security side, don't include onerous requirements around performance bonds when you know that New Zealand banks (there aren't many) won't accept them. Don't throw around inflated liquidated damages figures that can't be backed up."

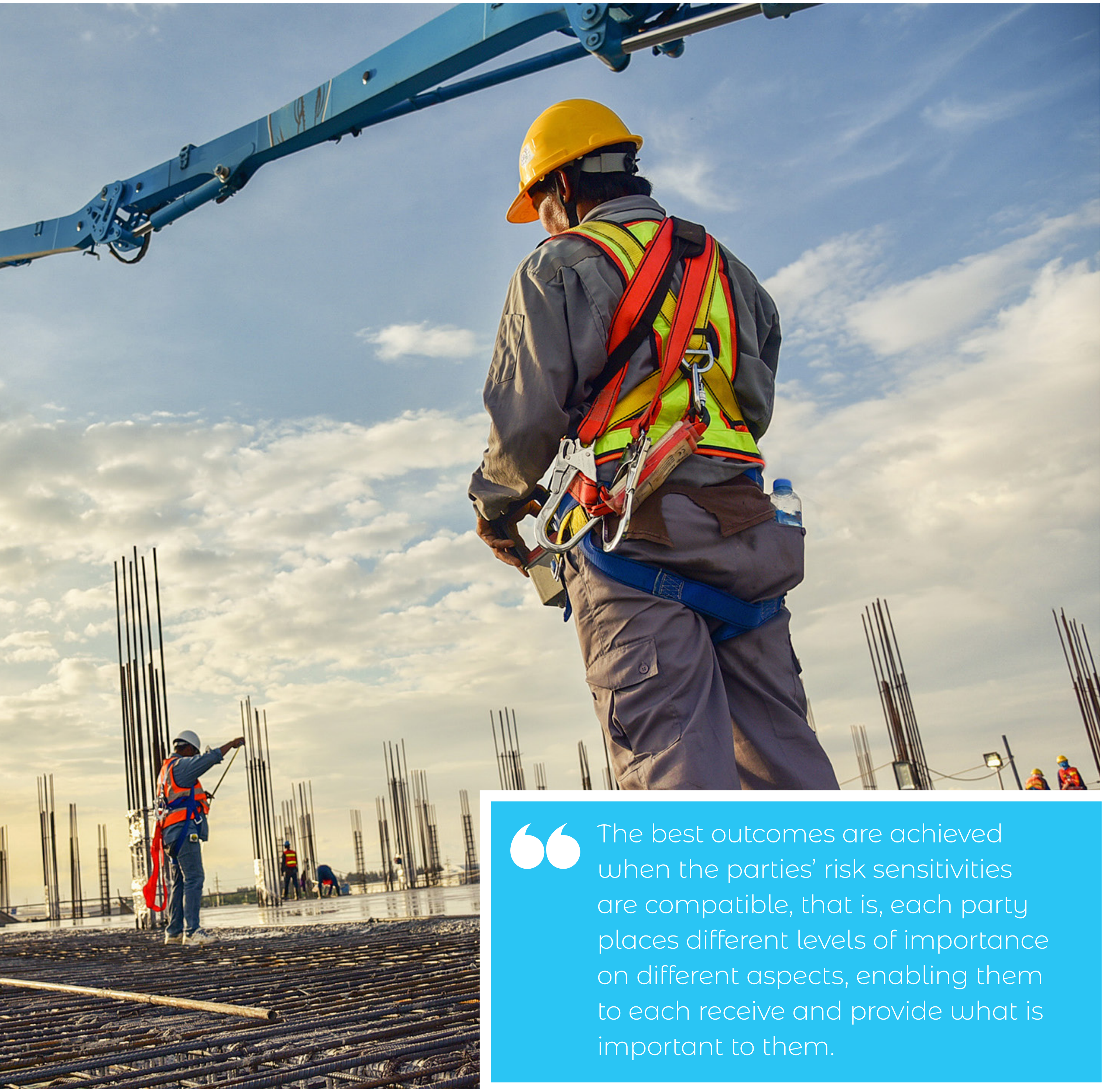
The same concept applies to contractors, says Craig. "Yes, you want to make a margin, but don't push for terms that you wouldn't entertain if you were on the other side of the table. Don't request months to lodge a variation or extension of time claim when you know that you have the resources available to comfortably prepare them in a couple of weeks. Be realistic around the defects periods you are proposing…".

As discussed in the next section of this article, there have been some positive changes in the industry in recent times. Of course, change takes time and we still often observe principals pressing for a full risk pass-through on a fixed price basis. Notably there is also increased resistance from contractors to take on certain risks, in some cases to such an extent that the contractor position is unlikely to ever be accepted by a prudent principal. In order to overcome these types of behaviours, and to embolden principals and contractors alike to adopt realism and pragmatism, a change in industry mind-set and approach is required.



Changing entrenched positions

At Bell Gully, we act on a range of infrastructure and construction projects for both public and private sector clients. This allows us a wide perspective on market behaviours and sentiment. As noted in the preceding section of this article, some conduct is still adversarial in nature, but it is clear that entrenched positional attitudes are beginning to soften at least in some quarters. Similar observations have been made by others in the market.



> The best outcomes are achieved when the parties' risk sensitivities are compatible, that is, each party places different levels of importance on different aspects, enabling them to each receive and provide what is important to them.

Part of this is no doubt due to increased and better quality contractor engagement in contractual negotiations. This includes more appropriate use of internal or external legal advice, better internal governance and an unwillingness (or indeed inability) to depart from board-imposed commercial rules of engagement. In turn, this has resulted in principals no longer being able to push the boat out on risk allocation if they want to receive tenders from reputable contractors or, in some cases, if they want to get their projects out of the ground at all.

Other initiatives, such as the 2018 Entwine Report and the industry-led Construction Sector Accord, are beginning to resonate in the market and will hopefully drive significant change in a range of ways. We are noticing evidence of the public sector's commitment to move away from lowest price procurement, in line with the Accord principles and consistent with the impending application of the new edition of the Government Procurement Rules from October 1.

David Jewell, director and owner of BondCM, considers such a change in approach critical to fair risk allocation. He

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says giving the contractor the opportunity to include a fair value for the risks it is carrying in the contract price is a very important part of the process. "Too often we see this process become part of a price competition, and it leads to under-valuation of risk, mostly due to over-optimism on the part of the contractor."

Constructive thinking around the prevalence and suitability of NZS3910:2013 and the use of special conditions is another indicator of growing market maturity and openness. Resolving the debate currently swirling around NZS3910 (including in the Infrastructure Transaction Unit's recent report on the use of NZS Conditions of Contract), is a condition precedent to achieving real harmony between contractors and principals and, therefore, fairer risk allocation and better project outcomes.

It is not within the scope of this article to delve into this debate, suffice to say that in our view any desire to throw the NZS3910 'baby out with the bathwater' needs to be tempered by the reality that a standard form contract can't be everything to everyone. A universally applicable standard form contract isn't realistic. Rather, we need a contract which is up-to-date, user-friendly, and principles-based so as to enable flexible application or additional prescription, where required, through the use of special conditions. Most importantly, we need a contract that facilitates better behaviour from project participants.

In the last 12 months we have been involved in a number of projects where the parties have engaged early and openly in conversation to try and appreciate different perspectives and risk sensitivity. This is the compatibility that Glen identifies as being key to fair risk allocation, and David agrees: "A fair risk allocation can only occur after the contracting parties are given the opportunity to have genuine conversations about the particular risks in a specific contract, and to also discuss the terms and conditions of the contract before they are finalised. This leads to agreed strategies to mitigate risks, and an open conversation about which party is best able to manage the residual risks."

David points out that these types of conversations happen in the infrastructure sector where the alliance model is used, or in negotiated Early Contractor Involvement (ECI) contracts. We have recently been involved in build-only contracts which, unusually, adopted a similar process.

From the foundations up

When we look at successful projects – in spite of everything, there are still quite a few out there – the common elements are alignment of objectives and intent, transparency in all dealings and appropriately tailored risk allocation which is properly understood. This is captured by one of the four key guiding principles of the Accord: 'build trusting relationships'.

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Mansons TCLM has the unusual perspective of being both a commercial property developer and a main contractor, giving it deep insights into the subcontracting market which is the engine room of the industry. It is at this level that trust needs to be set, and fostered, in order to permeate the upper contracting tiers. Glen explains that Mansons' success is contingent on trusted relationships with its subcontractors, built up over multiple projects.

"We typically don't utilise retentions regimes, rarely have liquidated damages except for only the more substantial packages (for example façade), and have a rigorous policy of paying everyone on time with any disputes resolved before due date. Treating subcontractors fairly results in better performance and pricing for us as the head contractor" he says. Although the risks associated with a subcontract are different to that of a head contract, the fact that such an approach can work at any level in the current market suggests that there is value to be found in resetting the adversarial principal-contractor dialogue.

Where to from here?

Our view is that together we need to move away from the oft-quoted and poorly understood catch-phrase of 'the risk should be borne by the party best placed to bear it' and, as Krista says, acknowledge as an industry that "care should be taken before reaching this conclusion that a contract is unfair for an individual contract. Each contract and project is likely to have a complex factual context that impacts on whether this pure approach to fair risk allocation is appropriate and 'fair' in all circumstances".

Across the industry we have the experience and capability to be more nuanced, pragmatic and even innovative in the way we approach risk allocation, and we can do this efficiently. We should be prepared to consider bespoke solutions where appropriate, including amending standard form contracts if required to ensure the mutual intention of the parties is clearly articulated and understood.

As Craig opines, "It has been frustrating ... (as a New Zealander as well as a construction lawyer) because if we got our approach to these contracts right we would be delivering better projects and enhancing our country's reputation both locally and internationally." There is certainly room for improvement.

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Is unfair risk allocation really to blame?

UNDERSTANDING THE CURRENT STATE OF THE CONSTRUCTION INDUSTRY

Aided by the views of our panellists, we concluded that the theory that risk should be 'allocated to the party best placed to bear' does not automatically create fair risk allocation in practice.

To achieve objectively fair risk allocation, it is necessary to move beyond a blanket application of the Abrahamson principles and look at risk allocation project by project in a realistic, transparent and informed way.

Given the current dynamics at play in the market, this necessarily requires a resetting of behaviours. There are some good initiatives that are already underway in this space.

The purpose of this article is to test whether the current state of the industry has primarily resulted from a collective failure to fairly allocate risk, or whether other factors are also culpable to a greater or lesser degree. This is particularly pertinent because of the sharp focus on risk allocation in the current public debate about the state of the construction industry.

What is the current state of the market?

Perhaps if anything to do with the construction market is beyond contention, it is that the industry is in a poor state of health, characterised by failed projects, delayed projects, insolvent contractors and unpaid subcontractors. A lot of the pain has been felt by those in the middle of the market: Ebert Construction, Arrow International, Accent On, Corbel Construction, Stanley Group and others. To the outside observer, there is an obvious question: how can this be happening in what appears to be a bull market? There is clearly more than enough work to go around and basic economic theory suggests that demand should equal profit.

The pain is not isolated to the vertical building market. In the infrastructure sector, David Jewell, director and owner of BondCM, observes that "while the failures in the commercial building sector have in some instances been high profile, there are signs of trouble in the infrastructure sector as well, albeit less visible. Many large civil projects are currently failing to meet their financial targets, and while there is no current evidence that the construction companies themselves are failing, these project losses and overruns are of concern to clients and contractors alike."

Interestingly, similar dynamics are being experienced across the ditch in Australia. Krista Payne, partner at global law firm Ashurst, notes that in spite of the record levels of government commitment to infrastructure spend, it is still difficult for some contractors to turn a profit. "There is much talk about a "profitless boom" and some of the big players are losing money on key projects", says Krista. "This outcome is seemingly counter-intuitive as the volume of work should mean there is plenty of work to go around, which should reduce competition and enable contractors to price work at a higher level to when there is only a handful of projects in the market."

Of course, not all market participants fare the same when presented with similar market conditions explains Craig Wheatley, head of legal at HEB Construction. "Yes, we have seen some high-profile projects run into trouble, but there have been many more medium to large jobs that have gone very well. In Auckland for instance, with the CRL group of projects many contractors and subcontractors are experiencing periods of unprecedented growth. What can't be denied though is that we are seeing higher than average rates of SMEs in the construction industry struggle."

Is it all down to unfair risk allocation?

Undoubtedly principals have successfully sought to allocate considerable project risks to contractors over the last decade or so. Combine this with a predisposition on the part of many principals to favour lowest price bids and it is unsurprising that losses are being realised at all levels of the contracting chain. "In the last decade we have seen main contractors presented with extremely onerous provisions by both public and private clients," says Craig. "This has often led to some of those risks being passed down to parties ill-equipped to handle them (like small subcontractors and suppliers) and we have seen some disastrous consequences arising from that."

A similar view is shared by Glen Heath, CEO and general counsel at Mansons TCLM: "I think unfair risk allocation is one of the biggest contributors to the poor current state of the New Zealand construction industry. And banks, head contractors and developers are all to blame. Head contractors create the expectation in developers that the developer can get these developer-favourable terms (because they've all been agreeing to them!), developers can't resist the natural temptation to take the best terms on offer regardless of the wider impact on the specific project or subsequent projects (which are affected if contractors fail), and banks actually insist on such terms as a condition of the development funding."

For all the rhetoric in the market about principals (and, in particular, public sector principals) being responsible for unfair risk allocation, risk allocation is not effected via a unilateral process. A construction contract allocates a risk to a party by making that party responsible for particular consequences which arise if that risk eventuates. But that allocation only becomes effective once a party accepts the risk by executing the construction contract and binding itself to the terms of that contract. Simply providing in a construction contract that a party to a contract will be responsible for the consequences of an uncertain event arising does not of itself create manifest unfairness.

In the world of commercial contracting, where considerations of undue influence, duress, unconscionable conduct and the law of consumer rights are generally absent, it is incumbent on each party to make sure it properly scopes and understands each risk allocated to it. A prudent party should only accept a risk if it accepts the consequences of that risk on an informed basis. If the commercial drivers of a party are such that it is willing to accept an unwise risk allocation, it does not wash to later point the finger at the counterparty. Primacy has to

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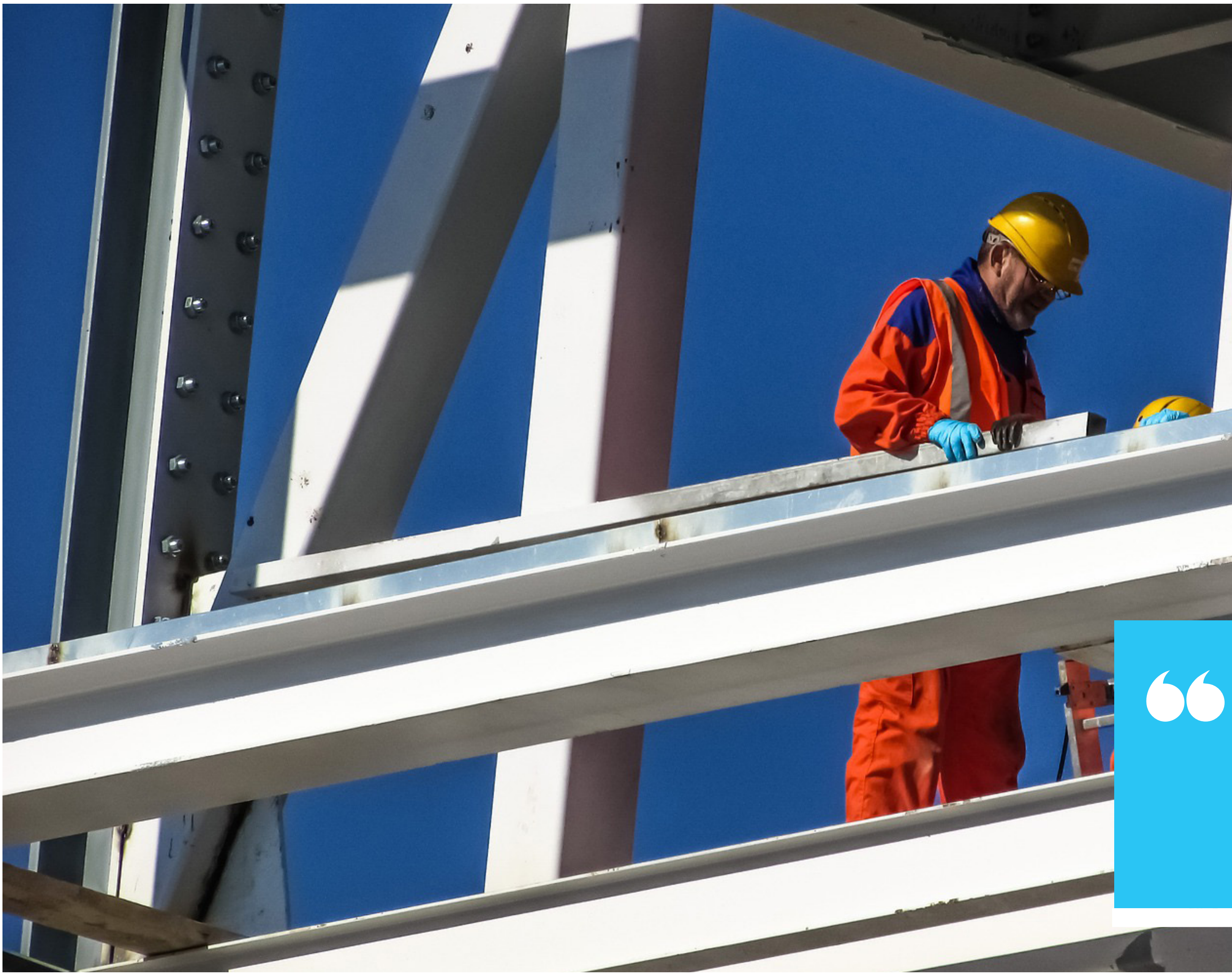
Of course, if a significant number of project sponsors are only ever prepared to contract on terms which are essentially 'risk free' it will force the hand of the contracting market – either bid on our terms or do not bid at all. Contractors depend upon winning construction contracts in order to generate revenue and derive profit (in that order). In turn, subcontractors depend upon the main contractor to win contracts in order to award subcontracts and so keep the entire contracting ecosystem alive. If a contract is awarded primarily on the basis of price, then this amplifies the potential for greater loss to be passed through. Risk and loss wind their way hand-in-hand down the contracting chain.

In this environment, better quality contractor participation in contractual negotiations and increased rigour in the assessment and acceptance of risk by contractors at all levels is critical. Smart principals are responding in kind, recognising that building a trusting relationship with the contracting market is a must if they want a successful project now, or to have

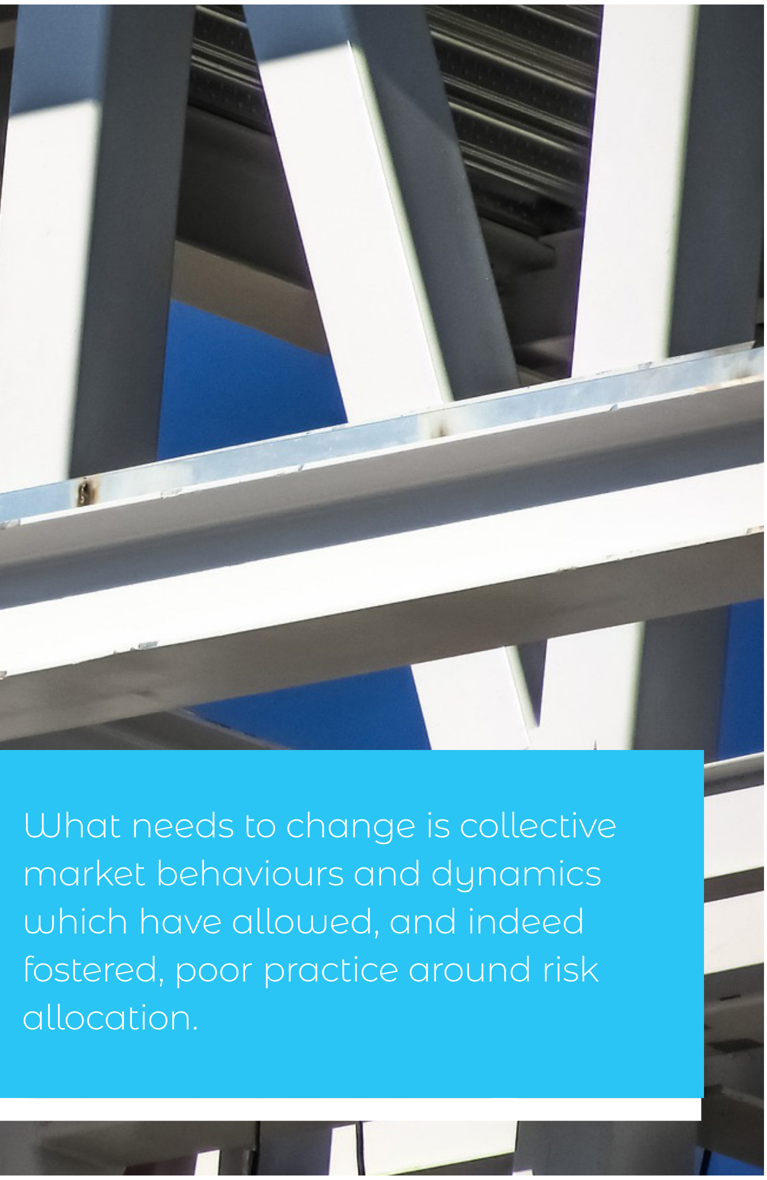


successful tenders in the future. Arguably (and hopefully) the penny seems to have dropped that what needs to change is collective market behaviours and dynamics which have allowed, and indeed fostered, poor practice around risk allocation.

Insufficient profit and poor pricing practices

In its recent report on NZS Conditions of Contract, the Infrastructure Transactions Unit highlighted a perception in the market that the public sector does not properly understand the difference between lowest value and value for money procurement. The report notes the existence of a "lowest price culture", leading to "the cost of transferring the risk to the contractor being discounted when assessing tenders."

An unhealthy emphasis on lowest cost procurement is not isolated to the public sector. Perhaps the most telling perspective is that offered by Glen. "At Mansons, we are both the developer and the head contractor," he explains. "There is no way we would contract to deliver a project for another developer – the head contractor's margins do not justify the risks the current market expects the head contractor to absorb."



What needs to change is collective market behaviours and dynamics which have allowed, and indeed fostered, poor practice around risk allocation.

Over the last few years Bell Gully has advised on or negotiated standard form-based construction contracts with a collective contract value of more than $2.5 billion. These contracts range across public and private sector projects, and utilise different standard form conditions of contract. This has given us a wide perspective on the rate of recovery of off-site overheads that is being achieved across the market and for different asset types. Although we have seen off-site overheads exceed 10 per cent of the contract price in some isolated instances (and noting this is arguably reflective of a premium being properly priced for risk acceptance), the average remains well below that at circa 5-6 per cent of the contract price. Take out the actual cost of off-site overheads and most contractors will tell you that actual profit is closer to 1-2 per cent of the contract price. Whatever your view is on what constitutes a reasonable return, such slim margins are obviously a questionable consideration for the level of risk being accepted by contractors. It does not take much for any 'profit' to disappear into a loss.

As with the issue of fair risk allocation, to properly understand the reasons for loss of profits and insolvencies in the current market, it is necessary to look beyond lowest cost procurement towards inaccurate pricing and poor cost modelling. David points out that in the infrastructure sector, one of the key factors leading to underperformance and loss is inadequate risk valuation, arising from a lack of understanding of the nature and extent of the risk exposure, and amplified by "optimism and the desire to win".

A similar comment is made by Glen in the context of the vertical build market. "It is as simple as head contractors committing to fixed price and tightly programmed contracts, then finding their expectations of subcontractor pricing and availability are being exceeded due to the excess demand over supply in the industry. Those costs are absorbed by the head contractor, who see their relatively small margin quickly disappear leading to solvency issues for themselves and eventually and by definition their subcontractors."

Krista explains that "there have been a number of examples where head contractors have not sufficiently locked in their subcontractors and pricing" in the Australian market. "Given the heated market, the subcontractors have then found themselves in a position where they can push for bigger margins or better terms when the bid is won because there is a shortage of supply."

A house of cards

Even with best practices in place, there will inevitably be project losses that need to be absorbed by market participants. Tight availability of bank funding aside, there are relatively few stories of principals unable to pay contractors. A rise in availability of mezzanine lending has helped. These days we rarely, if ever, see a principal's bond being required under a construction contract.

On the flipside, many contracting businesses are being run on a low-equity model. When profits exist they are largely being taken out of the company. With margins tight, the popular strategy appears to be to win as much work as possible with a view to creating greater revenue and spreading out risk – the notion being that a loss on one project can be absorbed by the profit on another. Suffice to say, liquidators are kept busy when that strategy does not work as intended.

In 2014, the Queensland Government introduced a minimum financial requirements licensing regime. It requires certain contractors to satisfy minimum financial thresholds, including net tangible assets, based on the value of the work they are undertaking. Satisfying these requirements is a pre-requisite to obtaining a licence to carry out building work. The information that must be provided depends on what category the contractor falls into. There are nine categories based on annual turnover ranging from AU$200,000 to AU$30 million. Contractors with maximum annual revenue greater than AU$30 million are also required to report any decreases of more than 20 per cent in net tangible assets.

Whether or not such a regime would work in the New Zealand market is the question. It has been suggested to us that if a similar regime were introduced here there would only be three contractors left in the market. But it is clear that greater financial integrity would in turn create greater resilience to project losses. We understand that the Registered Master Builders' Association is already looking at a certification scheme that would set minimum financial and competency standards for companies to meet if they want to win jobs above a certain value. Conceivably, for such a regime to succeed in achieving minimum levels of equity and competency, it would need to stretch across the construction industry, capturing both tier one contractors and small subcontractors alike.

You can only work with what you have

There is no doubt that a shortage of skilled labour and a constrained supply chain are both impacting on the fortune of individual projects as well as the health of the industry as a whole. "Poor performance by a contractor is most often a function of staff capability and experience," explains David.

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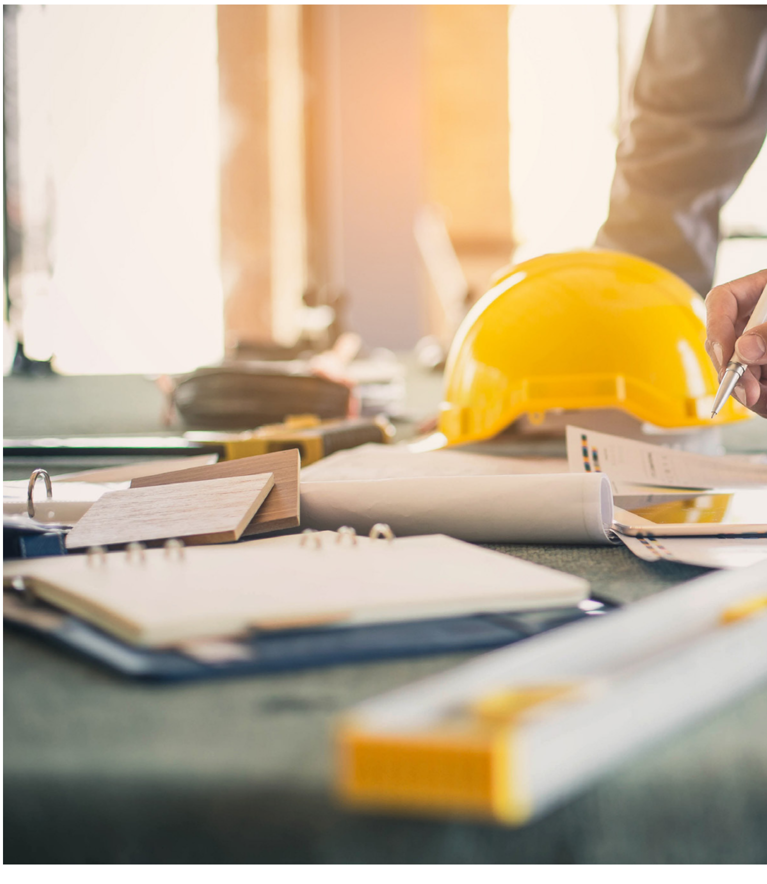
"An inability to source appropriately skilled staff when needed leads to poor execution of the works due to a lack of skilled staff."

At Bell Gully's 2018 construction panel event, the panel members unanimously agreed that there needed to be greater policy incentives towards learning of trade qualifications. The point was also made that, as a society, we need to move away from the perception that a trade qualification is somehow subordinate to a professional tertiary qualification.

Sharing his perspective from more than a decade working within New Zealand construction companies, Craig agrees. But he points out that this is just one of a number of factors: "It is difficult to attract top construction talent to New Zealand projects, including project directors, construction managers, engineering managers and others. I have heard many reasons put forward for this – from the cost of living in New Zealand being a barrier to overseas talent to a lack of focus here on training people to have careers in engineering or the trades. Failing to recruit the right people to complex projects means that those projects are likely to struggle right from the start."

Of course this issue is not exclusive to New Zealand, but when we look at the experience in Australia it is apparent that all resourcing will be squeezed even further as demand rises and more complex and consuming infrastructure projects come to market. "There are various examples in the media of contractors referring to labour shortages and constraints around materials," explains Krista. "This has resulted in contractors being very stretched and perhaps not resourcing projects in the same way. Combined with the fact that there



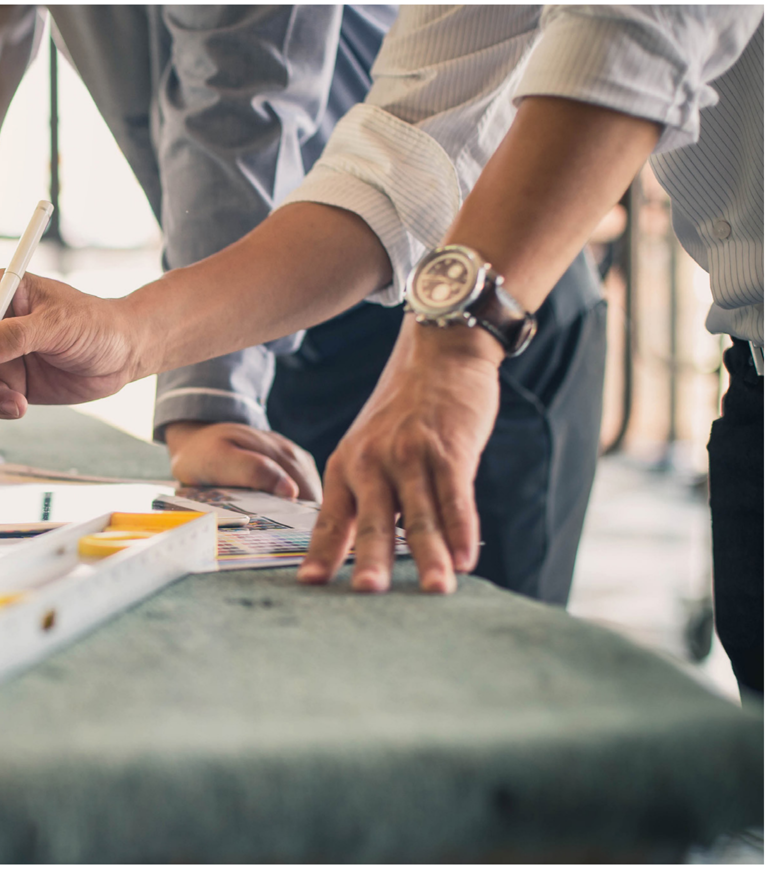
are many 'mega' projects in delivery and procurement, and the size of these projects necessitate that only a handful of big players can take the balance sheet risk, creating further resource constraints."

What is the basis for investment?

It is, of course, one thing to advocate for greater retention of equity in the industry and greater investment in resources, but for that there must be a basis for investment. Contractors cannot be expected to leave profit in their businesses or to invest in resources in the absence of any degree of certainty around future revenue-making opportunities or any policy support.

Much has been said recently about the need for certainty around the timing and scope of future public sector projects. "A lack of coherent planning at government level - or rather, the lack of a real opportunity to plan coherently - is one reason for the disjointed state of our industry at present," Craig explains. "New Zealand's three-year election cycle doesn't help with this. We can have one government whose infrastructure focus is on large public transport projects like rail or light rail replaced within three years by one who prefers to invest in large national roads (or vice versa). Then after three years the pendulum may swing again." He says that "this creates a 'jumble' of projects and often competing priorities which can discourage participation and investment from those parties who are best suited to assist."

The establishment of a pipeline of anticipated government infrastructure projects by the Infrastructure Transaction Unit is a step in the right direction. It could help provide those in the industry with the confidence needed to invest, and may also smooth over some of the disruption caused by the short-term electoral cycle that Craig identifies. The pipeline needs to be further developed and its success is contingent on public sector agencies adhering to it. Without that, it is unrealistic to expect industry to rely on pipeline commitments and to invest on the basis of them.



Holding ourselves to account amidst a complex web of factors

To seek to pin the woes of the construction industry exclusively on unfair risk allocation in construction contracts is itself illustrative of the actual fundamental problem: poor market behaviours characterised by adversarial dealings, short term self-interest and a lack of self-accountability. The underlying issue is not the allocation of risk, but rather the consequences of those risks not being properly understood or properly priced but nonetheless accepted time and time again. The challenge, as we identified in our first article, is resetting market behaviours across the board: holding ourselves and each other to account so that this is no longer the norm.

The other challenge is to shift the dial on the current debate. We need to move away from claims that a theoretical notion of fair risk allocation has been transgressed – including by the modification of standard form conditions of contract – to meaningful conversations about what else is wrong and how might we fix it. This is not to discount the need to devise efficient ways in which risk can be allocated on a basis which is transparent and objectively fair, but rather to recognise that will not be a silver bullet. Craig puts it particularly well: "As with many things, there is a web of interconnecting reasons behind the struggles our industry is facing. All levels of our sector (from the highest levels of government to tradespeople) are caught up in it in some way. We mustn't discount unfair risk allocation, and I do think that it is more culpable than other factors for the current state of the industry, but it is by no means the only reason."

David shares a similar view, reiterating the earlier point that much rests on accountability and acceptance. "The reasons for the under-performance of projects are complex. It certainly can't be attributed to inappropriate risk allocation on its own," he says. "In fact, many of the affected projects are being delivered under NZS3910 (largely unmodified) and Alliance agreements where the risk allocation is well known. While it could be that the contractors have undervalued the risks that are allocated to them, it is not the inappropriate allocation that is the issue."

> The establishment of a pipeline of anticipated government infrastructure projects by the Infrastructure Transaction Unit is a step in the right direction. It could help provide those in the industry with the confidence needed to invest, and may also smooth over some of the disruption caused by the short-term electoral cycle.

Assessing options for mitigating and allocating risks

IN THE NEW ZEALAND CONSTRUCTION INDUSTRY

In this third article, we assess a number of options and initiatives for mitigating and allocating risks – both at an industry level and at a project-specific level – to look at where efforts for reform and improvement might best be directed.

In doing so, we asked our panellists a series of short-answer questions to uncover shared viewpoints on these options and initiatives. Many of these questions lend themselves to a 'yes/no' response, and panellists could choose from suggested options or provide their own response. Their answers and comments, and Bell Gully's own views, are set out below.

#	TOPIC	QUESTION	PANELLISTS' VIEWS	BELL GULLY COMMENT
POLICY INITIATIVES				
1	Construction Sector Accord A partnership between government and industry which aims to be a "catalyst to transform the construction sector for the benefit of all New Zealand". The Accord promotes principles-based behavioural change across all industry participants. It targets improving leadership, business performance, workforce capability, regulation and risk. The Accord Steering Group is currently preparing a Transformation Plan which will set out a range of practical and measurable initiatives to give effect to the Accord Principles.	Do you consider that policy initiatives such as the Accord or, in the NSW context, the NSW Government Action Plan: A Ten Point Commitment, have the capability to achieve fundamental industry reform?	David Jewell: Yes, but "it requires commitment from all parties, especially the procurer of construction services... it will require dedicated leadership and resources to meet the challenges identified and make the changes desired". Glen Heath: No (in response to the Accord only). Krista Payne: Potentially, but change will require "ALL industry participants to consider changes in the way they approach procurements, negotiations and contract administration". Craig Wheatley: Yes. "I agree that the creation of the Construction Accord in New Zealand is a positive step – it represents an official commitment to amend what are generally perceived to be serious flaws in the industry. The potential to achieve fundamental reform over time is definitely there. Like many, though, I am reserving judgment on the impact of the Accord until it has been in play for a year or two. I do have some niggling concerns that it could be a case of lots of talk but not much action – although I hope I'm wrong on that."	Bell Gully is a supporter of the Accord and considers that the development and implementation of a workable plan which builds on the principles of the Accord to be a valuable and necessary initiative. We believe a fundamental change in certain industry behaviours will produce better results in procurement, contracting and delivery of projects. We do, however, share the hesitations of some of our panellists. Whether or not the Accord achieves its goals will be dependent on the Accord receiving maximum industry buy-in. Much also now depends on the critical Transformation Plan stage and how the principles are given practical effect. In some ways, the challenge facing the Accord is perhaps greater than that facing the NSW equivalent. The former is intended to apply across the industry and will require buy-in from a wide-range of stakeholders in order to be successful. The latter is focussed on infrastructure projects procured by the NSW government, with a view to achieving healthy competition throughout the industry supply chain.

#	TOPIC	QUESTION	PANELLISTS' VIEWS	BELL GULLY COMMENT
POLICY INITIATIVES				
2	A certification scheme to set minimum finance, governance and skill standards The Registered Master Builders Association and others are looking at the introduction of a certification scheme that would set minimum financial and competency standards for companies to meet if they want to win jobs above a certain value. A similar regime already exists in Queensland (as discussed in our second article).	Do you think that the introduction of a certification scheme that sets minimum finance, governance and skill standards for contractors working on jobs above a certain value would improve the industry and lessen the occurrence of contractor insolvency?	David Jewell: No. "The procurement processes used by the client organisations should ensure that the tenderers for their projects are capable of the delivery – this includes assessment of these. I'd prefer to see improved procurement practices from clients – pre-qualification of tenderers, and evaluation on value for money, not just price." Glen Heath: No. Krista Payne: Depends. "As with any minimum standard, setting the goal posts in the wrong spot is a real risk and could undermine the effectiveness of the scheme and actually create new problems." Craig Wheatley: Yes. "I agree that the introduction of these sorts of procurement rules should reduce the occurrence of contractor insolvency – it will mean that companies delivering large-scale projects are well-run and well-resourced. I expect that this will yield positive results for contractors in tiers 1 and 2. The reverse argument is that the rules will make it harder for smaller players to grow in the market as they may never be in a position to meet the standards required to deliver projects over a certain value. It should however provide those smaller contractors with an incentive to improve their processes."	As we noted in the second article in this series, many contracting businesses are being run on a low-equity model. When profits exist they are largely being taken out of the company. With margins tight, the popular strategy appears to be to win as much work as possible in an attempt to create greater revenue and spread out risk – the notion being that a loss on one project can be absorbed by the profit on another. Of course, this means multiple projects can be taken down with one bad contract, as there is no equity in the structure to absorb the loss. We consider this to be a fundamental problem in the industry, but it is not accurate to say that it is the contractor's problem alone. For contractors to be expected to retain equity in their businesses, realisable margins need to improve. This entails a shift to holistic procurement, rather than just lowest price, coupled with better understanding and acceptance of risk transfer on both sides. David Jewell notes that the recently revised Government Procurement Rules are "a positive move in this direction". The fourth edition of the Government Procurement Rules came into force on 1 October 2019. At their core, the Rules seek to achieve 'public value', being the best available result for New Zealand for the money spent and not necessarily the option with the lowest cost. Given the Rules do not apply equally to all public sector procurers, or across all types of procurements, the extent to which they will improve procurement practice remains to be seen. Another step towards giving contractors the confidence they need to invest equity into their businesses is the introduction of an infrastructure pipeline by the Infrastructure Transactions Unit. The pipeline is in its infancy, but is intended to give greater visibility and certainty over future infrastructure projects. As with the Rules, questions remain over the ability of the pipeline to overcome political change, notably the three year electoral cycle. Our view is that for the introduction of an appropriately tailored accreditation regime to improve industry resilience, it must be contingent on these other fundamental industry changes being properly effected. Tailoring the regime so that it applies differentially to different value procurements would be critical so as to avoid adversely impacting on market capability, a point noted by Krista. A similar concern is shared by David, who said: "I think that a certification scheme would introduce elitism that is not beneficial to the evolution and growth of contractors".

#	TOPIC	QUESTION	PANELLISTS' VIEWS	BELL GULLY COMMENT
CONTRACTING				
3	'Alternative' contracting models In recent times there has been a noticeable shift towards what might be termed 'alternative' contracting models. These include the use of early contractor involvement (ECI) arrangements, alliancing contracts and target cost contracts. The recently announced 'Enterprise Model' between Watercare, Fletcher Construction and Fulton Hogan is notable for its long-term commitment (10 years) to a programme of works rather than an individual project.	Do you agree that more prevalent use of alternative contracting models would improve the current state of the industry (examples include ECI, alliancing, target cost, the Enterprise Model or programme delivery contracts)?	Panellists all agree: Possibly (if used for the right project in the right context – not a silver bullet).	As a general observation, a growing number of principals (public and private sector) are adopting a more thoughtful and, on occasion, sophisticated approach when deciding on a procurement structure. In part this would seem to be a response to current market conditions and, in particular, growing reluctance on the part of contractors to take on certain risks. If a principal still wishes to allocate a certain risk to a contractor, they will have a better chance of doing so if the contractor has been given an opportunity to properly scope, assess and price that risk (for instance, through ECI), or an opportunity to realise some upside in the event so the risk does not materialise or they mitigate it sufficiently (through target cost, for example). A recent uptick in the use of alliancing, especially at a local government level, can similarly be traced back to market conditions and the government-policy response to those market conditions. It is possible that this could lead to alliancing being adopted for projects which easily lend themselves to more traditional contracting models, such as where the risk profile of the project is already known.
4	The suitability of NZS3910:2013 as an industry standard It is well known and, to an extent accepted, that in the current market modifications will inevitably be made to any contract based on NZS3910:2013. The same applies to the other standard form contracts in the NZS suite. Why is this happening? In its recent report on the use of NZS conditions of contract, the Infrastructure Transaction Unit cited a variety of "key challenges" which account for the way in which NZS3910 is being used. We have discussed many of these challenges in our previous two articles. In our view, the real issue is whether there is something fundamentally wrong with NZS3910, or whether its use is being distorted by market conditions and behaviours.	Do you consider NZS3910:2013 to be fit for purpose as an industry standard build-only contract?	David Jewell: "In the infrastructure sector, NZS 3910 is accepted as a fair and balanced contract. I'm a strong advocate of its use in NZ as a well-understood document that has been developed collaboratively by all industry participants. However, it is disappointing to see many client advisors advocating for extensive change to the standard wording." Glen Heath: No. Craig Wheatley: Yes. "I certainly wouldn't say that NZS3910:2013 is not fit for purpose – it deals with many issues in a generally fair manner (for example unforeseen physical conditions, valuation of variations and others). In my experience, problems have arisen when principals have made substantial changes to the general conditions of contract. Despite this, I do feel that there are improvements to be made to NZS3910 to bring it further into line with other international contracts such as FIDIC – for example the introduction of a liability cap for the contractor. I would like to see those sorts of issues addressed in any future 'refresh' of NZS3910."	As noted in the first article of the series, we consider that any desire to throw the NZS3910 'baby out with the bathwater' needs to be tempered by the reality that a standard form contract can't be everything to everyone. A universally applicable standard form contract isn't realistic. Rather, we need a contract which is up-to-date, user-friendly and principles-based, so as to enable flexible application or additional prescription where required, through the use of special conditions. What would this look like? The answer may be a standard form contract that looks quite similar to the current NZS3910, with adjustments to: • rectify some of the known glitches and shortcomings (for example, certain definitions, time of entry into the contract, rules of assignment, preparation and review of documents); • introduce some additional optionality (such as liability caps for contracts, standard exclusion of consequential and economic loss wording, for instance); and • reflect current law (such as the Health and Safety at Work Act 2015). Such an update would not completely 'do away' with the need for special conditions. Certain principals will, for example, always want a degree of prescription in the drafting of contract terms that a standard from contract cannot provide – but an update should result in the consistent treatment of some fairly core issues without the need for bespoke drafting. Finally, we cannot stress enough the need for NZS3910 and the rest of the NZS suite to be licensed in such a way that amendments can be marked up in track changes rather than described in a separate document. It is possible to do this with the Australian equivalent to NZS3910:2013, AS4000:19997, and with other standard form contracts such as FIDIC. It is high time NZS provided this simple efficiency.

#	TOPIC	QUESTION	PANELLISTS' VIEWS	BELL GULLY COMMENT
CONTRACTING				
5	Other standard form contracts (such as FIDIC or NEC4) In the wake of the discussion surrounding NZS3910 and its suitability to the current NZ construction market, there has been a steady call for a different form of standard form contract to be adopted, such as FIDIC or NEC.	Do you think other types of standard form construction contracts, such as FIDIC and NEC, need to be more widely used in the NZ construction industry as alternatives to the NZS?	David Jewell: No. "There is no reason in my opinion to introduce these forms of contract. NZS 3910 has been modified in its latest version to reflect the importance of the programme to the contract (as it is in NEC), and as long as NZS 3910 continues its evolution, then it should remain as the preferred form of contract for infrastructure works. It is accepted that large, complex projects may warrant a bespoke contract form, but this should not be the case for smaller projects". Krista Payne: "Not necessarily. FIDIC and NEC work well in the UK and part of this is because they are very tried and tested – the market knows these contracts. That is not the case in Australia / New Zealand, so the value may not be realised. Further, those standard form contracts are not without their own issues. Sometimes changes are made to contract form for change sake, which isn't always helpful – the point is probably more about consistency than about picking up a standard form used elsewhere in the world." Craig Wheatley: No. "Not necessarily. While I would like to see these contracts used more in the NZ market (particularly on large projects), I wouldn't say that they absolutely have to be used. I would, however, like to see the NZS suite amended to include certain aspects of the international standard forms, for example the early warning provisions of NEC and the liability cap provisions of both NEC and FIDIC."	Although both FIDIC and NEC contracts have been used in projects in New Zealand, the simple reality is that neither suite is well known or understood in the market outside of specific industries (such as plant-intensive sectors (such as dairy processing) or large scale infrastructure projects). FIDIC's use in NZ is limited primarily to those involved in the design, construction and installation of plant (FIDIC Yellow Book) or for large projects which are to be delivered on a turnkey basis, such as a powerplant (FIDIC Silver Book). Sometimes a FIDIC contract will also adopted for a large scale infrastructure projects – for example, Watercare used FIDIC Red Book for the $NZ1.2bn Central Interceptor project. NEC3 has similarly been used on a relatively limited basis in NZ. The perceived benefits of NEC are that it encourages collaboration between the parties and has a multitude of options which can be selected to reflect the specific requirements of the project. We're not aware of NEC4 having been adopted for any significant projects to date. NEC3 has been used by local authorities in New Zealand, although some in the industry have queried whether collaboration can truly be achieved through NEC's prescriptive notice requirements and communication protocols. The NZ contracting industry considers that it knows and understands the NZS suite-well: written by New Zealanders for New Zealand conditions. The obvious example is that (once it has another update) the NZS suite is reflective of current NZ law, unlike FIDIC or NEC. It is difficult to change the degree of incumbency that the NZS suite enjoys, irrespective of the merits.

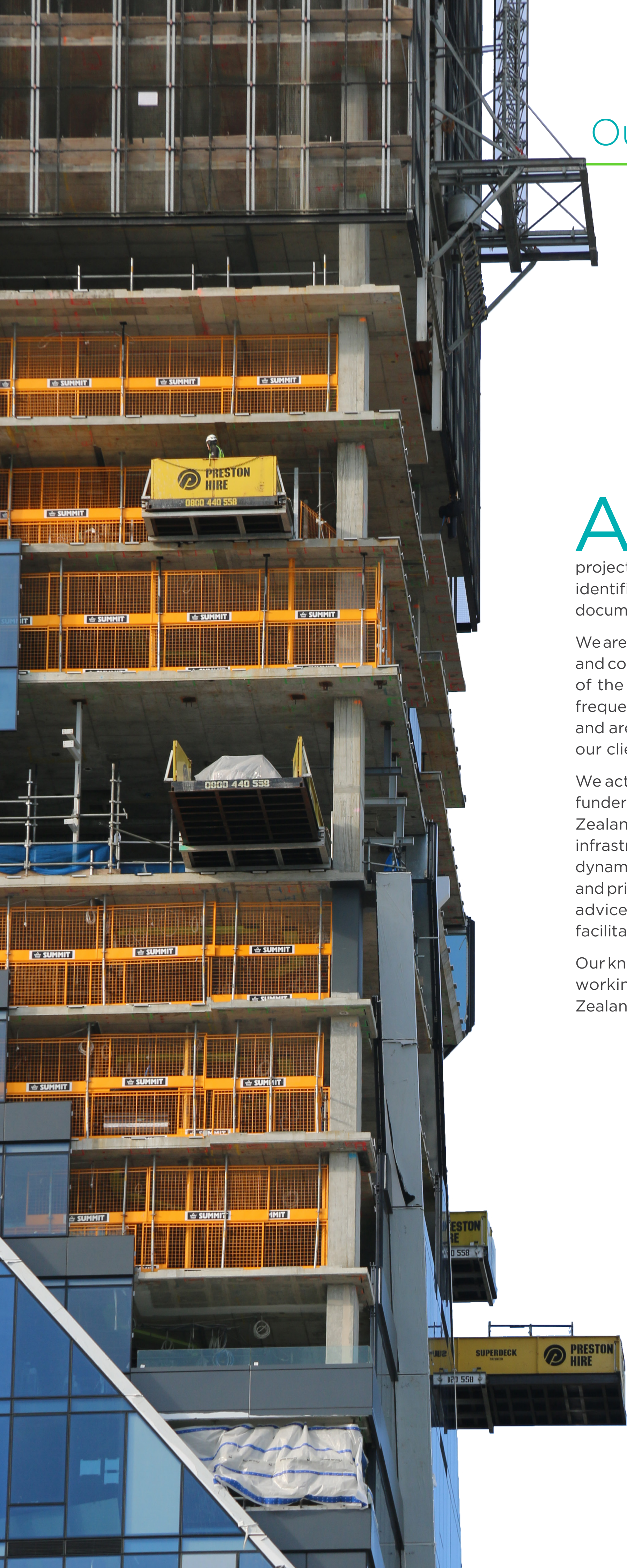
#	TOPIC	QUESTION	PANELLISTS' VIEWS	BELL GULLY COMMENT
CONTRACTING				
6	Problematic special conditions of contract There has been a lot of commentary in the market over the last 18 months or so about the use of special conditions of contract and how they affect and/or depart from the 'commonly understood' general conditions of contract. The debate is perhaps at its peak right now.	How often do you see examples of special conditions in construction contracts which you consider to be problematic and contributing to the poor state of the industry?	David Jewell: Often. "This is a real issue for construction contracts with local authorities. I have seen 60 pages of Special Conditions to 3910 from a local authority, and at the same time seen a half page of Special Conditions on a $100 million-plus contract from NZTA. Unfortunately, I have to say that this appears to be driven by legal advisors to the local authorities who are seeking to minimise their risk exposure. In my view, that risk exposure is often better managed through adopting the standard 3910 without all the amendments. Glen Heath: Not often (not really applicable to Mansons). Krista Payne: Not applicable – the issue is not the use special conditions per se, but a lack of industry understanding about the suitability of special conditions. Craig Wheatley:Often. "In my experience, examples of such special conditions include: • Broadening of the standard indemnity provisions to require indemnities for matters such as breach of contract. • Clauses allowing principals to discuss payment issues directly with the contractor's subcontractors, and make direct payments to those subcontractors at their discretion. • No entitlement for contractor to rely on documents provided by the principal, when the contractor has had no involvement in preparation of those documents and often little time to review them in the tender period • Narrowing of the circumstances for which variations and EOTs may be claimed (for example, unforeseen physical conditions)."	The argument from the other side is that, for certain types of principals, or for certain types of projects, special conditions are necessary. The simple fact that special conditions are included in a contract should not, and does not, mean that the contract is unfair or constitutes poor contracting practice. This resonates particularly loudly in the private sector, where absent initiatives such as the Accord, considerations of public policy do not carry much weight in terms of procurement selection or contracting terms. In our view, legitimate grounds to include special conditions include: • to fix a deficiency in the general conditions; • to reflect the particular requirements of the project; or • to reflect the particular requirements of a party. The second and third categories are often where the trouble starts, as it is unclear what a genuine requirement is, what is 'a nice to have' and what is simply an attempt to 'screw the scrum'. In our view, it is in this space that lawyers and other consultants have the opportunity to offer real value to all project participants by providing guidance on the practical and legal consequences of requiring a particular special condition (both in terms of the specific project as well as for future procurements). It is critical that all parties seek and obtain appropriate legal and other advice in any contractual negotiation. Too often we encounter situations where, based on an apparent understanding of the general conditions of a contract, a party will advocate for, accept or reject a special condition, even though it is clear that the party does not understand the meaning or effect of that condition. As we stressed in our earlier articles, in commercial contracting there has to be an emphasis on self-accountability, regardless of the rights or wrongs of using special conditions. Finally, in our view, any debate around the legitimacy or otherwise of public sector procurers using extensive special conditions needs to be holistic and take into account the drivers for those special conditions, including often the terms of upstream contracts such as development agreements or agreements to lease. Such upstream contracts often require the principal to pass through onerous conditions of the upstream contract to the contractor under the construction contract (including direct deeds of warranty). If the public sector is to be subject to rules around procurement and risk allocation, those rules must apply both directly and indirectly.

#	TOPIC	QUESTION	PANELLISTS' VIEWS	BELL GULLY COMMENT
RISK TRANSFER				
7	Understanding the contract Synonymous with the debate around the use of special condition is the discussion around how risk is in fact transferred under the contract terms. There are many accounts in the market of principals allocating a specific risk to a contractor through the P&G specification or an annotation on a plan. There are similarly many instances where a contractor accepts a risk simply because it did not properly comprehend the effect of a condition of contract, or agreeing to a condition with full knowledge of the risk profile and likely consequences. Are these issues mutually exclusive? Or is improvement required on both sides?	Which do you consider to generally be more culpable for poorly understood contractual positions around risk: • 'risk transfer by stealth' (that is, where the transfer of a risk by the principal to the contractor is buried in the contract documents or obfuscated in some other way such that it is not easily discernible); or • a failure by the contractor to properly read and comprehend the contract documents?	David Jewell: "I believe that both of these factors are in play, and they are closely linked. As discussed above, the extensive Special Conditions often transfer risk that is not easily identified by the contractor. While the standard 3910 clauses and risk allocation are well understood, the extensive Special Conditions are often a trap for the contractors who may not understand the implications and who then under-price their exposure." Glen Heath: Poor contractor practices. "Contractors know the risks they are taking, but due to market pressure feel obliged to accept them." Krista Payne: Poor contractor practices. "Obviously everyone will be able to point to an example of transfer by stealth, but most of the time it's about the parties understanding what is written on the page. This issue can be mitigated by mechanisms like ECI and reimbursing bid costs in appropriate scenarios and allowing suitable time for procurements." Craig Wheatley: Risk transfer by stealth. "It is not as black and white as this though - there is always a range of culpable factors. Contractors are not blameless."	We agree that there are two sides to this issue. The obvious solution is an improved and more transparent contracting process including, depending on the nature of the project and the risk allocation, sufficient time for pre-contractual due diligence and appropriate principal-contract engagement. The time and costs of such a process are always a consideration. There can, of course, never be any substitute for the words of the contract and so there is never any substitute for a party not reading and properly understanding the words of the contract. Equally, however, there should never be any reason to not present a contract for tender that is clear and transparent on its terms, and which is either consistent across its constituent parts or which has express rules for dealing with inconsistency. It should not be an unnecessarily difficult or burdensome task to properly understand the contract.
8	Disclosure of risk allocation Understanding how a risk is allocated under a construction contract is (or at least should be) an obvious pre-requisite to accepting and then properly scoping and pricing that risk. While there can never be a substitute for the words of the contract, could disclosure be made more transparent and efficient?	Do you think it would be useful tool for the industry if each construction contract were accompanied a by a one-page, tabular matrix indicating how certain risks had been allocated under the contract documents?	David Jewell: "Useful, but with an important caveat. Risk often manifests as shades of grey rather than black and white, so it is debatable whether such a table would help. What would take precedence – the table or the words in the contract?" Glen Heath: Possibly useful Krista Payne: Harmful – the parties need to properly understand and comprehend the contract terms in their entirety. "This creates a risk that the matrix is inconsistent with the contract due to summarising the terms, which creates more uncertainty. Further, it aids the approach of not reading the contract. Many organisations prepare these matrices in any event to assist with approvals processes but it is not clear what the benefit of including them in the contract would be." Craig Wheatley: Possibly useful. "I think this would be useful and I have seen it used to good effect on previous projects (although they are often longer than 1 page). If this practice were to be adopted, parties would need to be careful to avoid any conflict or confusion between the matrix and the terms of contract (which may be more detailed)."	Subject to the appropriate conditions being included in the contract to deal with the effect of the matrix on the written conditions and the issue of inconsistency between the two, we think this is a good idea. To indicate what such a matrix could look like, Bell Gully has prepared a draft, for-discussion version, for distribution at the panel event on 10 October 2019.

#	TOPIC	QUESTION	PANELLISTS' VIEWS	BELL GULLY COMMENT
DESIGN RISK				
9	Consultant limits of liability	As a general proposition, are 'market standard' limits on a design consultant's liability (for example, three times the fee) disproportionate to the level of responsibility a design consultant has for the success or otherwise of a project?	David Jewell: Unsure. "Possibly, but this is a complex issue, especially when it is linked to 'project success'. The designer has responsibility to deliver a design that meets the project's budget and programme. Management of designers to achieve these performance goals is an issue for the industry that needs addressing, but this is different to the designer's liability with respect to professional indemnity." Glen Heath: Yes. Krista Payne: Often, yes. Craig Wheatley: Yes. "Absolutely. I see this as one of the most imbalanced aspects of construction contracts in New Zealand. Under our standard head construction agreements, contractors currently have no entitlement to a cap on their liability (unless they negotiate one with the principal) while standard form design agreements contain liability caps at values far less than the size of loss that could arise due to defective design."	We agree that this issue is perhaps more nuanced than the binary nature of the question suggests. How the principal defines 'project success' and what requirements, objectives and constraints are subsequently imposed on the design team will invariably have an effect on the quality of the design. This naturally influences the extent to which the design team is prepared to accept liability for defective design. A contractor may argue that similar considerations inform its liability as those same barometers of 'project success' (cost, time and output) apply equally during the contracting phase. What is different, however, is that the contractor's methodologies and implementation of the contract works do not have the same extent of principal oversight and input as the preparation of design. Arguably, the contractor has greater autonomy and therefore responsibility and liability. It seems somewhat cursory and arbitrary to define a design consultant's limit of liability by reference to the fee, especially when the fee is often calculated using a variety of different means. It also seems slightly odd to define limits of liability by reference to the capacity of the domestic professional indemnity insurance market. As a point of contrast, many law firms have to look offshore to obtain sufficient levels of professional indemnity cover.
10	Responsibility for buildability As the interface between the design and the build, buildability involves assessing the design from a construction perspective to ensure that it is capable of being built within the programme and budget constraints. It involves consideration of a range of on-site and off-site activities and how they will be sequenced and interfaced in order to deliver against the requirements of the design.	Is it fair to ask a build-only contractor to accept responsibility for 'buildability' of a design?	David Jewell: "As long as the design is complete at the time the contractor tenders. And that any design change becomes a Variation after that". Glen Heath: No. Krista Payne: Yes. "Provided appropriate opportunity has been given during the procurement or the start of the contract to flag 'buildability' issues and the contractor not take risk on these flagged issues. The construct only contractor is the expert in this circumstance and is best placed to identify issues and find ways to deal with them." Craig Wheatley: No, "because "buildability" is subjective. An acceptable test is for a build-only contractor to take responsibility for building 'in accordance with the specification' (provided the specification is unambiguous) as that can be measured."	Provided that the design is complete and sufficient opportunity is given to the contractor to review that design and all other relevant information, including conducting site-visits, we agree that a build-only contractor is best placed to assess buildability. It is important that buildability responsibility is distinguished from design responsibility, the latter of which should rest with the design consultants in a build-only context. We note we concur with Craig's comments that any allocation of buildability responsibility needs to be pegged to the specifications or the design. An open-ended, immeasurable responsibility to ensure buildability is effectively a quasi-transfer of design risk as the line between responsibility for design and responsibility for construction is blurred.

#	TOPIC	QUESTION	PANELLISTS' VIEWS	BELL GULLY COMMENT
DESIGN RISK				
11	Liability for buildability Refer above.	If the answer to the preceding question is yes, to what extent should the contractor be liable for failing to properly discharge that responsibility?	David Jewell: Partly liable (depending on the nature of the issue, the design consultant should bear some responsibility). "Unless there is a design change (because the design doesn't work or can't be physically built) or some unforeseeable component or event that affects the buildability. For example, if a third party is successful with an injunction against the contractor in respect of the standard-practice construction methodology proposed, requiring a fundamental change to the construction." Krista Payne: Partly liable. "Assuming an appropriate mechanism has been put in place to allow constructability issues to be identified and dealt with, the contractor should be liable for any issues they fail to flag. The principal should be liable to arrange the design to be changed for issues flagged."	The nature of buildability is such that, where it becomes an issue, there is often a degree of overlap between the responsibility of the design consultant and the build-only contractor. Where this responsibility turns to liability, it is logical and fair that, to the extent practicable, that liability should attributed on a proportional basis and any claims framed accordingly. We agree that there should also be exceptions to any liability, along the lines of those outlined by David. It is also important that design changes are properly and completely disclosed to the contractor, with the contractor then being given an appropriate opportunity to review any buildability issues arising out of that change.
TIME BARS				
12	A current 'hotspot' in construction contract negotiations is the inclusion of time bars which prevent the contractor from making a claim for a variation or extension of time if that claim is not made within a set number of days after the contractor becomes aware of the circumstances giving rise to the entitlement to a claim.	As you are seeing them used in the market, do you consider time bars to be: • a legitimate contractual means of protecting the principal's interests (for example, by allowing the principal an opportunity to mitigate the relevant matter and by protecting the principal against the risk of claims made long after the fact); or • nothing more than an attempt to prevent the contractor from realising its genuine entitlement to time and/or cost relief in circumstances where it is not liable, under the contract, for relevant risk?	David Jewell: Legitimate means of protecting the principal's interests, "provided always that the time allowed is reasonable. Regardless, I prefer the wording of NZS 3910 that states 'within 1 month or as soon as practicable thereafter'". Glen Heath: Legitimate means of protecting the principal's interests. Krista Payne: "These mechanisms definitely commonly exist in contracts. However, that doesn't mean they are often being used to actually bar claims. There is a balance to be struck between the contractor receiving the relief they are entitled to and the principal having the ability to mitigate the impacts of delay and achieving some certainty throughout construction as to the delays and costs its responsible for." Craig Wheatley: An attempt to prevent the contractor from realising its genuine entitlement. "My real answer here though is 'it depends'! Note though that my view only applies to substantially reduced time bars – which is a common practice at the moment in some of the contracts I have seen. I have no issue with the presence of time bars where they are fair. I acknowledge that an overly lengthy time bar increases the risk of claims being raised long beyond the matter arising, which all principals will seek to avoid."	When it comes to time bars, the devil is in the detail (specifically in the numbers). Allowing a contractor an unrealistically short period of time to give a notice of a claim or circumstances giving rise to a claim, sometimes together with full and complete particulars of the claim as a pre-requisite to bringing the claim, are clearly an attempt to prevent the contractor from realising its genuine entitlement. Increase the relevant period of time so that there is sufficient time, plus a reasonable contingency for the contractor to give a notice, and the regime already begins to look fairer. Other relevant considerations include whether the knowledge test is objective or subjective, whether it is a 'two-stage' notice process, the effect of any intervening or contributory conduct by the principal on the time period, and how the process interfaces with any 'early warning' provisions. We note that there are questions to be tried around the enforceability of time bars, as well as how any attempt to enforce a time bar might play out in the context of the contract's dispute resolution provisions. We have also heard anecdotal stories of engineers/superintendents seeking to devise ways to work around the strict requirements of the time bar provisions. While we understand the purpose and basis for time bars, we note that they can produce absurd results due to the contractor having to take additional steps, including hiring or dedicating personnel to deal solely with the making and administration of claims (mostly where the time periods are short). Even where the cost of this can be sheeted home to the principal, it is an undesirable outcome, and is the type of conduct that the Accord is seeking to eradicate.

#	TOPIC	QUESTION	PANELLISTS' VIEWS	BELL GULLY COMMENT
SECURITY FOR PERFORMANCE				
13	Retentions The Construction Contracts Act 2002 requires retentions under a construction contract to be held on trust by the principal/ head contractor in favour of the contractor/ subcontractors downstream. The regime was introduced in response to the collapse of Mainzeal and first took effect on 31 March 2017.	Do you agree that the new retentions regime under the Construction Contracts Act 2002 is working as it should be (that is, to protect the cash retentions of those in the contracting chain against insolvency and/or misuse of cash retentions)?	David Jewell: No. "It seems that some contractors are not holding the retention funds 'in trust'. Consequently in the event of their failure, the money is still not available for the affected subcontractors. Could Directors be held personally liable for such retentions?" Glen Heath: Yes. Craig Wheatley: "Not enough information to say…we are complying with the rules and no issues have arisen since they were implemented - I have not been involved in any specific matters which would suggest that the regime is not doing what it was designed to. Media articles in the wake of the latest spate of contractor insolvencies however would suggest that the regime is perhaps not working as well as it could be."	Based on the situations where the regime has been tested to date, it would seem clear that it has not achieved its intended purpose. Although not all of Ebert's subcontractors were required to have the protection of a retentions regime, a substantial portion of those that did found themselves without its protection. This was largely due to Ebert's handling of the retentions Further, the Court found that the regime does not establish a deemed trust, but rather the usual requirements for establishing a trust at common law apply (that is, certainty of intention, subject matter and beneficiary). It appears that a similar shortfall will occur in the case of Stanley Group. Of course, as Craig points out, the regime has barely been tested, but the early signs are not great. Key issues which remain to be resolved include: • What are 'liquid funds'? • Perverse incentives for head contractors/ principals investing trust funds. • Co-mingling of trust and non-trust funds; • Entitlement to interest. • Non-compliance: does the regime have teeth? • How will contractors, principals and funds respond to this uncertainty and potential litigation risk?
14	Bonding As soon as the contract value of a project exceeds a certain de minimis amount (usually, in our experience, about $5 million), it is typical for a principal to require the contractor to provide a bond to secure the performance of the contractor's obligations. Many principals require these bonds to be 'on-demand', allowing the principal to claim under the bond without first satisfying any conditions to the drawdown.	Do you consider a requirement for an on-demand performance bond to be reasonable?	David Jewell: Depends on the project/context. "For certain projects, a performance bond to protect the principal against additional cost if the contractor fails or walks away is reasonable. Equally there are many projects where contractors need protection from failure of the principal, but it seems that principals bonds are infrequently used." Glen Heath: Depends on the project/ context. Craig Wheatley: Depends on the project/ context. "Only for the larger, more complex projects. Bonds are not always easy for contractors to procure and I am not convinced that they are necessary on smaller, low-risk contracts. They ultimately cost the principal money too of course. I also think that there is a tendency in NZ to assume that contractors should provide several forms of security on one contract (bonds, retentions, PCGs and others). This is unusual in some other jurisdictions where one form of security is often deemed sufficient. Performance bonds were incredibly rare when I worked in Scotland 15 years or so ago, but that may have changed now."	In a relatively recent case, Clark Road Developments, the Court found that a straightforward on-demand bond could be called upon by the principal, irrespective of any default by the contractor, termination of the construction contract or dispute between the parties to the construction contract. While there are constraints in the way in which bond proceeds can be dealt with, the case is a timely reminder of the potency of an on-demand bond and the risk it exposes the contractor to, especially where the principal can require a replacement bond to be tendered. In the current market, it can be difficult for certain contractors to meet the bonding requirements asked for by principals. These requirements are no doubt being partly informed by considerations as to the minimum levels of equity in the industry, and the credit-worthiness of SPV contractor entities. Those same constrained levels of equity, coupled with a need for multiple bonds across multiple projects, are in turn limiting the capacity of many contractors to obtain bonding. It is a difficult catch-22 for the contractor, but also a good example as to why fundamental reform and a rethink around terms of engagement between principals and contractors is required.



Our capabilities

At Bell Gully we offer a range of comprehensive legal services to the construction industry. We routinely advise on all aspects of construction and development projects, including commercial structuring, procurement, risk identification and mitigation, preparation and negotiation of documentation, contract administration and dispute resolution.

We are familiar with all the usual forms of construction contracts and consultancy agreements and have expert understanding of the role, purpose and effect of special conditions. We frequently draft and negotiate bespoke project agreements and are adept at finding the best contractual solution to suit our client's requirements.

We act for principals, contractors, consultants, suppliers and funders in transactional and contentious work on some of New Zealand's most significant construction, development and infrastructure projects. We are acutely aware of the broader dynamics and cycles of the New Zealand construction industry and pride ourselves on delivering pragmatic, "best for project" advice which protects the interests of our clients and also facilitates project delivery.

Our knowledge and approach is based on years of experience working on a wide variety of major projects in both New Zealand and internationally across various different sectors.

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