European Commission

European **Construction Sector** Observatory

Policy measure fact sheet

Ireland

Construction Procurement Reform

Thematic Objectives 1 & 4

March 2016

Implementing body:	**Department of Public Expenditure and Reform (PER)**
Key features & Objectives:	Reduction of the level of Construction Performance Bonds for use with Public Works Contracts (reduced from a maximum of 25% of the total contract sum to a maximum of 12.5%)
Implementation date:	1st May 2013
Targeted beneficiaries:	Construction companies contracted to deliver public works contracts. Construction performance bond providers.
Targeted sub-sectors:	Construction sector (especially SMEs), Financial Services (Bond providers), Public sector (Contracting authorities)
Budget (EUR):	n/a

In a nutshell

Public works contracts are used for all construction projects funded by the Government's Capital Investment Programme. They are estimated to be worth in the region of €2.25 billion annually[1], which equates to about 12% of construction sector annual turnover, according to the latest figures published by the CSO (€18.6 billion in 2011[2]). An effective and efficient procurement process is essential to ensure that projects are delivered without delay. The process must also enable the State to secure maximum value and quality on behalf of the taxpayer. In fulfilling both of these aims, the process must ensure that the interests of all parties (client, i.e. the State, and contractor) are considered fairly throughout the process and in accordance with the relevant procurement laws currently in place.[3]

The Government recognises the concerns of industry that some aspects of the procurement system are proving to be detrimental to participating companies and to the interests of the State as client. As a response, the Government launched the Construction Procurement Reform Initiative (CPRI) in 2007 to achieve greater cost certainty at the tender award stage, better value for money, and more efficient delivery of public works projects. The CPRI is due to run until 2017.[4]

According to a 2011 analysis of infrastructure project delivery[5] in Ireland, the overall cost of infrastructure development is disproportionately affected by non-construction costs, such as the high cost of building land[6], and costs and issues related to the planning process, procurement procedures and institutional arrangements for infrastructure projects. An example is the Inter-urban Motorway Programme which saw the non-construction costs amount to 25% of the overall project costs (€8 billion, including VAT) of the Programme.[7]

In recent years, the procurement of performance bonds has become a major problem for building contractors, the Government building capital programme and the construction industry overall. Many bond providers are exiting the market due to the losses they are incurring. Average losses incurred by bond providers in international markets are on average less than 5% of the contract sum. Bonds are therefore usually set at a maximum of 10%, compared to 25% of the contract sum in Ireland. High levels of uncertainty in the construction industry, disproportionately high project completion costs and the impaired balance sheets of many building contractors are some of the contributing factors. Bond providers point to below cost tendering[8], the excessively lengthy reprocurement process[9] and ancillary costs[10] as reasons for this disparity.[11]

Following industry recommendations, the Department of Public Expenditure and Reform (PER) issued a document entitled "Circular 07/13: Construction Procurement Reform – Reduction of the Current Level of Construction Performance Bonds for use with the Public Works Contracts" to all government departments and offices to announce a reduction of the level of construction performance bonds required on all public works contracts, effective from 1st May 2013.[12] A tightening market was leading to procurement delays, as it was increasingly difficult to award contracts where the required bond level exceeded 12.5%. Revised requirements now mean that performance bonds are capped at 12.5%.[13]

This measure brings cover levels in Ireland closer to those required in other developed nations. The general consensus is that the measure is both necessary and a welcome step in the right direction, though it may be insufficient on its own to balance work-out costs and to entice bond providers back into the market.[14] To do so, Government measures are required to address the many other factors that are contributing to high completion costs and the high risk of claims.

General description

There is a varying degree of uncertainty in every construction project – an issue that continues to be exacerbated by the economic climate since 2008. Low profit margins, late payments and insufficient capital are just some of the many reasons why a contractor may fail in its contractual obligations[15]. Consequently, clients in the construction industry are becoming more and more risk adverse. Many are looking to eliminate as much uncertainty as possible from every construction project. A common solution is to require all contractors and sub-contractors to provide a performance bond.[16]

As utilised in the construction industry, a performance bond is a "contract of guarantee" whereby one party (the Guarantor) undertakes to pay damages to a second party (the Employer) arising from a breach of contract by a third party (the Contractor). The damages payable typically include the additional expense incurred by the Employer as a result of the Contractor defaulting on its original contractual obligations. The largest and most obvious additional expense is the extra payment required to secure a new Contractor to complete the unfinished project. Other additional expenses can include, for example, additional design team fees, security and insurance.[17]

Effective from 1st May 2013, the Government has reduced the level of construction performance bonds for public works contracts as follows:

Contract sum (incl. VAT) (€ million)	Performance bond cover (% of contract value)
Cover required before 1st May 2013	
<2.5m	25%
2.5m-6.3m	20%
6.3m-9.5m	17.5%
9.5m-12.7m	15%
>12.7m	12.5%-10%
Cover required from 1st May 2013	
<0.5m	**X** (not required)
>0.5m	✓ (required)
<10m	12.5%
>10m	10%

Source: Construction Procurement Reform Website

Though performance bonds are generally only required for public works contracts in excess of €500,000, the new requirements state that "where a contracting authority has a number of contracts with a value less than €500,000 they are required to evaluate their exposure where the cumulative value of the contracts exceeds €500,000".[18]

Achieved results

Government guidelines were circulated (Circular 07/13) to all departments and offices stipulating that, from 1st May 2013, all public works contracting authorities must implement the new requirements.

Implementation methods	
1	The reduced level of performance bond sought on public works contracts shall apply to all tender processes commencing from 1st May 2013.
2	For tender processes which are underway and where the deadline for submission of the tender has not passed, contracting authorities shall review their bond levels in accordance with the new requirements and take steps to implement the necessary changes during the currency of the tender process and, where necessary, to extend the tender deadline ensuring that the change is communicated to all prospective tenderers.
3	For tender competitions where the tender deadline has passed and bond levels in excess of the new requirements have been sought. Where the contracting authority is unable to award the contract at the bond level originally sought then the contract shall be re-tendered with the reduced bond levels set out in the new requirements.

The overhauling of the previous bond levels, which date back to before 2007, has been done to bring levels into line with those applied in the UK, and which apply to the awarding of Public-Private Partnership contracts – both in the region of 10% of the contract sum. Equivalent bonds in the UK would typically be 10% of the contract sum whereas this figure drops to 5% in Spain.[19]

The reduced bond requirements were due to be formally reviewed in late 2014 (after an 18-month interim period) as a part of the Government's Public Works Contract Review Process. The consultation process began in December 2013 with the Government inviting stakeholders and interested parties to make written submissions. The final review report was published in December 2014, but it did not contain a review of construction performance bonds. It is therefore difficult to assess the real impact that the reduced bond levels have had on public works contracts and the Irish construction industry.

One reason for the omission of performance bonds in the review process may be that the new requirements have been generally well received by industry. An example of industry approval was voiced by the Irish Construction Industry Federation (CIF) who praised the Government for addressing industry concerns about the level of performance bonds[20]. Another reason could be that their inclusion in the review process was not a key request from stakeholders in the consultation process. A review of stakeholder submissions[21] shows that only one stakeholder[22] actually commented that performance bonds were missing from the process and recommended that they should be included.

Perspectives and lessons learned

From a **government perspective**, the decision to reduce the level of performance bond cover was informed by available evidence, extensive stakeholder consultation, and by changed market conditions where insurance premiums have increased four- and fivefold since the collapse of the construction industry. The reduction in performance bond levels is a sensible and pragmatic reform. It reflects the need to remove red tape that is blocking much needed investment and to bring stability to a construction sector that has seen its share of economic activity plummet from an unsustainable peak of 20% of GDP to an all-time low of 6% in recession times. Government needs to play its part in helping to return the construction sector to the more sustainable level of 11%-12% that applies in other developed economies.[23]

Reform of performance bond levels in public works contracts is an integral part of the Government's Construction 2020 strategy for a renewed construction sector. Reduced bond levels are a step in the right direction, but more is needed to make public works contracts more financially viable for contractors. The current strategy, published in May 2014, indicates that the availability and cost of performance bonds remains a constraint on the sector. The Government is committed to working with industry to develop a solution involving existing banks or new players to provide greater levels of performance bonds. The Government will also look at the issue of accessing performance bonds as part of its work with the EIB and NPRF on trade finance.[24]

From an **insurance (bond) provider perspective,** this measure is viewed as a necessary action to help avoid the future paralysis of the construction industry, though on its own it may prove insufficient, as there are many issues that impact public works contracts.

Together with construction industry representatives, the Quantity Surveyors Professional Group of the Society of Chartered Surveyors Ireland (SCSI) held information-gathering meetings in 2013 with bond providers to seek clarity and a better understanding of what was happening across the market. Providers explained that they were being obliged to re-assess their business models due to high levels of uncertainty in the construction industry and projects, the exceptionally high cost of completing out projects, poor credit facilities, the prolonged duration of the recession, and especially the frequency and scale of losses incurred by bond providers. This has led many providers to exit the market and those that remain often attach very stringent conditions to their offer of cover, making it unobtainable to many contractors.[25]

The conclusion of the SCSI is that the bond market is tighter and the availability of bonds will continue to be an issue until replacement providers can be attracted back into the market. By insisting on the provision of a bond, contracting authorities are by default allowing bond providers to dictate the award of a competitive tender process. In many instances the fifth or sixth placed tenderer has been selected solely on the basis that the better scoring tenderers could not procure a compliant bond. The net effect is that the taxpayer is not getting value for money, as the tendering system is only as effective as the availability of performance bonds at that time. The SCSI advises its members to be aware that reduced cover levels of bonds (though important) may prove insufficient to balance work-out costs and accordingly should advise their clients of potential shortfalls.[26]

From a **construction industry perspective**, the Irish Construction Industry Federation (CIF) welcomes the introduction of this new measure. CIF praises the Government for taking on board the concerns that it raised about bond requirements and for taking swift action to address industry needs as they arise. CIF points to a marked decrease in the availability of bonds and a steep increase in their cost as being a major burden on construction companies that are already financially vulnerable. Previous bond requirements also contributed to procurement delays and reduced the number of contractors able to compete. CIF describes the new bond requirements for public contracts as "much more amenable". They are now closer to the levels required in other developed nations and will have a positive impact on the roll out of capital infrastructure, help to cut down on project delays and lower costs to the Exchequer. Indeed, CIF argues that the private sector could enjoy the same benefits if they were to use the Government bond rates as a guideline. This would ensure more efficiency in the delivery of construction projects and encourage greater competition at the tendering stage.[27]

Comparison with other analytical sources

This Policy Fact Sheet concurs with the Country Fact Sheet 2016 on Ireland:[28]

- Key economic drivers of the construction sector – access to finance for construction enterprises;
- Key issues and barriers in the construction sector – time and cost of obtaining work permits and licences;
- Current status and national strategy to meet Construction 2020 objectives – TO 1 & 4.

Endnotes

1 http://www.per.gov.ie/en/hayes-welcomes-move-to-address-crippling- construction-sector-insurance-costs/

2 http://www.cso.ie/px/pxeirestat/statire/selectout/print.asp?pxfile=D:\Inetpub\csoie\px\pxeirestat\statire\Temp\2016591824421252760BAA12.px&outfile=D:\Inetpub\csoie\px\pxeirestat\statire\Temp\2016591824421252760BAA12&FileformatId=1&Queryfile=2016591824421252760BAA12&PLanguage=0&MainTable=BAA12&MainTablePrestext=Construction%20Enterprises%20by%20Nace%20Rev%202%20Activity,%20Year%20and%20Statistic&potsize=40&Buttons=5&TableStyle=

Turnover - Total (Euro Thousand) by Nace Rev 2 Activity and Year

	2008	2009	2010	2011
Development of building projects (411)	2,951,422	632,905	252,365	203,887
Construction of residential and non-residential buildings (412)	14,068,856	7,450,884	3,849,112	3,149,888
Construction of roads and railways (421)	1,519,849	1,051,027	684,555	361,102
Construction of utility projects (422)	523,373	537,946	246,382	245,677
Construction of other civil engineering projects (429)	1,871,578	1,485,072	691,380	631,425
Demolition and site preparation (431)	388,281	295,825	287,916	97,660
Electrical, plumbing and other construction installation activities (432)	4,510,366	2,770,982	2,334,711	2,232,064
Building completion and finishing (433)	3,417,258	758,284	520,963	1,325,577
Other specialised construction activities (439)	3,129,672	1,463,310	585,802	1,068,670
Construction (41 to 43)	32,380,656	16,446,234	9,453,186	9,315,950

3 https://djei.ie/en/Publications/Ireland-s-Construction-Sector-Outlook-and-Strategic-Plan-to-2015.html

4 Ibid

5 http://www.iae.ie/publications/publication/the-cost-effective-delivery-of-essential-infrastru/

6 Ibid (Page 9)

"Significantly higher land acquisition costs in Ireland (circa €187,000 per hectare) for motorways versus the EU norm are instanced."

7 Ibid (Page 8)

Source: F Barry, CEO, NRA – Engineers Ireland Roads & Transportation Society, May 2010.

8 http://www.propertyindustry.ie/Sectors/PII/PII.nsf/vPages/Research_and_publications~pii-submission-to-government-on-construction-costs-07-04-2014/$file/Construction+costs+submission+%2820.2.2014%29.pdf

"The Society of Chartered Surveyors Ireland (SCSI) Construction Tender Cost Index, the recognised industry standard for measuring tender prices, shows that in the first half of 2013, tender prices [were] 12% lower than they [were] in 2000, and some 30% lower than at the peak in 2007."

"This reduction has come about through contractors cutting margins, reducing overheads and profit and by utilising more efficient ways of working, including sourcing alternative material suppliers. In many instances, contractors have also bid at below cost to secure turnover and cash-flow and in the hope of clawing back some of the deficit through contract claims."

9 http://www.surveyorsjournal.ie/index.php/trouble-bonds/

Lasting many months and longer

10 Ibid

For example: retendering fees; maintenance; security; further deterioration; temporary works requirements; and insurance.

11 Ibid

12 http://constructionprocurement.gov.ie/wp-content/uploads/DPER-Circular-7-2013.pdf

13 http://www.per.gov.ie/en/investing-in-infrastructure-jobs/

14 http://www.iae.ie/publications/publication/the-cost-effective-delivery-of-essential-infrastru/

15 Grant Thornton's report "2005 Surety Credit Survey for Construction Contractors: The Bond Producer's Perspective" cited low profit margins, followed by slow collections (payments) and insufficient capital as the major causes of financial difficulties among contractors. Surety company executives also have named onerous contracts, unreasonable owners, bad or incomplete plans, tight completion schedules, consequential damages, delay damages and hold-harmless obligations, higher materials prices, and a shortage of qualified and skilled workers as factors that add risk and can ultimately lead to financial difficulties and default.

http://suretyinfo.org/pdf/CBO-whyfail.pdf

https://www.grantthornton.com/staticfiles/GTCom/files/Industries/ConstructionRealEstateAndHospitality/2007_surety_survey_new.pdf

16 http://www.constructionguarantee.ie/GetAttachment.aspx?id=7bba6e32-5c40-499d-803e-6d3849eeffe6

17 http://www.constructionguarantee.ie/GetAttachment.aspx?id=7bba6e32-5c40-499d-803e-6d3849eeffe6

18 http://www.per.gov.ie/en/hayes-welcomes-move-to-address-crippling-construction-sector-insurance-costs/

19 http://www.per.gov.ie/en/hayes-welcomes-move-to-address-crippling-construction-sector-insurance-costs/

20 http://cif.ie/news-feed/news/233-private-sector-should-follow-government-example-on-bonds.html

21 http://constructionprocurement.gov.ie/wp-content/uploads/Report-on-the-Review-of-the-Performance-of-the-Public-Works-Contract1.pdf

22 Ibid

National Development Finance Agency (NDFA)

23 http://www.per.gov.ie/en/hayes-welcomes-move-to-address-crippling-construction-sector-insurance-costs/

24 http://www.merrionstreet.ie/en/wp-content/uploads/2014/05/Construction-Strategy-14-May-20141.pdf

25 http://www.surveyorsjournal.ie/index.php/trouble-bonds/

26 Ibid

27 http://cif.ie/news-feed/news/233-private-sector-should-follow-government-example-on-bonds.html

28 European Construction Sector Observatory, Country Fact Sheet Ireland, March 2016, http://ec.europa.eu/growth/sectors/construction/observatory/index_en.htm