NSW Treasury

Policy and Guidelines: Guidance on security for construction projects

TPG25-05

4 April 2025

NSW GOVERNMENT

Acknowledgement of Country

We acknowledge that Aboriginal and Torres Strait Islander peoples are the First Peoples and Traditional Custodians of Australia, and the oldest continuing culture in human history.

We pay respect to Elders past and present and commit to respecting the lands we walk on, and the communities we walk with.

We celebrate the deep and enduring connection of Aboriginal and Torres Strait Islander peoples to Country and acknowledge their continuing custodianship of the land, seas and sky.

We acknowledge the ongoing stewardship of Aboriginal and Torres Strait Islander peoples, and the important contribution they make to our communities and economies.

We reflect on the continuing impact of government policies and practices, and recognise our responsibility to work together with and for Aboriginal and Torres Strait Islander peoples, families and communities, towards improved economic, social and cultural outcomes.

Artwork:
Regeneration by Josie Rose

Contents

Key information	
Treasury policy and guideline (TPG) is relevant to	☒ GSF agencies ☒ General government sector ☒ Public non-financial corporation ☐ Public financial corporation ☒ State owned corporations ☐ Other
	☐ Executive agencies related to departments
	☐ Subsidiaries of the NSW Government established under the Corporations Act 2001
Date issued	4/04/2025
Review date	7/04/2028
☐ Replaces ☐ Replaced by	
Issuing/publishing entity	Major Projects Division, NSW Treasury
Related instrument(s)	• TC14-01 Acceptance of Performance Bonds or Unconditional Undertakings by Government Agencies • SC0656-2022 Financial Capacity Framework
Document approver	Sonya Campbell, Deputy Secretary, Commercial, NSW Treasury
Contact	Major projects Division, NSW Treasury, MPD@treasury.nsw.gov.au

Document contains
☐ **MANDATORY POLICY** compliance set out by NSW Treasury.
☒ **RECOMMENDED POLICY** reflecting best practice standards.
☒ **GUIDANCE/ADDITIONAL INFORMATION** to provide clarity or explain requirements in detail.

Revision history				
Document version number	Approval date	Author	Approver	Description
1.0	2025	MDP, NSW Treasury	Sonya Campbell	First version of the Guidance

Guidance on security for construction projects

Purpose

In recent years, NSW has seen significant investment in infrastructure and construction, with the government's focus expanding from traditional sectors like road and rail to emerging areas such as renewable energy, water, and housing. The government aims to achieve value for money, deliver quality projects on time and within budget, and improve financial sustainability, despite the increasing scale and complexity of major infrastructure projects and the current fiscal environment. Contractors, while understanding these financial objectives, also aim to maintain profitability and good cash flow.

However, achieving these financial objectives has been challenging due to factors like COVID-19, cost escalation, supply chain risks, and skills shortages. These pressures have led to greater volatility in key building material prices and fluctuating industry profits over the past decade. In the 12 months leading up to May 2024, the construction industry accounted for 31% of insolvencies in NSW.[1]

The NSW Government continues to focus on the risk management over a project's lifecycle. Security guidance is one of the tools which the government can use to ensure security is commensurate with each project financial and performance related risks and ensure a consistent approach across the NSW Government.

This paper provides guidance on:

- the key types of security that are available
- how to optimise the Security Package
- alternatives and additions to security
- how to determine the appropriate type of security to obtain from the Contractor, and
- how and when to assess the adequacy of security for large-scale infrastructure projects.

Background

Definition of 'security'

Security is a financial assurance provided by a Contractor to secure its performance of its obligations under a contract. Security reduces the Principal's risk of financial loss if the Contractor defaults during construction and/or fails to fulfil its obligations under the contract.

Key parties to a construction contract

The *Principal* is the entity which engages the Contractor under a construction contract. The Principal is normally the procuring agency on NSW Government projects.

[1] Australian Securities & Investments Commission, Australian insolvency statistics, released 3 June 2024

The *Contractor* is the entity responsible for carrying out the works.

Summary of types of security

- There are several types of security which can be provided by a Contractor. The key types of security discussed in this paper include, *Parent Company Guarantees, Unconditional Undertakings* (also known as bonding such as bank guarantees and insurance bonds) and *Cash Retention*.

The Principal's entitlement to call on and use security

- The right to call on and use performance security is dictated by the terms of the underlying contract and any applicable legislative requirements.
- Construction contracts will generally include a clause that contains an express right on the Principal to call on security in specific circumstances.
- When a performance security is called on, the issuer of the security, as opposed to the Contractor, will be required to pay the Principal a monetary sum up to the secured amount on demand, or otherwise as set out in the terms of the security.
- Examples of when security is called on
- Situations where the Principal may call on security include:
- to recover amounts owing by the Contractor (e.g. liquidated damages), or
- to compensate it for loss suffered as a result of the Contractor's breach of contract (e.g. defective works.

Financial Capacity Framework

- Security in relation to a Contractor's solvency risk on large-scale infrastructure procurements is considered under the Financial Capacity Framework. In particular, the Framework considers the adequacy of security and its implications for the financial capacity and strength of a Contractor and its Guarantors.
- Treasury identified that there were inconsistent approaches to financial capacity risk identification and mitigation in the procurement of the State's major infrastructure projects. This was particularly concerning for the State with increasing levels of concentration risk faced by the State.
- The Financial Capacity Framework was developed to respond to these emerging risks. The Framework has been designed to enable more proactive risk management and consistency in assessing the financial capacity of Contractors and their Guarantors on large-scale infrastructure projects.
- The Framework was approved by the Government in August 2022.
- The Framework is mandatory for Tier 1 and 2 projects as defined by the Infrastructure Investor Assurance Framework with an estimated contract value of $500 million and above.
- Refer to Section 5 for further information on how the Framework can assist with assessing the adequacy of security during the lifecycle of a project (particularly during the procurement stage).

Common types of security

Guidance

- There are several types of security which can be provided by a Contractor.
- The most common types are discussed in this section – including:
  - Parent Company Guarantees (*PCG*)
  - Unconditional Undertakings – an umbrella term used to describe bank guarantees and insurance bonds
  - Cash Retention
- Each of these is used to achieve the same goal – to increase confidence and manage risk between the parties to the underlying transaction or project.
- Each type of security has a different cost, level of support, and legal and commercial consequences. Ultimately, the types of security chosen should be tailored to the specific project and the circumstances of the Contractor.

Parent Company Guarantee (PCG)

Purpose

A PCG strengthens the financial credibility of a Contractor.

How it works

Typically a parent company of a Contractor guarantees the performance of contractual obligations in the event the Contractor defaults, or is unable to perform the contract.

Identity of Guarantor

The *Guarantor* may be the ultimate parent or an intermediate holding company of the Contractor.

The Guarantor will generally have a stronger balance sheet, satisfactory credit rating, financial independence, and liquidity. This assessment is determined by a financial capacity assessment during the Contractor procurement phase, and by financial monitoring activities during the delivery or operational phases.

Refer to Section 3 *Determining the types of security* for specific considerations for foreign guarantors.

Cost

The Guarantor's overheads and risk premium (relevant to the PCG) are typically charged to the Contractor and passed through to the Principal as part of the contract sum.

A PCG is generally easier to put in place and less costly than other forms of security.

Scope of the guarantee

A PCG typically guarantees the Contractor's financial and performance obligations.

Amount

The total liability of a Contractor and its Guarantor are usually capped at a fixed percentage of the contract value, subject to any specified categories of liability which sit outside the liability cap.

Timing

A PCG is typically provided at the time the construction contract is signed. However, the form of the PCG should be provided with the procurement documents to ensure: Contractors have time to engage with the Guarantor during the negotiation phase prior to contract award; and the principal has time to confirm the suitability of the PCG and the financial capacity of the Guarantor.

Unconditional Undertakings (bonding)– including bank guarantees and insurance bonds

Purpose

Unconditional Undertakings such as bank guarantees and insurance bonds provide the Principal with a contractual right to access immediate financial support from a third party, known as the *Issuer*.

How it works

An Unconditional Undertaking involves three parties – a financial institution, as the Issuer, undertakes to pay a specified sum of money to the Principal on behalf of the Contractor.

The security is deemed 'unconditional' as the Issuer must make immediate payment on demand, regardless of whether the Contractor owes the amount claimed, or disputes the amount claimed.

The Principal will be required to give a written demand to the Issuer stating the Contractor's failure to perform, in order to call on the bank guarantee.

The financial risk of contractual failure is therefore transferred from the Principal to the Issuer.

Identity of Issuer

The Issuer is generally a financial institution such as a bank, a non-bank financial institution (i.e. a building society or credit union), an investment bank or an insurance company.

The Issuer should have acceptable creditworthiness as determined by APRA regulation or by an independent credit rating agency.

Refer to TC14-01 for the conditions under which an Unconditional Undertaking covering contracts entered into by NSW Government agencies are acceptable, including the types of issuers that are acceptable.

Amount

The specified sum of money that is guaranteed is typically a percentage of the contract value.

The amount should be enough to cover the Principal's potential financial exposure according to how quickly the Principal can act to step in and resolve in the event of Contractor default or insolvency.

Sculpting the security based on the risk profile of the project is particularly relevant to Unconditional Undertakings.

Cost

The fee structure can vary. Typically, the Issuer charges the Contractor a fee for providing the Unconditional Undertaking, e.g. 1.25-1.75% of the guaranteed amount, which may be passed onto the Principal.

A separate fee is charged to the Contractor if an amount is paid out under the Unconditional Undertaking.

Bank Guarantees are typically more expensive than insurance bonds.

Timing

The Principal has time to confirm the suitability of the Unconditional Undertaking and the Issuer.

The Unconditional Undertaking is typically provided at the time the construction contract is signed. However, like PCGs, the form of the security should be provided with the procurement documents to ensure contractors have time to engage with the financial institution during the negotiation phase prior to contract award.

Cash Retention

Purpose

Cash Retention is a form of performance security where cash due to the Contractor is withheld by the Principal to ensure that the work is completed.

How it works

The Principal withholds an agreed percentage of the contract sum from the Contractor's progress payments until the amount held is equivalent to the total amount of security required and agreed.

Retention money must be held in a retention money trust account established with an approved authorised deposit-taking institution (*ADI*) in accordance with *Building and Construction Industry Security of Payment Regulation 2020 (NSW)*. This regulation also sets out broader retention money trust account requirements.

Amount

The percentage of cash that is retained varies according to individual projects. Interim payment certificates issued by the Principal should clarify the amount of retention held. The value of Cash Retention improves over time as the amount of cash retained accumulates.

Cost

Contractors may need to fund the gap between the full progress payment and the payment received after Cash Retention. This may be priced into the contract sum.

Administration

The Principal may only access retention monies in accordance with the construction contract. The construction contract should set out the administration of any Cash Retention, including who is entitled to any interest paid on the cash held.

The Principal may also be required to meet requirements of the financial institution which holds the account where the money is held.

Optimising the Security Package

Recommendations

• A '*Security Package*' includes one or more types of security that can be provided by a Contractor.
• The Principal should have processes to monitor the level of security throughout the life of the contract.
• The amount and type of security held by a Principal towards the end of a project should take into consideration the Contractor's ability to pay any liquidated damages that may become payable by the Contractor for late completion.
• The Principal should ensure the effectiveness of the Security Package is optimised by:
  ○ tailoring the Security Package to individual projects and Contractors, balancing the desired type and amount of security with its effectiveness and cost;
  ○ sculpting the security (including its release) to align with the project's complexity, timeline, risk profile, the Principal's objectives and key milestones;
  ○ aligning the level of security with the Principal's risk management process for the project;
  ○ ensuring it is enforceable;
  ○ assessing the creditworthiness of the Guarantor; and
  ○ quantifying the required level of security to ensure it is enough to cover the Principal's potential financial losses under the contract. (Note: this is different to the contract value or the extent to which losses may be recoverable under insurances. Potential financial losses may include indirect costs, for example legal or public relations expenses, and direct costs, for example retendering costs and payments to subcontractors in the event of Contractor insolvency).

Guidance

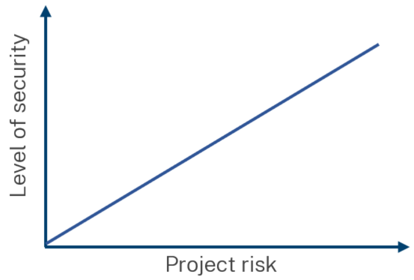
Cost of security

Regardless of the type of security, a Contractor typically prices the cost of the security into the contract sum that is payable by the Principal. The Principal should bear in mind the additional cost to the project when considering the Security Package, with respect to the following factors.

Project risk

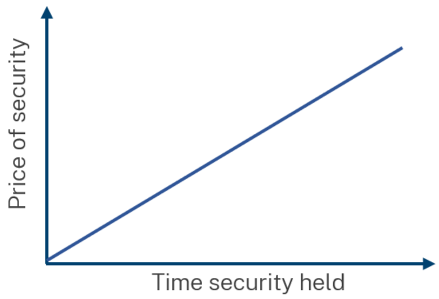
The level of risk is directly related to the level of security that should be obtained. This means the higher the risk of a project, the higher level of security would generally be obtained.

Project risks can also change during a project. It may be appropriate for the Principal to request additional security during the project where there is a significant variation which substantially increases the construction contract's value or risk.



Duration of the security held

The cost will increase the longer the security is required to be held by the Principal.

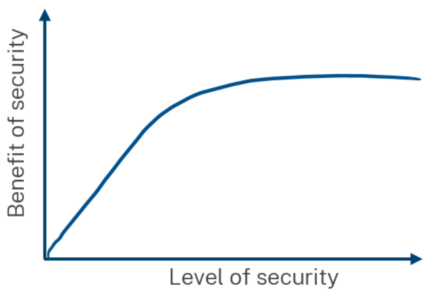


Value for money of having additional security

Cost of security will increase by the amount of security obtained. The cost of additional security may outweigh the marginal benefit it provides.

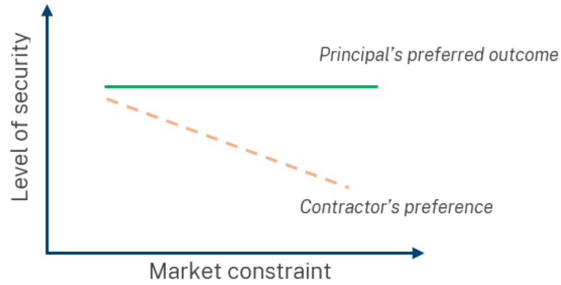
The Principal should consider the form of the security as some are more expensive than others, for example bank guarantees are typically more expensive than insurance bonds.

The Principal should consider whether the additional protection from the additional security is worth the additional cost.



Market capacity

A Contractor must be able to obtain security from the market in order to provide it to the Principal. Market constraints may reduce the level of security a Contractor can provide.

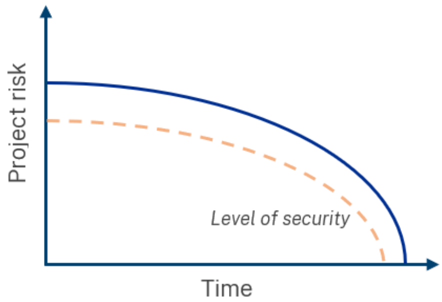


Sculpting security based on the project's risk profile

The risk and complexity of a construction project typically decreases over time as it approaches the end of the construction phase.

For example, activities such as excavation works performed during the earlier stages of construction are inherently higher risk and more complex compared to safety testing of pavements performed at the end of a project. In this situation, holding a large amount of security at the end of the project may not be the best value for money.

However, on a different project in the equivalent phase, higher levels of security may be justified. For example, higher levels of security may be appropriate during a commissioning and testing phase where infrastructure and operating systems are required to be fully integrated before the asset is operational.



Unseen costs

Cost is not limited to premiums on the security, but also, the inherent risk on the Contractor's cashflow, such as the threat of a call on the security.

Critical assets

A Principal's interests in critical assets or materials are also an important consideration when determining the level of security.

Assets manufactured by a third party

Some assets which are critical to a project, for example vehicles or equipment such as a tunnel boring machine, may be supplied or manufactured by a company that is not the Contractor.

Without a direct contract between the Principal and that supplier/manufacturer, it may be difficult for the Principal to enforce the timely supply of the asset with only security from the Contractor. This may be overcome by requesting additional security over the Contractor's manufacturing leases of the equipment.

Payment for unfixed assets

A Contractor may require payment for materials (i.e. unfixed assets) that will be incorporated into the works.

The amount of unfixed assets on site should be limited, and the Principal should ensure it is not obliged to pay for these materials until the Contractor has provided additional security to cover the amount claimed for the materials. This security should remain in place until the materials are incorporated in the works and there is evidence that title in the materials will transfer to the Principal on payment.

To determine the amount of security required to cover these risks, the Principal should undertake a detailed analysis to forecast unfixed asset risk during the construction phase. Certification by a payment certifier is a common approach to ensuring the level of unfixed assets is supported by security arrangements.

The Principal should also consider whether it should become a secured creditor in respect of certain items of personal property (which requires compliance with procedures set out in the *Personal Property Securities Act 2009 (Cth)*. Compliance with this legislation may be particularly relevant if a Contractor subsequently becomes insolvent. The Principal should seek legal advice when security is sought over any property of the Contractor (or third party).

Other factors to consider

Remedial period prior to contract termination and engaging a new Contractor

For example, consider a Design & Construct contract provides a remedial period of 2 months prior to termination, and the Principal anticipates that engaging a new Contractor will take an additional 3 months. The security should cover the estimated financial impacts over the cumulative 5-month period.

Principal makes a mobilisation payment to a Contractor

Mobilisation payments are usually sought by the Contractor to assist with meeting the project's start-up costs. The Principal should obtain an equivalent level of Unconditional Undertaking from the Contractor, which can be released when the mobilisation works are complete in accordance with the construction contract.

Sculpting the Contractor's liability cap

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

The Principal may consider sculpting the liability cap across the project timeline to reflect the level of risk exposure to the Principal at the certain points in time. This can be achieved by introducing step-changes to the Contractor's liability cap as opposed to a set percentage over the full contract term.

For example, on a general surface road works project, security requirements may be low during the design phase, with a step-up during construction and step-down during the defect liability period.

A more balanced risk allocation can be achieved with a tiered liability cap structure, and this may increase a Contractor's willingness to provide greater security. This can also incentivise performance by encouraging Contractors to meet specific project milestones that trigger a reduction in their liability exposure.

Determining the type of security

Recommendations
• When determining a Security Package, the Principal should consider the numerous factors which may impact the effectiveness of each type of security. • Contractor risks including financial capacity, experience, reputation, insurance, supply chains and consortium arrangements should be considered.

Guidance

Parent Company Guarantee

Financial versus performance guarantee

As a PCG typically guarantees a Contractor's financial and performance obligations, a Guarantor can be required to step-in to the contract to fulfil the Contractor's performance obligations. This may not be possible if the Guarantor does not have the necessary financial strength, capability, resources, registrations or accreditations (e.g. construction licenses). As a result, the Guarantor may seek to limit the PCG to financial obligations only.

Less protection where Guarantor is an intermediate entity

A Guarantor which is an intermediate entity within the company group structure (i.e. not the ultimate parent company) may not provide the same degree of confidence as that of the ultimate parent. This is because the intermediate entity may not be as creditworthy as the ultimate parent company. In addition, in a complex company group structure, it can be unclear where the Group's assets are held and the ultimate parent company may be able to divest the intermediate entity's major assets leaving very few assets to fund a call on the security.

Other obligations within the corporate structure

Where the Contractor is a subsidiary within a complex company group structure, the Principal should consider the broader group's involvement in projects as the value of a PCG may be diluted where the Guarantor is supporting a significant number of its subsidiaries on other projects.

Parent company's impact on the Contractor

The financial risk of a Contractor is heavily influenced (and can be constrained) by the financial capacity of its corporate group, regardless of whether a PCG is provided by the ultimate parent company. The proximity of the Contractor's credit rating to the parent company's credit rating increases when the Contractor has a high operational, strategic, financial and/or legal linkage to the parent company. In such instances, the Principal should ensure the ultimate parent company has a satisfactory credit rating (even where there is no guarantee being provided by the ultimate parent).

Contractor's impact on the parent company

The value of a PCG should be carefully considered where there are indicators of the Contractor experiencing problems, for example, under resourcing or delays across multiple projects. These problems may have a cascading effect on the Contractor's cashflow which may worsen the parent company's financial risk position.

Joint ventures

A PCG should be provided by the parent company of each member of a joint venture arrangement *(JV)*. A JV usually involves joint and several liability, so it is essential that each PCG covers the full liability of the Contractor and not just that parent's share of the potential liability.

Additionally, in a scenario where a JV is comprised of a highly creditworthy party and a less creditworthy party (e.g. a AAA rated entity and a B+ rated entity), it may be appropriate to obtain one PCG only, from the entity with the higher credit rating, depending on the financial and project capacity of the parent, location of the parent and ability to repatriate funds to Australia.

Foreign Guarantors

Due to the potential difficulty of enforcing a PCG provided by a foreign Guarantor, it may be more appropriate to obtain a PCG from the topmost local parent company domiciled in Australia.

There are three key factors to consider when a Guarantor is proposed to be a foreign entity:

- Enforcement – seek appropriate foreign legal advice to determine whether a court in the foreign jurisdiction is obliged to recognise or enforce the judgments of Australian courts or arbitrational awards.
- Repatriation of funds – determine any restrictions on the repatriation of funds from the foreign jurisdiction to Australia.
- Form and terms of the guarantee – a PCG provided by a foreign entity can be impacted by the relevant foreign jurisdiction, choice of law, dispute resolution provisions in the guarantee and related contracts. For example, some foreign jurisdictions require shareholder consent for the foreign entity to be able to provide a PCG.

Procuring agencies should contact the Infrastructure & Structured Finance Unit of NSW Treasury to discuss the acceptability of a proposed foreign Guarantor.

No protection where construction contract is unenforceable, illegal or invalid

A PCG alone may not provide protection where the construction contract is unenforceable, illegal or invalid. It is important that the PCG includes an indemnity from the parent company in respect of the Contractor's default or non-performance of its obligations to create a primary, independent obligation which will be enforceable separately to the construction contract.

Principal is an unsecured creditor

If the Guarantor becomes insolvent, the Principal may be one of many unsecured creditors. If the Guarantor's assets are exhausted, the PCG may be of limited or no value.

Impact on Guarantor's balance sheet

A PCG may be accounted for as a contingent liability and therefore may impact the balance sheet and financial position of the Guarantor. For this reason, a Guarantor may seek to limit its exposure under a PCG.

Change in control of the Contractor or parent company/Guarantor

This may lead to difficulties in enforcing a PCG or necessitate a replacement security. Change in control provisions in the contract and in the PCG may be needed to protect the value of a PCG.

Unconditional Undertakings – bank guarantees and insurance bonds

The Unconditional Undertakings must be compliant with TC14-01.

Unconditional nature

An Unconditional Undertaking should be in a form 'as good as cash'. The best form of Unconditional Undertaking is one that is truly unconditional and payable on demand without needing to prove the Contractor's default or its right to call on the undertaking under the construction contract.

Some common conditions requested by Contractors include:

- the Principal proves that the Principal has a claim or entitlement against the Contractor
- the Principal proves that the Contractor has a debt due and payable to the Principal
- the Principal gives notice to the Contractor that it intends to make a call
- the Principal demonstrates to the security issuer its entitlement under the construction contract
- a notice period elapses before the Principal can call on the security.

There should be limited (or no) conditions on the Principal's ability to call the security, as this may impact the Principal's ability to enforce the Unconditional Undertaking.

Form

An Unconditional Undertaking is usually comprised of:

- the instrument which sets out any relevant terms and conditions which must be satisfied by the Principal to make a compliant call on security, and
- the construction contract, which may set out any restrictions or qualifications on the Principal's ability to call on security.

Perceived uncertainties with insurance bonds

Insurance bonds, while less common and are not typically secured by a cash deposit, should not be considered inferior to bank guarantees. There is minimal evidence to suggest additional complexity or uncertainty associated with insurance bonds. Nevertheless, a Principal should ensure any Issuer of an insurance bond has an Australian branch and an appropriate credit rating, and that the terms of the bond and the individual institution's policies for responding to a call on the security are appropriate.

Size and trigger events

The contract should clearly state the purpose of the security by reference to specific performance required of the Contractor. This can be achieved by breaking down the amounts for specific events as opposed to having an aggregate bond for the entire contract, for example, security sized to meet obligations for provision of final documentation or specific completion requirements.

However, overly specific triggers can dilute the 'at-call' nature of a guarantee and establish a higher, less timely threshold on the Principal's ability to call on the security. This reduces the ability of the instrument to provide immediate liquidity to address project issues, particularly if the Contractor has an opportunity to dispute the call prior to funds being made available. The instrument itself should have no triggers. It should be unconditional.

Impact on cashflow

This type of security may require a Contractor to have cash reserves quarantined by the financial institution Issuer , equal to the amount of the guarantee, which may deplete a Contractor's working capital and create cashflow difficulties, particularly for smaller Contractors. This can also impact a Contractor's ability to compete for future projects.

Satisfaction of the Guarantor/Issuer

Prior to issuing the security, a Guarantor/Issuer will generally need to be satisfied that a Contractor can meet current and future obligations, has a good reputation, has experience meeting the requirements of the project to be undertaken, and has (or can obtain) the equipment necessary to perform the work.

Replacement security

The Contractor should be required to provide replacement security where the Guarantor/Issuer no longer retains the required credit rating (in accordance with TC14-01), or well in advance of any expiration.

Cash Retention

Cashflow

Cash Retention may affect a Contractor's liquidity and ability to meet project expenses, including paying subcontractors. It is therefore not recommended during the mobilisation phase due to the cash outlay normally required to mobilise a project.

Risk profile and timeline

Where critical risk elements of the project are expected to occur in the early phase of a project, Cash Retention may not be a suitable form of security as adequate cash reserves take time to accumulate.

Legislative requirements

Additional legislative requirements may apply where Cash Retention is used as security, such as under the *Security of Payment Act 1999 (NSW)*. The Principal should seek legal advice before utilising Cash Retention as security.

Size of Contractors

Cash Retention is more common for small projects or smaller Contractors when the Contractors do not have the means to obtain bank guarantees or insurance bonds, or where the value of assets sitting behind a parent company is not significant.

Alternatives and additions to security

Recommendation
• When considering the risk exposure on a project, a Principal should also consider other risk mitigation measures available which may offset certain risks.

Guidance

Alternative types of security

Other risk mitigation measures that can be used as alternatives or additions to the common types of security include:

- liquidated damages payable by a Contractor for late completion
- deductions, setting-off or netting provisions
- indemnities
- General Security Agreement under the *Personal Property Securities Act 2009 (Cth)*
- default triggers and cure plan requirements, for example, the failure to satisfy a 'look-forward test' (assessment of construction progress by an independent certifier to determine whether completion is likely to be achieved within a required timeframe) can trigger certain remedial rights for the Principal under the construction contract
- completion payments which are released when the project is defect-free
- contractual restraints such as dividend capping and limits on funds loaned to related parties, to protect against cash leakage from higher risk Contractors
- personal guarantee from company director(s) - more appropriate for smaller projects and Contractors and usually limited to an agreed amount.

Key considerations before calling on security

Recommendations
• A Principal calling on security may have significant consequences for a Contractor. Before calling security a Principal should carefully consider the factors set out below. • It may be appropriate to use a payment certifier for assessing project performance as a precursor, or indicator of the need, to calling security.

Guidance

Amount

The Principal should consider the project risks and capability of the Contractor at the relevant time, to determine if, and to what extent, security is required to be called on to deal with the consequences of the Contractor's breach/insolvency.

Guarantor's opportunity to remedy

With respect to a PCG, the Principal should communicate with the Guarantor in relation to any issues under the construction contract. The Principal may be required to give the Guarantor a reasonable period to take action to resolve the issue, e.g. cure plans. If an agreement is not reached, enforcement action against the Guarantor can involve lengthy litigation and arbitration, depending on the dispute resolution and associated provisions which apply to the PCG.

Compliance with call requirements

A call on security must comply with all relevant requirements including those in the construction contract and relevant security instrument (particularly for an insurance bond/bank guarantee), for example, presentation of the original security by an 'authorised person'. If the Principal does not comply with the requirements, the Contractor may seek a court injunction to stop the call on security or prevent the Principal using the proceeds of the security.

Not a reflection of final rights between parties

The Principal should ensure there is an appropriate approvals pathway and strong governance associated with any decision to call on security. If the Principal calls on security and it is later determined that the call was made improperly (e.g. the Contractor was not in default), the Contractor may be entitled to recover the proceeds of the security from the Principal, as well as other (potentially significant) losses suffered by the Contractor as a result of the improper call.

Financial distress or failure for a Contractor

Calling on security may lead to a Contractor's financial distress or failure, which may impact the delivery of the project.

Insolvency or voluntary administration of a Contractor

Calling on security may be more complicated if a Contractor is insolvent or in voluntary administration as the Principal may be required to liaise with a liquidator or numerous external administrators. In this case the Principal should seek legal advice before taking steps to enforce its rights, as there are some restrictions on creditor actions in an insolvency scenario. This includes the 'ipso facto' prohibition, which in some circumstances, restricts a counterparty's ability to exercise contractual rights because of an insolvency event.

Alternatives

It may be more appropriate and effective for the Principal to pursue alternatives in the construction contract.

Assessment of security in the procurement process – *for large-scale infrastructure projects*

Recommendations
• As part of the procurement and evaluation process, financial capacity assessments are generally undertaken on the Contractor and its Guarantors to assess their financial capacity. • The following guidance is mandatory for large-scale Tier 1 and Tier 2 infrastructure projects with a contract value of $500 million and above that are subject to the Financial Capacity Framework. • Projects outside of the scope of the Financial Capacity Framework are not required to implement the following guidance, though it is considered best practice. Procuring agencies of such projects should consider the following guidance in the context of the relevant project's complexity and contract value to determine the extent to which it adopts the following guidance.

Guidance

Background

The Financial Capacity Framework is NSW Government's framework to manage emerging risks from the delivery of the State's infrastructure program.

The Framework is designed to provide guidance to agencies in proactively identifying financial capacity risks and financial deterioration of Contractors. It also establishes a consistent approach to mitigating such risks during the procurement, delivery, and operational stages of projects.

The Framework comprises three pillars:

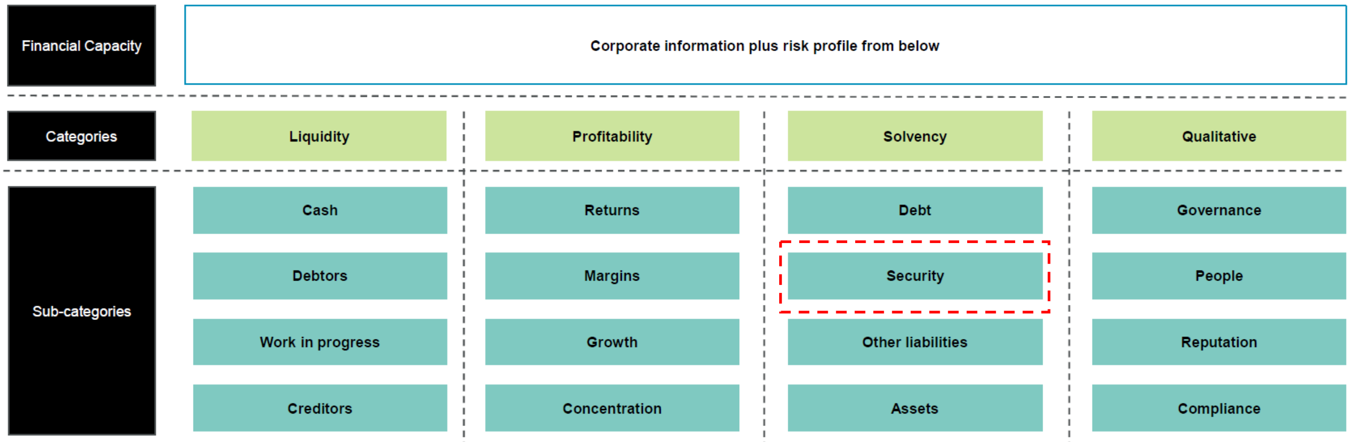
- A Financial Capacity Assessment Framework
- A Risk Management Framework
- A Financial Capacity Centralised Unit

Financial Capacity Assessment Framework and Contractor Deep Dives

The Financial Capacity Assessment Framework is a risk-based assessment methodology for a new form of financial capacity assessment known as a Contractor Deep Dive.

This methodology is designed to identify any areas of potential concern with respect to four key risk areas – profitability, liquidity, solvency, and qualitative factors (pictured below).

Contractor Deep Dives are anticipated to be utilised at the EOI and RFT stages and may also be performed during delivery and operational phases where risk indicators arise during financial capacity monitoring.



Risk Management Framework

The Risk Management Framework helps to identify, mitigate and monitor risks throughout the project lifecycle based on the risks flagged in a Contractor Deep Dive.

This will ensure that the State can proactively respond to the changing financial capacity risk profiles of its key Contractors through the prescription of mitigating activities and standardised contract terms for financial reporting requirements.

The Financial Capacity Centralised Unit

The Financial Capacity Centralised Unit provide specialist financial capacity advice to agencies on all matters related to financial capacity as well as projects that fall under the scope of the Framework.

The Centralised Unit can be contacted via FinCapCentral@treasury.nsw.gov.au.

52 Martin Place
Sydney NSW 2000

GPO Box 5469
Sydney NSW 2001

W: treasury.nsw.gov.au