

Inform Practice Note #7

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Subcontracting Arrangements

cidb's Inform Practice notes provide guidance and clarity in achieving client objectives in construction procurement and delivery. Practice notes inform clients and practitioners on how to embrace best practice and how to deal with issues that may arise. They are aligned with, but do not replace regulation.

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Synopsis:

Subcontracting is a well established practice within the construction industry. It is an effective means of involving small, medium and micro enterprises in the construction works contracts.

This practice note examines the different types of subcontractors that are encountered in construction works, namely nominated, selected and domestic. It presents an overview of the subcontracting provision of the FIDIC, GCC 2004, JBCC Series 2000 and NEC3 standard forms of contract as well as the cidb registration requirements and other public sector requirements.

cidb Standard for Uniformity in Construction Procurement

4.5.8 Employers, wherever appropriate, in support of industry development, shall in the application of the register of contractors, promote the participation and development of registered contractors by means of one or more of the following:

- a) Unbundling projects into smaller contracts;
- b) Implementing targeted development programmes to support potentially emerging contractors in accordance with the provisions of the Construction Industry Development Regulations;
- c) Offering preferences to contractors who undertake to enter into joint ventures with or subcontract portions of the works to such contractors; and
- d) Requiring a prime contractor to subcontract defined portions of the works to such contractors in accordance with the provisions of 4.4.6.

SANS 1914-1:2002, Targeted procurement procedures, Part 1: Participation of targeted enterprises

A contractor may achieve the contract participation goal (see annex A) as follows:

- a) By virtue of his targeted enterprise status;
- b) By entering into an acceptable joint venture agreement with one or more targeted partners as set out in 3.2.3;
- c) By engaging one or more targeted enterprises to perform commercially useful functions in the performance of the contract;
- d) By engaging non-targeted enterprises, who in turn engage one or more targeted enterprises to perform commercially useful functions in the performance of the contract;
- e) By engaging non-targeted enterprises, who in turn enter into joint venture agreements with one or more targeted partners as set out in 3.2.3 to perform commercially useful functions in the performance of the contract; or
- f) By a combination of the above.



1. Introduction

The practice of subcontracting portions of a construction works contract to others is a well established practice in South Africa and elsewhere in the world. Subcontracting is an important and effective means of involving small, medium and micro enterprises in the construction industry.

The reasons for subcontracting vary between the different types of construction works contracts. In some contracts, there may be a need to acquire specialist capabilities to perform certain aspects of the work. In others, there may be a need to subcontract portions of the work to increase the contracting capacity of the contractor or to satisfy client requirements or expectations relating to the engagement of small and micro enterprises or local enterprises in a contract. Subcontracting may also be used as means of addressing racial and gender imbalances in the ownership of contracting companies or to develop cidb registered contractors (see cidb Construction Procurement Best Practice Guideline #A8, Procurement Measures to Develop Registered Contractors).

2. Subcontracting issues

Subcontractors often have unequal negotiating power with main or prime contractors due to the sheer size of the parties and the presence of a "next job syndrome". Some of the historic problems expressed by subcontractors include the "hawking" of prices by prime contractors in order to obtain lower prices from others (i.e.

the practice of "Dutch Auctioning"); the risk of non-payment; and the use by prime contractors of subcontractors' monies as an interest free overdraft facility and the lack of representation or participation by subcontractors in trade associations, at forums or even at site meeting with the employer's representatives.

Traditionally, as employers only have a contractual relationship with the prime contractor, they regard subcontracting issues to be the prime contractor's problem and of no concern to them. Subcontracting is, however, an effective means of involving small, medium and micro enterprises in public sector procurement activities. As such, the plight of subcontractors cannot be ignored. Accordingly, measures need to be taken to address the shortcomings in current subcontracting arrangements.

Considerations

Prime or main contractors may:

- a) Be free to negotiate the prices and terms for subcontracting; or
- b) Be required to invite competitive tenders from amongst targeted enterprises in terms of a specified procedure and specific forms of subcontract and upon the award of the contract become domestic subcontractors i.e. the contractor remains responsible for providing the subcontracted portion of the works as if the work had not been subcontracted.

The advantage of the approach whereby contractors are required to call for tenders is that targeted enterprises tender for the work in the same manner as the prime contractor does. It also allows the employer to determine the terms and conditions under which targeted enterprises are subcontracted.

FIDIC – Red book

In the Contract, "nominated subcontractor" means a Subcontractor:

- (a) Who is stated in the Contract as being a nominated Subcontractor; or
- (b) Whom the Engineer, under Clause 13, instructs the Contractor to employ as a Subcontractor.

The Construction Regulations, 2003, issued in terms of the Occupational Health and Safety Act of 1993, require principal (prime or main) contractors to appoint subcontractors in writing.

3. Approach to subcontracting in the different standard forms of contract

3.1 General

There are three types of subcontractors provided for in standard forms of contract for construction works, namely:

- **Domestic subcontractor:** subcontractor appointed by the main contractor at his discretion;
- **Nominated subcontractor:** a subcontractor nominated by the employer which the contractor is obliged to appoint as a subcontractor; and
- **Selected subcontractor:** a subcontractor selected by the contractor in consultation with the employer in terms of the requirements of the contract.

The main contractor has no control over the appointment of nominated subcontractors. Accordingly, if there is any delay in the appointment of such a subcontractor for whatever reasons, the employer is liable for any expenses and costs that the main contractor may incur as a result of such delay.

The main contractor has control over the appointment of selected subcontractors if he is made responsible for the procurement process. As a result, the employer is not liable for any expenses or costs associated with a delay in the appointment of the selected subcontractor, unless the employer or the employer's representative is responsible for developing the selected subcontractors' procurement documents or controlling the procurement process.

The standard forms of contract included in the cidb Standard for Uniformity in Construction Procurement approach subcontracting differently.

3.2 FIDIC

The FIDIC Conditions of Contract for Construction (Red Book) do not permit the Contractor to subcontract the whole of the works. These conditions of contract hold the Contractor responsible for the acts or defaults of any of his domestic subcontractors as if they were the acts and defaults of the Contractor himself.

Provision is made for nominated subcontractors. In terms of these conditions, a Contractor is not under any obligation to employ a nominated subcontractor against whom he raises reasonable

objection by written notice to the Engineer which may include:

- The subcontractor has insufficient competence, resources or financial strength; and
- The subcontract does not:
 - Require the subcontractor to indemnify the Contractor against negligence or misuse of goods; or
 - Specify that the nominated subcontractor undertake all obligations and liabilities to discharge the Contractor from obligations under the contract and indemnify the Contractor from all the consequences of any failure of the subcontractor to perform his obligations or fulfill his liabilities.

These conditions of contract empower the Engineer to request reasonable evidence before issuing a payment certificate that the nominated subcontractor has received all monies due in previous certificates. In the event that no reasonable evidence is provided, the Employer is permitted to pay the nominated subcontractor directly.

The FIDIC Short Form of Contract (Green Book) has no specific provisions for subcontracting. Contractors may accordingly subcontract portion of the work to domestic subcontractors, but are responsible for the work executed by such subcontractors as if they had not subcontracted such works.

FIDIC does not provide any standard form of subcontract for use with the FIDIC Red Book or any of its standard forms of contract.

3.3 GCC 2004

The General Conditions of Contract for Construction Works (GCC 2004) do not permit the Contractor to subcontract the whole of the works and require the Contractor to obtain the Employer's written consent before doing so. GCC 2004 does, however, make provision for the selection of subcontractors in consultation with the Employer in terms of a procedure established in the scope of work i.e. selected subcontractors. The conditions of contract make it clear that such subcontractors are to be treated as if they were appointed by the Contractors i.e. as domestic subcontractors. They expressly state that any consent or participation in the selection of a subcontractor does not imply any contract between the employer and the subcontractor, any responsibility or liability on the part of the employer to the subcontractor or relieving of the Contractor from any obligation under the contract. The Contractor remains liable as if he did not subcontract any portion of the works.

These conditions of contract empower the Engineer to request reasonable evidence before issuing a payment certificate that the selected subcontractor has received all monies due in previous certificates. In the event that no reasonable evidence is provided, the

Principal Building Agreement



"DIRECT CONTRACTOR" means a party appointed by the employer to do specialist work on site prior to practical completion.

"NOMINATED SUBCONTRACTOR" means a subcontractor executing work provided for in a nominated subcontract amount included in the contract sum or, in respect of additional specialist work, a subcontractor appointed as a nominated subcontractor in terms of a contract instruction.

"SELECTED SUBCONTRACTOR" means a subcontractor executing work provided for in a selected subcontract amount included in the contract sum or, in respect of additional specialist work, a subcontractor appointed as a selected subcontractor in terms of a contract instruction.

Employer is permitted to pay the nominated subcontractor directly.

The South African Institution of Civil Engineering, the publishers of GCC 2004, does not provide any standard form of subcontract for use with GCC 2004.

3.4 JBCC series 2000 Agreements

The JBCC Series 2000 Principal Building Agreement makes provision for direct contractors, domestic subcontractors, nominated subcontractors and selected subcontractors.

Contractors are required in terms of this agreement to permit work to be executed and installed by direct contractors on instruction by the Principal Agent to do so. (Direct contractors are appointed directly by the employer and

as such are neither nominated or selected sub-contractors.) The risk associated with and payment for such work is the direct responsibility of the Employer. The Contractor is required to make reasonable allowance in his construction programme for work by direct contractors.

Contractors are required to appoint domestic subcontractors in terms of fair and equitable conditions of contract that are compatible with the Principal Building Agreement. Such subcontractors are the direct responsibility of the contractor.

The Principal Agent is required to:

- Prepare tender documents for nominated and selected subcontractors using the JBCC Series 2000 Nominated/Selected Subcontract Agreement; and
- Nominate a subcontractor and instruct the contractor to appoint this subcontractor or call for tenders from a list of tenderers agreed between the contractor and the principal agent and in consultation with the contractor choose a subcontractor and instruct the contractor to appoint the selected subcontractor.

The Contractor may refuse to appoint a nominated subcontractor:

- If he has a reasonable objection to the appointment; or
- If the subcontractor is unable to provide security.

The Contractor is required to issue the nominated/selected subcontractor with a payment guarantee for an amount of ten percent of the contract sum. The contractor is also required to furnish proof of payment to such subcontractors within 5 days of being instructed to do so.

NOTE

Clause 21 of the JBCC Series 2000 PBA requires the principal agent to "call for tenders from a list agreed to between the contractor and the principal agent" and to "in consultation with the contractor, choose a subcontractor and instruct the contractor to appoint such a contractor."

The constitutional requirement for public sector procurement is that the procurement system must be fair, equitable, transparent, competitive and cost effective. This includes the agreeing of a list of subcontractors from which tenderers are invited. Accordingly, the current JBCC procedures for calling for tenders for selected procedures need to be amended and aligned with the requirements of the cidb's Standard for Uniformity in Construction Procurement, unless the list is drawn up following a prequalification process involving a call for expressions of interest in accordance with the requirements of the Standard.

The Employer is liable for all expense and loss suffered by the Contractor where the nominated subcontract is cancelled due to default or insolvency. The Contractor may decide to cancel a subcontract where the selected subcontractor is in default for whatever reason, but is responsible for the cost of carrying out and completing the selected subcontract works unless it was cancelled due to default by the Employer or his agents.

The JBCC Series 2000 Minor Works Agreement makes provision for direct contractors but not for nominated or selected subcontractors. Contractors may accordingly subcontract portions of the work to domestic subcontractors, but are responsible for the work executed by such subcontractors as if they had not subcontracted such works.

3.5 NEC3

The NEC3 Engineering and Construction Contract (ECC) has been designed on the assumption that work may be subcontracted. There is no provision for the nomination of subcontractors within the NEC contracts. Provision for selected subcontractors may, however, be included in the Works Information (scope of work). The Contractor is permitted to subcontract works provided that he submits the names of such Contractors to the Project Manager for acceptance. The Project Manager may reject the proposed subcontractor on the grounds that it will not allow the Contractor to provide the work in accordance with the stated requirements. The Contractor is nevertheless responsible for providing the works as if he had not subcontracted.

The NEC3 contracting system includes the following standard forms of subcontract:

- Engineering and Construction Subcontract (ECS).
- Engineering and Construction Short Subcontract (ECSS).

These forms of subcontract are very similar to the ECC in terms of its clauses and wording. They provide back to back provisions but include a small number of changes appropriate to subcontracts. It is also possible to appoint subcontractors in terms of the Engineering and Construction Contract (ECC) or the Engineering and Construction Short Contract (ECCS).

The Contractor is required to submit the proposed conditions of subcontract for each subcontractor to the Project Manager for acceptance unless an NEC contract is proposed or the Project Manager has agreed that no submission is required.



Engineering and Construction Contract: Guidance notes

No provision is included in the ECC for nomination of subcontractors. This is because of the legal and practical problems of accountability which frequently ensure. The principle of the ECC is that the Contractor is fully responsible for every aspect of managing the work he has contracted for. Nominating subcontractors conflicts with this principle and causes many practical problems. Alternatives to nominating Subcontractors whilst achieving similar objectives are:

- (a) Making the contractor responsible for all work; he may then subcontract parts and the Project Manager retains some control over the identity of the Subcontractors provided any withholding of acceptance is for the reason stated;
- (b) Providing for separate contracts, with the Project Manager managing the time and physical interfaces between the two;
- (c) Including lists of acceptable Subcontractors for particular tasks in the Works Information.

Where national or international law requires, the Works Information should include a statement of award criteria for subcontractors.

The ECC has six main options:

- Option A: Priced contract with an activity schedule
- Option B: Priced contract with bill of quantities
- Option C: Target contract with an activity schedule
- Option D: Target contract with bill of quantities
- Option E: Cost reimbursable contract
- Option F: Management contract

Contractors are in Options A and B required to price the Works Information (Scope of Work) i.e. everything that the Contractor is required to do in an activity schedule or a bill of quantities as relevant. Any change to the Works Information is a compensation event which requires assessment in terms of its affect on prices and the completion date using a prescribed procedure.

Contractors are required to tender a number of parameters to enable compensation events to be evaluated including a fee for subcontracted work.

Under Options C and D the Contractor is paid his actual costs as defined in the contract (defined cost) plus a fee and his share (gain or pain) of the difference between the agreed target cost, adjusted for compensation events, and actual cost (defined cost). Contractors are required to tender a number of parameters to enable defined cost and compensation events to be evaluated including a fee for subcontracted work.

Under Options E the Contractor is paid his actual costs as defined in the contract (defined cost) plus a fee. Contractors are required to tender a number of parameters to enable defined cost and compensation events to be evaluated including a fee for subcontracted work.

In management contracts (Option F) design, construction and installation are intended to be subcontracted by the main Contractor using the Engineering and Construction Subcontract (ECS) agreement. The Contractor's principal role is the management of the works packages. Initially the scope of the project is not fully developed, but as the scope is developed and construction progresses, successive works subcontracts can be awarded, but the interfaces between these successive packages must be managed.

The NEC3 Engineering and Construction Short Contract (ECCSC) permits portions of the work to be subcontracted, but makes the Contractor responsible for the work executed by such subcontractors as if they had not subcontracted such works.

Option F: Management contract

Management based contracts are generally suitable:

- Where there is a need to co-ordinate a number of works contractors and suppliers;
- When the Employer does not have sufficient capability to manage the project; and
- When the time scale of the project is tight requiring an early start of construction.

NOTE

Unacceptable forms of subcontracts are those which contain provisions for:

- Payment procedures based on a pay-when-paid, or pay-if-paid, system;
- A right of set-off in favour of the contractor not provided for in the law;
- Authoritarian rights given to the prime contractor, or his agent, with no recourse to independent adjudication in the event of a dispute arising;
- A dispute resolution procedure which does not include inexpensive alternative dispute resolution (ADR) procedures and makes use only of formal proceedings such as arbitration, or litigation;
- Unreasonable retention percentages and periods of retention after completion; or
- Conditions that are more onerous than those which exist in the principal contract.

4. Standard forms of subcontract

Subcontractors should be engaged in of fair conditions of contract which are recorded in writing. The NEC3 and JBCC Series 2000 Agreements contain principal (prime or main) contracts and subcontracts whereas FIDIC and GCC 2004 only provide the principal contracts.

It is acknowledged that there may be differences between principal and subcontract agreements which may not necessarily make them incompatible. The argument for "compatibility" is, however, based on factors such as convenience, style, language and common dispute resolution mechanisms. Whilst there is considerable merit in this approach, it is possible, and may be advantageous to manage risks differently between a principal contract and related subcontracts.

The South African Federation of Civil Engineering Contractors (SAFCEC), the Building Industries Federation of South Africa (BIFSA) and cidb have developed forms of subcontract which may be used with any approved of the forms of contract.

5. cidb Registration requirements

In terms of the Construction Industry Development Regulations, prime or main contractors who contract with an organ of state must be registered with the cidb. Subcontractors need not be registered but nominated subcontractors must, however, be registered as they are nominated by an organ

Recommended combination of forms of contract and forms of subcontract

Series of contract	Recommended
FIDIC	BIFSA Standard Subcontract Agreement 1995 edition (Amended 2000), for use with
GCC 2004	Principal Building Agreements other than the JBCC Principal Building Agreement BIFSA Labour-only sub-contract cidb Standard subcontract (labour only) SAFCEC General conditions of subcontract (2003 edition)
JBCC Series 2000	BIFSA Non-Nominated Subcontract for use with the JBCC Series 2000 Principal Building Agreement JBCC 2000 Nominated/selected Subcontract Agreement
NEC3	NEC3 Engineering and Construction Subcontract NEC3 Engineering and Construction Short Subcontract

4.4.6 Subcontracting arrangements

Where it is desirable that an employer and a contractor jointly select a subcontractor, the manner in which this is to be done shall be described in the Scope of Work in accordance with the provisions of Annex I.

Annex I - Selection of subcontractors by employers and contractors

Insert the following in the Scope of Work:

Scope of mandatory subcontract works

The following portions of the works shall be subcontracted in accordance with the subcontracting procedures described in this scope of work: Subcontracting procedures Competitive tenders shall be invited in respect of each portion of the works that must be subcontracted in terms of the contract in accordance with the relevant provisions of the latest edition of the cidb Standard for Uniformity in Construction Procurement. The Contract Data in the associated procurement documents shall be based on the(insert title of standard form of subcontract that is to be used), with minimal project specific variations and amendments that do not change their intended usage.

The Employer together with the Contractor shall evaluate the tenders received in accordance with the provisions of the Standard Conditions of Tender contained in Annex F of Standard for Uniformity in Construction Procurement. The evaluation panel shall comprise equal representatives from the Employer and from the Contractor.

The Contractor shall without delay enter into contract with the successful tendering subcontractor based on their accepted tender submission

The Contractor shall remain responsible for providing the subcontracted portion of the works as if the work had not been subcontracted.

of state in terms of the public procurement system.

The Regulations exempt from registration labour only contractors and those contractors who are provided with the bulk of the materials required for engineering and construction works by the employer or an agent of the employer from registration.

6. Public sector requirements

A nominated subcontract must be treated in a similar manner to the appointment of a contractor as the organ of state is responsible for the procurement in its entirety. Although an organ of state does not enter into and sign a contract with the subcontractor it does make a final award i.e. a final decision on which tender or quote to accept. Nominated subcontractors must be registered with the cidb since they are appointed by means of a public sector procurement process. The procurement documents for the nominated subcontract must be in accordance with the requirements of the cidb's Standard for Uniformity in Construction Procurement.

The process for the selection of a selected subcontractor falls outside the public sector procurement system as the contractor is required to follow the process laid down in the contract. The involvement of the representatives of the employer in the evaluation process ensures that the contractor follows the process provided for in the appointment of the selected subcontractor. These subcontractors are not required to be registered. However, it is very desirable for such subcontractors to be registered.

The employer should approve the selected subcontract documents to ensure that they satisfy his requirements. The representatives of the employer involved in the evaluation of tenders should preferably be built environment professionals who are either employees or agents of the employer.

Contractors should be required to engage domestic subcontractors using one of the recommended forms of subcontract provided in the cidb Best Practice Guideline # D1, Subcontracting arrangements.

Domestic subcontractors are not required to be registered with the cidb. Where such work involves work which is very commonly undertaken by cidb registered contractors, consideration should be given to requiring that such contractors be registered (see cidb Construction Procurement Best Practice Guideline #A8, Procurement Measures to Develop Registered Contractors).

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