

REGIONAL MUNICIPALITY OF OTTAWA-CARLETON
MUNICIPALITÉ RÉGIONALE D'OTTAWA-CARLETON

REPORT
RAPPORT

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DATE 6 May 1998

TO/DEST. Co-ordinator
Corporate Services and Economic Development Committee

FROM/EXP. Finance Commissioner

SUBJECT/OBJET **SECURITY REQUIREMENTS FOR REGIONAL CONTRACTS**

DEPARTMENTAL RECOMMENDATION

That the Corporate Services and Economic Development Committee recommend Council approve that there be no change to the existing security requirements for Regional contracts.

BACKGROUND

At its September 16, 1997 meeting, the Corporate Services and Economic Development Committee requested that staff examine options for alternative security requirements in appropriate contract situations and that a report be presented to Committee outlining the results of this review. Accordingly, staff undertook an examination of the Regional Municipality of Ottawa-Carleton's standards for security and have now concluded that no alteration in Regional policy is warranted.

Security requirements for Regional contracts are dependent on many factors, including the size, nature and duration of the contract. The two types of security that may be required are bid security and contract security. Bid security, where requested, must be submitted by all contract bidders with their respective bids. Its purpose is to ensure that the selected bidder will enter into a contract with the Region at the prices quoted in its bid. By contrast, contract security is requested only of the successful bidder and it serves as a guarantee for the Region that the project will be completed to its satisfaction.

Since contract security is only requested, if at all, after the successful bidder has been selected, all bidders on projects requiring contract security are usually asked to submit what is known as an "Agreement to Bond" with their bids. The Agreement to Bond provides assurance that contract security will be available if that bidder is selected as the successful tenderer.

Security is not required for every Regional contract. Although it is fairly standard in construction contracts, security is less common in the case of service or material contracts. The Region's Corporate Policy Manual dictates that contracts over \$50,000.00 must be entered into by way of a call for Tender or Request for Proposal. The Manual further provides that the relevant Department Head may require contract security for such contracts. In practice, both bid and contract security are almost always required for construction contracts of any amount. By contrast, service or material contracts, whether above or below \$50,000.00, are assessed on a case by case basis in order to ascertain whether security is appropriate or necessary.

As part of the examination into this issue, staff surveyed other Canadian municipalities comparable in size to Ottawa-Carleton. Fifty-five per cent of those surveyed (11 out of 20) responded. The respondents included six Ontario municipalities. The results obtained provide a basis for comparison against which to measure the Region's security requirements. In fact, these results confirm that the Region's security requirements are consistent with other major Canadian municipalities, as will be explained below.

Given that construction contracts generate different concerns from service and material contracts, each of these two categories will be analyzed separately.

CONSTRUCTION CONTRACTS

The Region requests bid security on virtually all construction contracts, particularly those estimated to cost over \$50,000.00. Bid security for a construction contract usually takes the form of a bid bond. However, the Region will accept a certified cheque as an alternative form of bid security. The requirement for bid security ensures that bidders will not be able to withdraw their tenders without foregoing the specified dollar value of the bid security. Typically, the Region will ask for bid security in the amount of 10% of the contract price. The survey of other Canadian municipalities has confirmed that 10% is a standard percentage for bid security in the case of construction contracts. In rare cases, 5% is the requisite percentage of bid security.

Similarly, contract security is standard for virtually all construction contracts. Most often, a *performance bond* is requested in the amount of 50% of the contract price. In addition, the Region generally requires a *labour and material payment bond* for construction contracts, also in the amount of fifty per cent. This practice parallels that of most other municipalities surveyed. If a contractor abandons a project before it is completed, the Region is entitled to call upon the bonding company which has issued a performance bond and that company will either complete the project or ensure that it is completed by someone else. Labour and material payment bonds, unique to construction contracts, are designed to protect sub-contractors and suppliers in the event that they are not paid by the contractor.

Before issuing a bond, a bonding company will usually require that the principals of the contractor sign personal indemnities to protect the bonding company in the event of the contractor's default. The cost to the contractor of obtaining a bond is a small percentage of the face value of the bond (approximately \$6.00 to \$8.00 per \$1,000.00 bond).

Lack of labour and material payment security does not represent a substantial risk for the Region on contracts under \$50,000.00. Moreover, where it is known that the contractor will not enlist sub-contractors or suppliers, there is little justification for labour and material payment security.

As an alternative form of contract security for construction contracts, the Region's policy is to accept an irrevocable letter of credit representing 100% of the amount of the contract. The letter of credit has to cover 100% of the contract price in order to protect the dual interests of performance and payment security. This can be achieved either by way of one 100% letter for performance and payment security or two 50% letters (one for performance and the other for payment security). There is a risk to the Region in accepting less than 100% security. Unfortunately, a 100% letter of credit represents a very onerous request to make of a contractor. Thus, letters of credit are rare in the case of construction contracts.

As a final point, where bonding will be required for a particular construction contract, the Region ordinarily requires tenderers to submit an Agreement to Bond with their respective bids. An Agreement to Bond may be replaced by an irrevocable letter from a bank undertaking to provide the Region with an unconditional and automatically renewing letter of credit if the bidder is successful. This alternative option may be approved where the contractor is unable to obtain bonding or in fields of work where contractors are not typically bonded. However, as explained above, a letter of credit is not an ideal form of contract security, particularly in the construction industry. It is interesting to note that some municipalities specifically refuse to accept such a promissory letter from a bank as an alternative to an Agreement to Bond. Such a refusal likely derives from interpretation problems associated with such letters.

If a contractor is unable to obtain an Agreement to Bond, it will be unable to obtain contract security, so the Agreement to Bond provides assurance for the Region of the contractor's willingness and ability to meet the contract requirements at the time of the submission of tenders.

SERVICE CONTRACTS AND MATERIAL CONTRACTS

Contracts for the supply of services, as well as contracts for the supply of material, present their own set of concerns. Typically, these types of contracts are for smaller monetary amounts than most construction contracts. Another important distinction relates to the potential consequences of a disruption in the contract. It is usually less devastating to have to replace a service or material provider in the middle of a contract, in marked contrast to having to find another contractor in the midst of a construction contract. Therefore, unlike the highly-defined rules governing security for construction contracts, the Region approaches service and material contracts on a more flexible basis.

Bid security is rarely demanded in the case of material contracts, either at the Region or in other municipalities. This is likely attributable to the ease of replacing one supplier with another where the lowest bidder fails to comply with its bid. Bid security is somewhat more pervasive in the case of service contracts. Given the rarity of bonding outside the realm of construction contracts, bid bonds are not generally the form of bid security sought for service or material contracts. Instead, an assortment of other forms of bid security is usually acceptable.

Both the need for, and the amount of, contract security for Regional contracts is based on the risk to the Corporation of non-performance. Contract security, in a variety of forms, may be requested on Regional service or material contracts. The amount of such security can range up to 50% of the contract price. Although not advisable for construction contracts, letters of credit are more appropriate for service or material contracts (in the amount of 50% of the contract). Alternatively, the Region's security in these types of contracts might simply be the right to hold back payment.

Security is important in service or material contracts where the product being supplied is specialized and cannot easily be replaced by an equivalent product. Similarly, where there is substantial lead time associated with the production of a certain good, security provides insurance for the delay which would result if the contractor were to default.

The previously mentioned survey of other Canadian municipalities reveals that most municipalities require some form of contract security for most service and material contracts, with bid security being considerably less common for these types of contracts. Thus, the Region's guidelines coincide with those of other municipalities across the country.

CONCLUSIONS

Ottawa-Carleton's differing treatment of construction versus service and material contracts, as well as the details of that treatment, is in line with the standards of other comparable municipalities in Canada. Staff have, therefore, determined that no change to Regional policy is warranted. Regional security requirements are only suggested, not mandated, giving staff the flexibility to apply an analysis before requiring security for any given contract. In order to ensure that bidding is open to smaller companies (which might be able to perform the job just as well, perhaps for a better price), security should only be demanded where it is justified to protect Regional interests. To that end, a number of guiding principles are enumerated below to assist Regional staff in assessing whether security is appropriate in any case.

To document the fact that staff have addressed the following principles, they are being requested to note on file a brief analysis of the reasoning behind every decision to either require, or not require, bid or contract security.

• GENERALLY

- *the decision to require bid and/or contract security should be dependent upon the attendant risks associated with the potential default by the contractor (the more serious the consequences to the Region for failure of the contractor to perform, the more important security becomes)*
- *the estimated dollar value of the contract will sometimes play a role (very small contracts represent little risk to the Region)*
- *contracts for longer terms tend to be more risky and, therefore, will often demand some form of contract security*

- *where there is little risk to Regional interest, the benefits of avoiding hidden costs (those incorporated into the bid price as a result of the cost to the contractor of having to provide security) might justify lessening the requirement for security*

- CONSTRUCTION CONTRACTS

- *some form of bid security should usually be considered for construction contracts of any value*
- *for contracts over \$50,000.00, 10% bid security is standard*
- *since Regional contracts worth less than \$10,000.00 can be entered into by the applicable Department Head without any formal tendering procedure, bid security may be deemed to be unnecessary for such relatively small construction contracts*
- *bid security should be a bid bond or a certified cheque (other alternatives are less reliable and can be difficult to administer)*
- *100% contract security is customary for all contracts over \$50,000.00 (generally, a 50% performance bond and a 50% labour and material payment bond are required)*
- *a 100% letter of credit may replace bonding, but this is rarely a desirable option for either party in a construction contract*
- *the level of risk associated with construction contracts valued at less than \$50,000.00 dictates that there is little need for labour and material payment bonds for such projects*
- *where it is known that the contractor will not engage sub-contractors or suppliers, then there is little need for labour and material payment security*
- *an Agreement to Bond should be required wherever contract security is required*
- *as an alternative, where a letter of credit is acceptable as contract security, the bidder should be required to submit an irrevocable letter from its bank promising to issue a letter of credit in the event the bidder is selected as the successful candidate (both the letter of credit and the letter from the bank promising to issue the same must be in a format acceptable to the Region)*

- SERVICE AND MATERIAL CONTRACTS

- *bid security is not as common for these types of contracts*
- *bid security will be appropriate where there is a substantial risk to the Region associated with the successful bidder failing to comply with its bid*
- *bid security may take a number of forms for service or material contracts (e.g. bid bond, certified cheque, letter of credit, cash, bank draft)*

- *contract security for service or material contracts may also take a number of alternative forms (in addition to bonding), since bonding is not standard outside the construction industry (e.g. letter of credit, certified cheque)*
- *in appropriate cases, contract security may simply be the right to hold back payment under the contract*
- *labour and material payment security is inapplicable for service or material contracts*
- *contract security will usually be in an amount ranging up to 50% of the contract price*
- *contract security will be justified where the risk to the Region of default is significant*
- *factors which might justify contract security for service or material contracts include:*
 - *the product or service being supplied is sufficiently rare or specialized as to require some assurance that it will continue to be supplied without interruption*
 - *there is a substantial lead time in production which would cause delays if the contract were interrupted*
 - *there are health or safety issues which necessitate the performance of the contract*
 - *the contract will be for a long term*
 - *the amount of the contract is substantial*
 - *past performance within the industry suggests security is advisable*

It is not possible to set down absolute rules to govern bid and contract security because of the many factors at play in each contract situation. By adhering to the above principles, the Region can be confident that a broad pool of potential contractors will be eligible to participate in Regional contracts and that the Region's interests will be protected in the process.

*Approved by
J.C. LeBelle*