



REPORT TO LAW & LEGISLATION COMMITTEE City of Sacramento

915 I Street, Sacramento, CA 95814-2671

4

CONSENT REPORT
September 4, 2007

Honorable Members of the
Law and Legislation Committee

Title: Legislative Position: Oppose State SB 619 Amendment to Public Contracts Code Regarding Retention Proceeds

Location/Council District: Citywide

Recommendation: Oppose SB 619 which is the adoption of an amendment to the Public Contracts Code requiring contract retention proceeds not exceed 5 percent of the contract price.

Contact: David Flores, Administrative Analyst, 808-8277

Azadeh Doherty, Principal Planner, 808-3137

Presenters: None

Department: Transportation

Division: Engineering Services

Organization No: 3437

Description/Analysis:

Issue: Existing law authorizes the City to enter into contracts with suppliers for goods and services. Existing law provides that in a contract between the original contractor and a subcontractor, and in a contract between a subcontractor and any subcontractor thereunder, the percentage of retention proceeds withheld cannot exceed the percentage specified in the contract between the public entity and the original contractor. Currently the City of Sacramento has set its contract retention rate at 10%. This bill would instead require that retention proceeds not exceed 5% of the payment, as specified, for all contracts entered into on or after January 1, 2008, between a public entity, as defined, and an original contractor, between an original contractor and a subcontractor, and between all subcontractors thereunder.

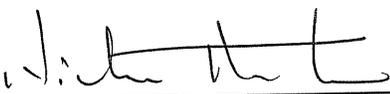
Policy Considerations: Opposition of SB 619 is consistent with the City Council approved Legislative Guidelines which include opposing legislation that reduces local control over local government issues. SB 619 is opposed by the League of California Cities and the Construction Employers' Association among others. A bill analysis and list of supporters and opponents is included as Attachment 3.

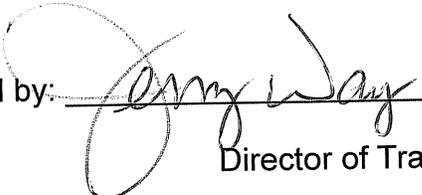
Environmental Considerations: Opposition of SB 619 has no adverse environmental impacts.

Rationale for Recommendation: Retention is a common and effective tool used in public works contracted projects to protect against additional expenses and project delays. SB 619 would require the City of Sacramento to reduce its contract retention amount from the existing 10% to 5% regardless of the progress or good faith of the contractor. Preserving the 10% retention creates the appropriate incentive for a contractor to complete a project in accordance with the specifications and the terms of the contract and ensures that the contractor fully pays its subcontractors and all employees.

Financial Considerations: None as a result of this action.

Emerging Small Business Development (ESBD): There are no ESBD considerations as there are no goods or services are being purchased.

Respectfully Submitted by: 
Nicholas Theocharides
Engineering Services Manager

Approved by: 
Jerry Way
Director of Transportation

Recommendation Approved:

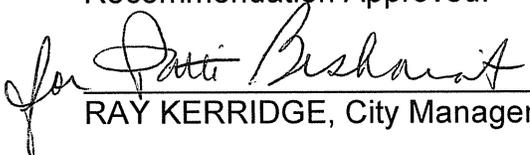

RAY KERRIDGE, City Manager

Table of Contents:

Report Pg 1

Attachments:

1 Sample Letter of Support Pg 3

2 Summary of the Bill Pg 4

3 Bill Analysis Pg 7

Attachment 1

September 5, 2007

The Honorable Mark Leno
Chair- Assembly Appropriations Committee
State Capitol, Room 2114
Sacramento, CA 95814

Subject: Opposition to Senate Bill 619 (Migden) – Retention Proceeds As amended on March 29, 2007.

Dear Assembly Member Leno:

On behalf of the City of Sacramento in order to protect public interests and public funds, I express the City's opposition to Senate Bill 619.

SB 619 would require the City of Sacramento to reduce its contract retention amount from the existing 10% to 5% regardless of the progress or good faith of the contractor. Preserving the 10% retention creates the appropriate incentive for a contractor to complete a project in accordance with the specifications and the terms of the contract and ensures that the contractor fully pays its subcontractors and all employees.

We appreciate your consideration on this important legislation.

Sincerely,

Sandy Sheedy, Chair
Law and Legislation Committee

CC: Senator Darrell Steinberg
Senator Dave Cox
Assembly Member Dave Jones
Assembly Member Roger Niello
Assembly Member Alan Nakanishi
Mayor Fargo and City Councilmembers
David Jones, Emanuels and Jones and Associates

BILL NUMBER: SB 619 AMENDED
BILL TEXT

AMENDED IN SENATE MARCH 29, 2007

INTRODUCED BY Senator Migden

FEBRUARY 22, 2007

An act to amend Section ~~10500~~ of ~~10261~~ of,
and to add Section 7201 to, the Public Contract Code, relating
to public contracts.

LEGISLATIVE COUNSEL'S DIGEST

SB 619, as amended, Migden. ~~Competitive bidding-~~
~~University of California.~~ Public contracts: retention
proceeds.

(1) Existing law authorizes the Department of General Services, or any other department with authority to enter into contracts, to contract with suppliers for goods and services. Existing law provides that in a contract between the original contractor and a subcontractor, and in a contract between a subcontractor and any subcontractor thereunder, the percentage of retention proceeds withheld cannot exceed the percentage specified in the contract between the public entity and the original contractor.

This bill would instead require that retention proceeds not exceed 5% of the payment, as specified, for all contracts entered into on or after January 1, 2008, between a public entity, as defined, and an original contractor, between an original contractor and a subcontractor, and between all subcontractors thereunder.

(2) Existing law contains various provisions relating to contracts for the performance of public works of improvement, including provisions for the disbursing and withholding of retention proceeds. Existing law requires the Department of General Services to withhold not less than 5% of the contract price until final completion and acceptance of the project.

This bill would require the Department of General Services to withhold not more than 5% of the contract price until final completion and acceptance of the project.

~~Existing law establishes procedures for competitive bidding of certain contracts by public entities, including the University of California. Existing law defines "project" to include the erection, construction, alteration, repair, or improvement of any University of California structure, building, road, or other improvement that will exceed \$50,000 in cost, as specified.~~

~~This bill would include in the definition of "project" the modernization of any University of California structure, building, road, or other improvement that will exceed \$50,000 in cost, as specified.~~

Vote: majority. Appropriation: no. Fiscal committee: yes.
State-mandated local program: no.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. Section 7201 is added to the Public Contract Code , to read:

7201. (a) (1) This section shall apply with respect to all contracts entered into on or after January 1, 2008, between a public entity and an original contractor, between an original contractor and a subcontractor, and between all subcontractors thereunder, relating to the construction of any public work of improvement.

(2) Under no circumstances shall any provision of this section be construed to limit the ability of any public entity to withhold 150 percent of the value of any disputed amount of work from the final payment, as provided for in subdivision (c) of Section 7107. In the event of a good faith dispute, nothing in this section shall be construed to require a public entity to pay for work that is not approved or accepted in accordance with the proper plans or specifications.

(3) For purposes of this section, "public entity" means the state, including every state agency, office, department, division, bureau, board, or commission, the California State University, the University of California, a city, county, city and county, including chartered cities and chartered counties, district, special district, public authority, political subdivision, public corporation, or nonprofit transit corporation wholly owned by a public agency and formed to carry out the purposes of the public agency.

(b) (1) The retention proceeds withheld from any payment by a public entity from the original contractor, by the original contractor from any subcontractor, and by a subcontractor from any subcontractor thereunder shall not exceed 5 percent of the payment. In no event shall the total retention proceeds withheld exceed 5 percent of the contract price. In a contract between the original contractor and a subcontractor, and in a contract between a subcontractor and any subcontractor thereunder, the percentage of the retention proceeds withheld may not exceed the percentage specified in the contract between the public entity and the original contractor.

(2) This subdivision shall not apply if the contractor provides written notice to the subcontractor, prior to or at the time that the bid is requested, that a bond may be required and the subcontractor subsequently is unable or refuses to furnish to the contractor a performance or payment bond issued by an admitted surety insurer.

(c) No party identified in subdivision (a) may require any other party to waive any provision of this section.

SEC. 2. Section 10261 of the Public Contract Code is amended to read:

10261. Payments upon contracts shall be made as the department prescribes upon estimates made and approved by the department, but progress payments shall not be made in excess of 95 percent of the percentage of actual work completed plus a like percentage of the value of material delivered on the ground or stored subject to or under the control of the state, and unused, except as otherwise provided in this section. The department shall withhold not ~~less~~ more than 5 percent of the contract price until final completion and acceptance of the project. However, at any time after 95 percent of the work has been completed, the department may reduce the funds withheld to an amount not less than 125 percent

of the estimated value of the work yet to be completed, as determined by the department, if the reduction has been approved, in writing, by the surety on the performance bond and by the surety on the payment bond. The Controller shall draw his or her warrants upon estimates so made and approved by the department and the Treasurer shall pay them. The funds may be released by electronic transfer if that procedure is requested by the contractor, in writing, and if the public entity has, in place at the time of the request, the mechanism for the transfer.

~~SECTION 1. Section 10500 of the Public Contract Code is amended to read:~~

~~10500. As used in this article, "project" includes the erection, construction, alteration, modernization, repair, or improvement of any University of California structure, building, road, or other improvement that will exceed in cost, including labor and materials, a total of fifty thousand dollars (\$50,000).~~

Date of Hearing: July 3, 2007

ASSEMBLY COMMITTEE ON BUSINESS AND PROFESSIONS
 Mike Eng, Chair
 SB 619 (Migden) - As Amended: March 29, 2007

SENATE VOTE : 38-0

SUBJECT : Public contracts: retention proceeds.

SUMMARY : Prohibits state and local government agencies from withholding from an original contractor, or an original contractor from a subcontractor, more than 5% of a payment on public works contract. Specifically, this bill :

- 1) Provides that retention proceeds withheld from any payment by a "public entity" from the original contractor, or by the original contractor from any subcontractor, or by a subcontractor from their subcontractor, shall not exceed 5% of the payment, except when a subcontractor is unable to furnish a payment or performance bond requested by the original contractor.
- 2) Defines "public entity" to mean every state agency, office, department, division, bureau, board, or commission, the California State University, the University of California, a city, county, city and county, chartered cities and counties, district, special district, public authority, political subdivision, public corporation, or nonprofit transit corporation wholly owned by a public agency.
- 3) In addition, provides that in a contract between the original contractor and a subcontractor, and in a contract between a subcontractor and their subcontractor, the percentage of the retention proceeds withheld may not exceed the percentage specified in the contract between the public entity and the original contractor.
- 4) Provides that these provisions shall apply to all contracts entered into on or after January 1, 2008.

EXISTING LAW :

- 1) Requires payments on contracts with progress payments to be made as the awarding department prescribes and provides that

contract price until final completion and acceptance of the project, and that progress payments upon public contracts shall not be made in excess of 95% of the percentage of actual work completed, except as follows:

- a) At any time after 95% of the work has been completed on a state project, the state may reduce the funds withheld to an amount not less than 125% of the estimated value of the work yet to be completed, as specified.
 - b) At any time after 50% of a local government project is complete and the legislative body finds that satisfactory progress is being made, it may reduce or eliminate withholding.
- 2) Provides that in a contract between the original contractor and a subcontractor, and in a contract between a subcontractor and any subcontractor, the percentage of retention proceeds withheld cannot exceed the percentage specified in the contract between the public entity and the original contractor, and requires the distribution of retention proceeds by an original contractor to subcontractors within seven days of receipt of retention proceeds from the public agency.
- 3) Requires a contractor in a public works contract to file a performance bond with the public entity in specified amounts depending on the value of the contract.
- 4) Requires every original contractor who is awarded a contract by a state entity involving expenditure in excess of \$5,000 for any public work to file a performance bond with the state entity in a sum not less than 100% of the total amount payable by the terms of the contract.

FISCAL EFFECT : Unknown

COMMENTS :

Purpose of this bill . According to the author's office: "State policy regarding payment procedures on public works diminishes the likelihood of California small businesses from being able to fully participate in the next wave of infrastructure and public works development approved by voters in 2006. Existing law

SB 619
Page 3

allows public agencies to withhold payment indefinitely to contractors for goods and services already provided. This policy effectively harms local contractors and ultimately serves to artificially inflate the cost of infrastructure to the taxpayer.

"Current state law requires the withholding from contractors of not less than 5% of total payment for time and materials (Public Contract Code Section 10261). Often times this retention amount

4

can be as much as 10% or more.

"The typical profit margin in the construction industry for public works projects is 3%. In some cases, contractors must wait for years before being fully paid for their work. California small businesses, in many cases, have to pay a premium for capital loans to make payroll and pay for materials if they want to bid on public works projects. The current "payment retention" policy constitutes an unfair and unreasonable requirement for licensed, responsible and bonded California contractors."

Background . Retention proceeds represent a percentage of the amount of a contract that is withheld from a progress payment by the public entity to the original contractor, or the original contractor from one its subcontractors. By withholding a percentage of a contract, the public entity or the original contractor maintains a degree of financial control over a project. In general, the public entity or the original contractor withholds at least 5% of payment until the contract is completed to the satisfaction of the public entity or original contractor.

Support . The California Association of Sheet Metal and Air Conditioning Contractors' National Association (CAL SMACNA), a co-sponsor of this bill, writes: "Current state law requires the withholding from contractors of not less than 5% of the contract price (Public Contract Code 10261). Often times this retention amount can be as much as 10% or more. The typical profit margin in the construction industry for public works projects is 3%. In some cases, contractors must wait for years before being fully paid for their work. Thus, any contractor who bids on a public works job must anticipate the financing of as much as 7% of the total value of the contract for an undefined period of time just to make payroll and pay suppliers. This includes a non-reliance on the realization of a 3% profit.

SB 619
Page 4

"It is a classic "pay-to-play" scenario. If the contract is worth \$5 million, a small business contractor will have to anticipate taking out a loan of up to \$350,000 to cover their payroll and material expenses in building the project. Many qualified small businesses simply cannot afford to tie-up their own capital or operate on costly capital loans for an indefinite period of time. The current payment retention policy constitutes an unfair and unreasonable requirement for licensed, responsible and bonded California contractors. It is also unfair to the taxpayer. The total cost to taxpayers for public works improvement projects increase as a result of 1) the loss of bids from qualified local small businesses, and 2) the bid inflation that occurs due to the fact that the cost of these capital loans are built into the cost of the project.

9

"Public agencies are protected from problems associated with contractor "non-compliance" through a variety of mechanisms rendering the existing retention codes obsolete. In fact, under Public Contract Code 20129, contractors on public works of improvement must post 'performance bonds' to ensure completion of the project. Further, Public Contract Code 7107(c) allows a public agency to withhold an amount up to 150% of the value of disputed work from the final payment. These protections, pre-qualification procedures and others allow public agencies more than adequate assurances of contractor compliance.

"Finally, SB 619 (Migden) will move California policies closer to those already employed by the federal government when it comes to retention and public works. The federal government understands that a performance bond protects the fiduciary responsibilities of government. And, they will pay one hundred percent (100%) of the amount owed for work completed and accepted because they know they can withhold the necessary amounts for any work in dispute from the appropriate progress payment. The Federal Acquisition Regulation (FAR 32.103) states, "Retainage should not be used as a substitute for good contract management, and the contracting officers should not withhold funds without cause."

Opposition . The Construction Employers' Association writes in opposition: "SB 619 requires subcontractors to 'furnish' but not necessarily pay for a payment or performance bond. Under SB 619 a subcontractor could "furnish" a bond along with an

SB 619

Page 5

invoice, thereby leaving the contractor on the hook for the cost of the bond. This cost would come directly out of the general contractor's profit margin if they have already submitted a bid to the public entity, or, the contractor would have to factor the possible bond cost in to their bid, potentially making them uncompetitive. CEA members oppose having to absorb all bond costs or risk losing jobs, primarily for the benefit of subcontractors. CEA proposed requiring subcontractors to pay for their bonds for the benefit of reduced retention proceeds but this suggestion was rejected by the bill's proponents.

"SB 619 places contractors in the unenviable role of having to weigh risk versus competition, for something that primarily benefits subcontractors. Because the bonds are not mandatory, contractors would be forced to make a business decision; forgo subcontractor bonds in order to keep their bid price low and risk subcontractor defaults, or, factor bond pricing in to all bids and risk losing jobs. Contractors should not be forced to weigh this risk to benefit subcontractors. This risk would be negated if bonds were mandatory for all subcontractors performing work on public works projects.

"SB 619 will waste precious bond dollars. Approximately 85 percent of each project is completed by subcontractors. Assuming contractors stipulate that their subcontractors must

10

provide a bond, approximately 1.5 percent (the average bond cost) would be added to the cost of all projects. For the recent \$40 billion plus bond package, this means that over \$50 million will be lost to cover the new bond costs. With its emphasis on bonding, this measure would also benefit large subcontractors to the detriment of small subcontractors who may not be able to obtain bonds and may be less attractive to risk adverse contractors. This would drive prices even higher through reduced competition.

"SB 619 also contains significant technical problems. As drafted, the measure appears to conflict with numerous 'prompt pay' statutes which require a direct payment pass through between the owner, contractor and subcontractor. If a subcontractor is unable to obtain a bond, the contractors will likely withhold more than 5 percent, thereby eliminating the possibility of a direct pass through. The bill also stipulates that a contractor may request a performance or payment bond. These bonds cover two entirely different items; a performance bond covers the performance of the subcontractor on a job and a

SB 619
Page 6

payment bond covers payments made by subcontractors to their employees and suppliers on a job. If a subcontractor defaults on a project they will fail to perform and they will likely still owe money to their employees and suppliers, thereby leaving the contractor with insufficient bond coverage."

The California Special Districts Association writes: "Current law allows public entities to withhold at least 5 percent and up to 10 percent from payments to the general contractor, pending satisfactory completion of the project. Payment retention is an effective method of keeping contractors on the job until it is fully complete. Withheld money becomes a financial loss to contractors if a job is abandoned, and the retained funds can help the agency pay for the cost to finish the work. Our members have found the current retention of 10 percent to be adequate to retain contractors through project completion.

"SB 619 proposes to reduce retention withheld by a public entity, including special districts, to no more than 5 percent of the contract amount. This bill would weaken an important tool needed for safeguarding public money and ensuring that public works projects are completed in a timely and satisfactory manner. If retention is capped at 5 percent, there is less incentive for the contractor to stay on the job. This ultimately costs the agency and taxpayers more in terms of money and time because of delayed projects and lawsuits.

"Current law allows local public agencies to reward contractors that are doing a satisfactory job by 'ratcheting down' the retention amount from 10 percent to 5 percent, or even pay the full contract right away. Public Contract Code Section 9203(a) cites that "at anytime after 50 percent of the work has been completed, if the legislative body finds that satisfactory

11

progress is being made, it may make any of the remaining progress payments in full for actual work completed." Good contractors doing satisfactory jobs do already get the retention amounts lowered to SB 619's desired 5 percent level, or even lower. This bill is not necessary, raises the financial risk associated with construction, and threatens special districts' ability to manage construction projects."

Previous legislation . AB 940 (Miller) of 1997 would have, among other things, limited retention payments by public entities on public works to 5 percent. AB 940 was vetoed by Governor Wilson, who made the following statements in his veto message:

SB 619
Page 7

"Regrettably, once again, I find a bill before me that establishes a double-standard for the treatment of the retention levels charged by public agencies. The private sector is free to establish its own level for retention in an open marketplace, where building owners, contractors and subcontractors freely enter into construction contracts, which often include a 10 percent retention level. Here before me is a bill which would arbitrarily restrict public agencies to retention rates of half the private sector standard.

"As I expressed in my veto message of AB 1949 (Conroy) last year, 'Government agencies must be able to protect public construction projects from unnecessary risk in a fashion similar to the private sector.' I have not deviated from that stance. As a public manager, I believe it is reasonable to ask public agencies to manage public works projects according to the same standards, criteria and level of professionalism as is practiced in the private sector. It would be irresponsible of me, however, to tie the hands of public agencies with statutory restrictions and expect a similar performance standard.

AB 1949 (Conroy) of 1996, would have, among other things, limited retention payments by public entities on public works to 5%. AB 1949 was vetoed by Governor Wilson.

REGISTERED SUPPORT / OPPOSITION :

Support

- American Subcontractors Association
- Associated General Contractors of California
- California Association of Sheet Metal & Air Conditioning Contractors' National Association
- California Chapter of the American Fence Contractors Association

- California Fence Contractors Association
- California Landscape Contractors Association
- California Legislative Conference of Plumbing, Heating & Piping Industry
- Engineering Contractors Association

12

Engineering ad Utility Contractors Association
Flasher Barricade Association
Marin Builders Exchange
National Electrical Contractors Association

SB 619
Page 8

Opposition

California Special Districts Association
Construction Employers' Association (CEA)
County Sanitation District of Los Angeles County
Vista Irrigation District
Western Municipal Water District

Analysis Prepared by : Ross Warren / B. & P. / (916) 319-3301