

Digest



Issue 9

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➤ Welcome

In this edition of the *ADR Digest*, David Longbottom looks at the new Civil Justice Reforms with particular regard to the impact that these may have on the use of mediation in construction disputes. David also examines the pros and cons of using mediation to settle construction disputes.

Our guest article in this edition is an abridged version of a paper prepared by the British Chamber of Commerce Construction Industry Group concerning the use of the NEC form of contract in Hong Kong. The paper has recently been submitted to the Construction Industry Council for discussion and advocates the increased use of the NEC form of contract.

Our *ADR Analysis* series considers the different methods available for calculating depreciation. This is a head of claim that often features as part of prolongation claims.

As part of our continued growth within the region, we extend a warm welcome to Jeanny P L Tan to the ADR team - see our *ADR News* section for further details.

Finally, we are pleased to enclose with this edition of the *ADR Digest* organ donation cards from the Department of Health. There remains a chronic shortage of donors in Hong Kong and we would encourage you to complete these cards and register with the Department of Health at www.organdonation.gov.hk. Should you require further cards for your family, friends and/or colleagues then please contact charlotte.mak@adrpartnership.com.

Have a Happy New Year and a prosperous 2010!

Patrick J O'Neill
Director



➤ Mediation and the Civil Justice Reform



By **David S Longbottom** BSc(Hons) PgD(Law) MRICS
MCIArb AMInstCES - Director, ADR Partnership Limited

Introduction

The Civil Justice Reform (CJR) has been implemented from 2 April 2009 and applies to civil proceedings of the High Court and the District Court with the aim of improving the cost-effectiveness of the civil justice system, to make it more efficient and reduce unnecessary delay whilst continuing to ensure fairness between the parties.

One of the key implications of the CJR is to encourage and facilitate the early settlement of civil disputes. The CJR also seeks to facilitate the parties resolving their disputes by means other than litigation in Court, using Alternative Dispute Resolution (ADR). ADR is a procedure which falls outside the judicial process and by which the parties to a dispute agree to appoint a third neutral party to assist them in resolving their dispute. Generally, ADR aims to resolve the parties' disputes in a less costly and more efficient manner than litigation. The most common form of ADR procedure and that which is expressly referred to in the CJR practice directions is mediation.

This article outlines the principles of mediation, and the advantages and disadvantages of the mediation process in general, with particular reference to the Civil Justice Reforms.

The CJR New Practice Directions

The new Practice Direction-31 (PD-31), requires parties to legal proceedings to consider using mediation in order to resolve their disputes. The Chief Justice has announced that the PD-31 on mediation will not come into effect on 2 April 2009 (like other Practice Directions) but instead, its implementation will be postponed to 1 January 2010.

This postponement is to allow practitioners more time to become familiar with the mediation process. PD-31 will apply to all High Court and District Court civil proceedings which have been begun by writ, except proceedings set out in *Appendix A* to the practice direction which excludes actions in the Construction and Arbitration List.

However, section F of the new Practice Direction-6.1 (PD-6.1) which came into effect on 2 April 2009, encourages voluntary mediation between parties as a possible cost-effective means of resolving disputes in the Construction and Arbitration List (i.e. specialized classes of civil action for cases including civil or mechanical engineering, building and other construction work). To this end the practice direction advises¹:

"To promote the use of mediation, the Court may impose cost sanctions where a party unreasonably refuses to attempt mediation."

In essence, section F of PD-6.1 provides the 'nuts-and-bolts' on how to proceed with mediation for cases in the Construction and Arbitration List and the expectations of the Court in this regard.

During the mediation process there is a high degree of party control present, with the parties controlling the resolution process by developing their own solutions and forming their own agreements.

Mediation - Advantages and Disadvantages

Mediation is a voluntary, non-binding, private dispute resolution process which helps the parties to reach their own negotiated settlement through an impartial third party (the 'mediator'). The mediator has no power to impose a settlement on the parties. Rather, the parties themselves determine the conditions of any settlement reached. If a settlement is reached, an agreement will be drawn up and once signed by the parties, will be legally binding.

The mediator's role is to overcome any impasse that might be responsible for preventing the parties from reaching agreement and encourage the parties to reach an amicable settlement. In order to do this mediators are usually professionals who have undergone mediation training and who are therefore capable of adopting appropriate techniques and/or skills to open up and/or improve dialogue between the parties. Various organisations in Hong Kong, such as The Law Society and The Hong Kong Mediation Council (a division of the Hong Kong International Arbitration Centre), maintain a list of accredited mediators and the parties can choose a mediator with a background and substantive knowledge suitable to the nature of the dispute in question. A skilled mediator will

typically help to avoid entrenched positions of the parties and facilitated discussion is often useful if negotiations have broken down or if strong emotions are present.

During the mediation process there is a high degree of party control present, with the parties controlling the resolution process by developing their own solutions and forming their own agreements. To this end, there is true flexibility in the way in which the mediation can be performed and with solutions which can be tailored to the needs and underlying concerns of the parties, and which are unavailable through the litigation process.

Any information exchanged during the mediation process is on a '*without prejudice*'² basis and protected by privilege; therefore, the Court cannot compel its disclosure or admission into evidence in a litigation. Hence, there is risk-free communications between the parties, with the process promoting communication, preserving and helping maintain or enhancing future commercial relationships, avoiding publicity and allowing frank discussions of all relevant issues - both legal and non-legal.

The mediation process also offers a potential fast resolution to a dispute³, and one which is generally less costly than litigation in terms of both money and relationships. Through its informal nature, the mediation process may even be less stressful on the parties involved.

Any signed settlement agreement binds the parties⁴; however, if the mediation does not result in a settlement, the parties can still litigate⁵ and may at any time during the mediation process pursue other options since they are not compelled to continue the mediation if they cannot reach a mutually acceptable solution.

However, there are disadvantages with the mediation process. For example, there is no way to force the other party to mediate⁶. To this end, the Practice Direction provides that:

"[n]o party to an action shall be compelled to go to mediation⁷ and if a party has a reasonable explanation for non-participation he should not suffer any adverse costs order."⁸

Further, when establishing whether:

"a party has acted unreasonably in refusing mediation, the Court will not take account of or inquire into:

- (1) what happened during the mediation;*
- (2) why the mediation failed; or*
- (3) whether any failure in the course of mediation may be ascribed to unreasonable conduct by any party."⁹*

Hence, the disclosure of information and truthfulness of communications between the parties in the mediation depends on the good faith of the parties. To this end, the process can be abused, being used for discovery or as a stalling tactic. For example, as regards PD-6.1, participation of the parties is only required:

"... up to the minimum level ... agreed by the parties beforehand or as determined by the Court."¹⁰

In addition, the exclusion of pertinent parties during the mediation process also weakens the possibility of a final agreement, if, for example, the representatives of the parties have limited bargaining authority. Further, if one party to the dispute has been domineering during the contractual relationship or has more business clout, then the other party may not feel as fully capable of expressing important concerns



as he would if through lawyers in Court. Having the support of lawyers during mediation is an option, but it adds additional expense to the process and runs the risk of the issues becoming bogged down in legal argument.

Finally, the mediation process may not resolve all (or any) of the issues in dispute and the parties may still have to go to Court and litigate in any event; to this end, time and money may therefore be lost in the process of the mediation. Notwithstanding this, even if a settlement is not reached, the mediation process may still be fruitful and assist the parties in crystallising and narrowing the issues in dispute.

In ADR's experience, mediation has proven a successful management tool for resolving difficult construction disputes, often producing a 'win-win' situation.

Mediation in Practice

In ADR's experience, mediation has proven a successful management tool for resolving difficult construction disputes¹¹, often producing a 'win-win' situation, with increased satisfaction and compliance with settlements which the parties have directly participated in.

According to PD-6.1:

"where a Mediation Notice has been served, an unreasonable refusal or failure to attempt mediation may expose a party to an adverse costs order."

What constitutes an adverse costs order will be a matter in the Court's discretion after taking into account all relevant circumstances".¹²

Hence, in light of the CJR's practice direction and current trends, mediation will no doubt take on a greater role in the future processing of legal proceedings in the Construction and Arbitration List. Consequently, parties should prepare for such and as with any dispute resolution process, the key to a successful mediation is the comprehensive preparation for the process. <

Footnotes:

¹ PD-6.1, paragraph 21.

² PD-6.1, paragraph 40.

³ To this end, PD-6.1, paragraph 26 requires the timeframe of the mediation to be specified.

⁴ PD-6.1, paragraph 39.

⁵ PD-6.1, paragraph 38.

⁶ PD-6.1 'encourages' the parties to use mediation, with the possibility of court imposed cost sanctions where a party unreasonably refuses to attempt mediation.

⁷ PD-6.1, paragraph 37.

⁸ PD-6.1, paragraph 42.

⁹ PD-6.1, paragraph 44.

¹⁰ PD-6.1, paragraph 42.

¹¹ World-wide experience has shown that mediation enjoys a settlement rate of about 80% (Judiciary August 2006).

¹² PD-6.1, paragraphs 41 and 42.

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➤ New Engineering Contract - A Strategic Trial Plan to Achieve Best Value in Hong Kong

By *The Procurement Sub-Group¹, British Chamber of Commerce Construction Industry Group*

Introduction

The New Engineering Contract (NEC) is a contractual partnering form created by the Institution of Civil Engineers (ICE) and designed for facilitating mutual trust and co-operation between clients and contractors. The adversarial stance between clients and contractors has long been associated with project delays, cost overruns, disputes and the like as each party endeavours to protect their own interests. Although partnering has been on the agenda of the Hong Kong construction industry since 1994 with different projects adopting either non-contractual or contractual partnering, contractual partnering has yet to be trialed in the public sector.

Two public projects utilising the NEC form of contractual partnering have been recently instigated. One is already contracted out and the other is under preparation for tender. This article questions whether the method of introducing NEC is effective and whether there is a better way to introduce the trial projects in Hong Kong to properly benchmark the value of this procurement approach.

The New Engineering Contract (NEC) is a contractual partnering form created by the Institution of Civil Engineers (ICE) and designed for facilitating mutual trust and co-operation between clients and contractors.

Why NEC?

As a means to achieve best value for construction, NEC includes various options to be adopted for different procurement strategies:

Option A: Priced contract with activity schedule

Option B: Priced contract with bill of quantities

Option C: Target contract with activity schedule

Option D: Target contract with bill of quantities

Option E: Cost reimbursable contract

Option F: Management contract

These options differ primarily in regard to the different mechanisms by which the contractor is reimbursed and motivated to control costs. For example, Option C is a Target Cost Contract where the contractor is reimbursed for the actual cost incurred, subject to an agreed target cost, with a 'pain share gain share' incentivisation to save costs. As the cost overruns and underruns are shared by both employers and contractors, typically with a 50%-50% pain/gain share percentage, value engineering is often used to reduce costs.

Besides these different procurement options, NEC is also characterised with the following merits:

- Easy: simple language used rather than legal jargon;
- Good project management: e.g. early warning and advance evaluation of changes/delay/disruption;
- Flexible: "Options" besides "Core Clauses", e.g. target contract plus W1 or W2 dispute resolution option;
- Mature: the form has evolved from the first edition in 1993, the second in 1995, to the latest third edition in 2005;
- Comprehensive: a suite of contract forms including target contract, cost reimbursable contract, framework contract, etc. for different projects; and
- Collaboration spirit: e.g. fostering the change in attitudes and behaviours which enables a team to work in a very different way and perform better.

All these merits of NEC can be used to justify its use in Hong Kong.

Current Trial Plan of NEC by Hong Kong Government and its Implications

The current trial plan of NEC by the Hong Kong Government includes one project by the Drainage Service Department (DSD) and another by Highways Department (HyD). The project by DSD comprises the decking of a 180m long by 12m wide open nullah at Fuk Man Road in Sai Kung, landscaping works and local road junction improvement with an approximate contract value of HK\$96M. The project by HyD is a road project with an approximate contract value of HK\$150M.

There is concern that these two pilot projects are too small-scale and will not provide sufficient data and results to adequately test the success or failure of NEC in Hong Kong. Moreover, there are several major differences between these pilot projects and how projects are usually procured in Hong Kong, which will require all parties to undergo a learning curve.

'Gain share pain share' incentivisation in Target Cost option (Option C in NEC)

By incentivisation, the gain and pain beyond the tender price is shared by the client and contractor. Whilst in the UK the pain/gain share is usually 50%-50%, the DSD project caps the pain share percentage. For a share range of within 110%, the share percentage is 50%-50%. For a share range beyond 110%, it is the contractor's pain. This arrangement indicates that there is a nervousness in trialing NEC in Hong Kong. It should also be noted that there have been some clauses deleted in the standard NEC form. Concern thus arises as to how these deviations from the standard NEC form will impair the partnering spirit for NEC projects.

Open book accounting

Although it is not compulsory to use open book accounting in Target Cost Contract (TCC), it is quite common to see it associated with TCC. Open book accounting does not normally rely on being 'pay when paid'. However, in the DSD project,

contractors can only 'get paid when they actually pay their subcontractor'. In other words, contractors need to pay their subcontractors first in order to be reimbursed from the client. However, as there is only one accounting system, clients will have the advantage of seeing how much contractors pay their subcontractors. In this regard, there will be no hidden cost. An impact of the open book accounting system is ensuring there is adequate trained quantity surveying/accountant staff and such staff are trained to accommodate such systems into their organizations.



Early warning and compensation event assessment

Early warning and compensation event assessment is a key feature of the NEC form for dealing with variations and claims. When any party is aware of a potential change/risk, they need to notify the other party as soon as possible. This proactive approach to mitigate risks and agree issues as they occur will help to reduce claims at the end of the project and provide project certainty. It is also why NEC is designed to facilitate the avoidance of disputes and early/fast cashflow in a project. However, the parties still need to learn how to file early warnings effectively and proactively seek value engineering methods to mitigate the risks.

Contractual partnering

Although partnering is not new in the construction industry, partnering with a subcontractor, or even adopting 'pain/gain share' with subcontractors, will be definitely novel to many contractors. Attitude change of both contractors and subcontractors will be needed to avoid the abuse of the partnering, which might result in the loss of NEC benefits.

Ideal target cost estimate

Similar to lowest price bidding, the experience of NEC target cost projects in other countries shows that the acceptance of lowest target cost may not provide value for money in either the final cost of construction or the whole lifecycle and operational costs. Clients thus need to be mindful of the selection criteria in NEC target cost tendering.

Suggestions on the NEC Trials by the Hong Kong Government

If the lessons learnt from the pilot projects are not replicated quickly on further projects, there is unlikely to be long term development of this procurement route. The following

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proposals are thus put forward in this regard to provide a bank of meaningful data to fully support, or not as the case may be, the intent of trial projects, so that benchmark data and continuous improvement can be extracted from the trial programme.

Given the local conditions, the following options are proposed to introduce NEC in Hong Kong:

Option 1: Same contracting party, multiple consecutive projects

Dw'r Cymru Welsh Water (DCWW) in the UK, carried out a water service NEC trial project with a 5-year term in 4 consecutive stages. Replicating its success, a collection of projects could be undertaken in Hong Kong but with a 3-year term (see Figure 1).

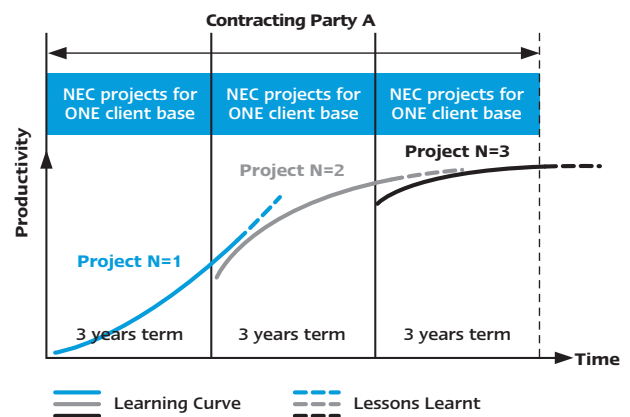


Figure 1: Option 1 - same contracting party, multiple consecutive projects

The 3-year term/plan, in a framework agreement format, would be an excellent model by which to trial NEC contracts in the local construction industry. The benefit of this model is that efficiency and comparison can be measured over specified periods of time and continuous improvement made during the 3-year plan. For this process to work to its best effect, the parties to the contract would need to be aligned such that all stakeholders are embedded within one organization. The NEC Target Cost Contract is an excellent vehicle by which to achieve these goals. DSD refurbishment and renewal drainage projects would be an ideal series of projects to test this model.

Option 2: Different contracting parties, multiple overlapping projects

As an alternative to the two small projects being trialed, a more ambitious approach could be adopted. There are many

major projects due for release in the next 3 years and it would seem an ideal opportunity to implement an alliance approach on a sample of these projects.

A series of projects released on the NEC form could be benchmarked against projects awarded on Hong Kong Government's traditional procurement route (see **Figure 2**). This would then provide the necessary data to properly test the efficiencies of the NEC model.

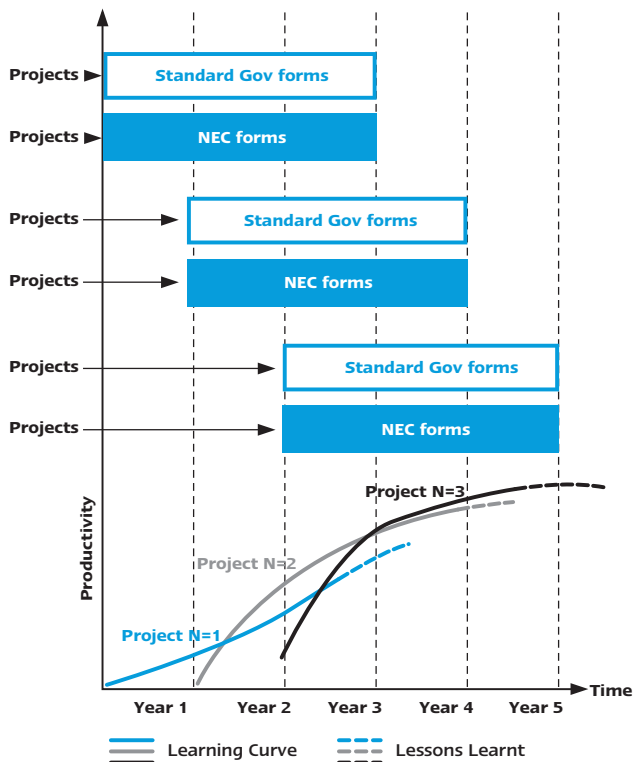


Figure 2: Option 2 - different contracting parties, multiple overlapping projects

Recommendations

There appears to be much dissatisfaction within the Hong Kong construction industry over Government's existing procurement methods. This is evidenced by the large volume of commercial disputes that exist within the industry. Further, in a market that may become overheated over the next 5 years, Government may not see the best out-turn costs by following traditional procurement routes, as contractors, consultants and the supply chain become able to fully price risk to win contracts.

This article strongly supports the Hong Kong Government's trial of the NEC contract on public projects. Yet, the current two trial projects are widely believed to be too small and too slow in implementation to provide sufficient data as benchmarks, or indeed to provide meaningful and much needed change within the industry.

Now is the ideal time for Government to put into place an innovative solution to the industry's existing procurement practice. There are many large projects which can be used as a trial. Some of the projects include:

- Central Wanchai Bypass
- Kai Tak Redevelopment
- Hong Kong-Zhuhai-Macau Bridge
- West Kowloon Cultural District, etc.

...the current two trial projects are widely believed to be too small and too slow in implementation to provide sufficient data as benchmarks, or indeed to provide meaningful and much needed change within the industry.

This article proposes two options for taking a more ambitious approach by Government to trial the NEC contract to evolve the whole industry towards an attitude of change and performance improvement.

In view of the procurement achievement in other jurisdictions, this article highlights the targets from UK's Strategic Forum as a cross-reference for the Construction Industry Council (CIC) and the Hong Kong Works Bureau:

- " - Delivery which is 25%-40% faster... with 11%-30% less capital required
- Improved profitability, reduced operating costs and more sustainable outcomes
- Significantly improved predictability of programme, price and quality
- To work in a safer environment where empowered people are open, honest and realistic and go home feeling trusted, valued and fulfilled"²

By following the proposals in this article, real advancement in existing procurement practice could be made which would place Hong Kong at the forefront of best-practice, and more importantly, provide best-value for society. 🚀

Footnotes:

¹ Members of the Procurement Sub-Group are Steve Rowlinson, University of Hong Kong; Mike Allen, EC Harris (Hong Kong) Limited; Colin Birkby, Nishimatsu Construction Co Limited; Kiki Cai, Gammon Construction Limited; Nigel White, Gammon Construction Limited; and Patrick O'Neill, ADR Partnership Limited. Comments to the Sub-Group are always welcomed and should be addressed to Nigel White.

² UK's Strategic Forum - <http://www.strategicforum.org.uk>

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➤ Straight Line versus Reduced Balance Depreciation

What is Depreciation?

Depreciation is one of the components of ownership costs that is inherent in owning a tangible capital asset. Depreciation is essentially the charge that is applied over the useful life of an asset and which is calculated as being the actual cost of the asset less the assets estimated residual value. Actual depreciation can clearly only be determined once the asset is actually sold and once the salvage proceeds are then known. Any calculations done prior to the date of sale are hypothetical, and, in many cases, can be difficult to determine with any degree of accuracy. A delay to Site activities may demand that, say, plant and equipment remains on Site for prolonged periods and this will adversely affect the residual value of the item, and, hence, the depreciation amount. Depreciation can therefore form an integral part of a prolongation cost claim.

How to Calculate Depreciation

Depreciation can be calculated via several methods. Two such methods are a straight line depreciation method or a reduced balance method, and the depreciation amount varies depending on which technique is used.

Straight Line Method

The straight line method calculates depreciation by spreading the depreciation cost evenly over the life of the asset. For example, a new item of plant is purchased at a capital cost of HK\$12m. The expected life is 8 years with a 10% residual value. The annual depreciation is therefore \$1.35m (i.e. HK\$12m less 10% - 8 years).

Reduced Balance Method

The reduced balance method differs from the straight line method since it takes into account the fact that the depreciation of an asset will be greater in the early years than when the asset is older, and so the depreciation amount is not uniform over the life of the asset. Therefore, the annual depreciation in year 1 of the life of the new item of plant could actually represent 20% of the purchase cost of the plant, i.e. HK\$2.4m, rather than the HK\$1.35m calculated above. This therefore represents a 75% increase on the depreciation amount to that calculated using the straight line method.

Summary

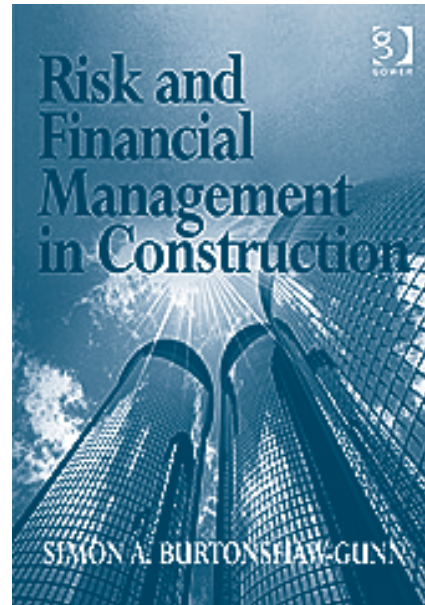
Adopting different methods of calculating depreciation can result in different answers and so it is vital that the correct approach is adopted. For large value plant and machinery, the reduced balance method more accurately reflects the current resale value of an asset by taking into account the higher rate of depreciation in the early years, and, is, therefore, arguably a more appropriate method to use when analyzing the impact of delay on asset values as part of prolongation cost assessments. ⚡

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➤ Books

Risk and Financial Management in Construction

By Simon A. Burtonshaw-Gunn



Risk and financial management in construction projects are issues that are high on the agenda of every project manager.

This practical guide introduces the topic of risk management from a project, business and operational view point. The first part of the book deals with how risks should be identified, quantified, monitored and controlled according to their potential effect on the project objectives.

The tools available for the identification and evaluation of risks together with the various types of checklists, risk matrices and analysis techniques that are available are given particular attention, as is discussion on how to determine the most appropriate tools given the operational complexities of a project and given the levels of risk involved.

The second half of the book concentrates on the financial management of projects and how the financial performance of projects can be impacted by risk and uncertainty. The author provides an analysis on contract strategy including public-private-partnership and partnering arrangements and how risks are managed where such contract strategies are adopted. The book is aimed at project managers, however, the subject matter of financial management is a central theme running through all of the chapters and which therefore makes it equally relevant to commercial professionals in construction. ⚡

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Date: February 2009

ISBN: 978-0-566-08897-1

Price: £47.50

➤ Expanding the ADR Team



We are pleased to announce that **Jeanny P L Tan** has joined the ADR team. Jeanny is a Quantity Surveyor with a Masters Degree in Management in Construction and Construction Law from Kingston University in the UK. A fluent Cantonese and Mandarin speaker, Jeanny has previously been employed by consultancies in the UK, Malaysia and in Dubai and has experience in providing commercial and contractual advice and providing arbitration and litigation support. Further details of all our consultants and directors can be found on our website. <

➤ German Beer Festival 2009

On 5 November 2009, staff and guests attended the German Beer Festival held at the Hong Kong Marco Polo Hotel. Further photos can be viewed on our website in the News section. <



➤ Chartered Institute of Arbitrators - Young Members Group

In November 2009, ADR Partnership Limited sponsored the Chartered Institute of Arbitrators - Young Members Group running team for the UNICEF Charity Run, and in December 2009 their annual party. <



UNICEF Charity Run 2009

ADR | Diary

➤ Forthcoming Events 2010

- 12 Jan** Society of Construction Law - Infrastructure Development in Hong Kong after the Financial Tsunami, Mr. Daniel KW Chung - Hong Kong Club
- 22 Jan** Lighthouse Club - New Year Dinner - Hong Kong Jockey Club, Happy Valley
- 25 Jan** Chartered Institute of Arbitrators - Challenges to Arbitrators, Part 2, Mr. Colin J Wall - Hong Kong Club

- 26 Jan** Chartered Institute of Arbitrators - Arbitration Practice in China, Ms Jessica Fei - HKIAC
- 30-31 Jan** Hong Kong International Arbitration Centre - Dispute Resolution Advisers Structured Training Course - HKIAC
- 5 Feb** Lighthouse Club - February Get Together - Delaneys, 1st Floor, Wanchai
- 5 Mar** Lighthouse Club - March Get Together - Delaneys, 1st Floor, Wanchai
- 19 Mar** Lighthouse Club - Safety Awards - Hong Kong Club

Based in Hong Kong, ADR Partnership Limited is a dynamic practice of construction professionals providing specialist commercial and contractual services to the construction industry.

If you would like to discuss any of the articles published in this Digest or your project requirements, please contact James Longbottom, Patrick O'Neill or David Longbottom at ADR Partnership Limited on **(852) 2234 5228** or e-mail us at info@adrpartnership.com

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