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Briefing note on Retentions payments in the construction sector for the Finance Committee and the Economy, Infrastructure, Skills and Finance Committee of the National Assembly for Wales by the Chartered Institute of Building (CIOB)

Summary

The provision of credit by suppliers to customers is an established feature of business transactions and essential for the efficient operation of economy. However, the provision of goods and services ahead of payment means that suppliers can be vulnerable to payment delays. For this reason, it is crucial that businesses have sound credit management skills as otherwise late payments, and worse still bad debts, will eat into profits.

Introduction and General Comments

Late payment is an issue that matters hugely to businesses, particularly small businesses. A 2014 YouGov poll stated that 85% of small businesses say they have experienced late payment in the last two years, and according to government statistics they are owed around a total of £26.8 billion. In a separate Basware and YouGov poll in May 2018, over 2,000 small businesses with less than 250 staff found that more than half support a change in the law around late payments – with six-in-ten backing the introduction of a 45-day minimum payment term.[1]

In tough economic times the problem is heighted as cash retention becomes a greater priority for businesses.

The construction industry is often highlighted for its issue with late payment and it continues to pose a serious threat to the competitiveness of the sector. For example, for a project to finish on time, on budget and to the highest standards of quality, prompt payment must be made to ensure progress is not delayed to cash flow issues.

For context, construction in the UK is characterised by complex supply chains; this is a result of each building or piece of infrastructure being unique in some way. Main contractors with a direct commercial relationship with a client are termed tier 1. Sub-contractors and suppliers with a direct contract with the tier 1 main contractor are termed tier 2. Sub-contractors and suppliers working for sub-contractors are termed tier 3. Tier 3 sub-contractors also employ their own suppliers and sub-contractors, so in many cases there will be a fourth, fifth etc. tier involved in construction delivery.

A widely held view is that clients and tier 1 contractors retain money for as long as possible, for example to bolster their balance sheet, whereas sub-contractors wish to obtain their money as soon as possible. Longer payment periods, in turn, have a knock-on effect down the supply chain and those further down the chain may become cash starved, forcing greater reliance on borrowing and potentially risk insolvency. However, the counterargument is that retentions are held as a form of surety against defects which may be outlined in contract terms and conditions.

Some statistics that highlight the scale of the issue can be seen below.

[1] Basware & YouGov, *New poll shows 61% of small businesses want legislation around late payments*, May 2018

- The construction and real estate sector are particularly adversely affected by long waits for payment. Waits for payment have increased by 22% in the last five years to 107 days, from 88 days in 2008.[2]

- The squeezing of sub-contractors and suppliers is commonly seen as an accepted practice. In a survey of over 200 subcontractors it was found nine in ten (89%) are waiting over 30 days to receive payment from main contractors on private sector contracts. In the public sector, 92% of respondents who had worked in the sector reported that they were paid in 30 days or more.[3]

- A joint survey in 2015 from Constructing Excellence and Construction News found that, as a result of late payment, many subcontractors respond by inflating their tender prices to cover the costs (financing shortfall, administration involved in recovering costs etc.) they incur when their customers pay late. The survey suggests, on average, 4% is added to the tender price to cover late payment, which creates an additional hidden layer of cost to project delivery. The survey suggested that if main contractors paid promptly (i.e. in under 30 days) subcontractors would discount their prices by an average of 2.35%. In short, construction cost savings and improved margins could be achieved by quicker payment.[4]

UK legislation

Fair and transparent payment practices are essential to the achievement of successful integrated working on construction projects. Successive governments have tried numerous different approaches to tackle late payment. Some of the more well-known legislative approaches can be seen below:

- **The Housing Grants, Construction and Regeneration Act 1996:** Intended to ensure that payments are made promptly throughout the supply chain and that disputes are resolved swiftly. Provisions include:

  - The right to be paid in interim, periodic or stage payments
  - The right to be informed of the amount due, or any amounts to be withheld
  - The right to suspend performance for non-payment
  - The right to adjudication
  - Disallowing pay when paid clauses

The Act applies to all contracts for 'construction operations' (including construction contracts and consultants' appointments). If contracts fail to comply with the act, then the Scheme for Construction Contracts applies[5].

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[2] Asset Based Finance Association (ABFA), *Late Payment: An analysis by sector*, May 2015
[3] Building, *Nine in ten subcontractors wait over 30 days for payment*, October 2014
[4] Constructing Excellence, *Late Payment: Digitising the Supply Chain*, September 2015
[5] The Scheme for Construction Contracts is a scheme which applies when construction contracts do not comply with the Housing Grants, Construction and Regeneration Act. Part 1 of the Scheme makes provision for adjudication where the contract does not comply with the Act. Part 2 of the Scheme replaces those provisions in relation to payment that do not comply with the Act.

The Act was amended in October 2011 to close loopholes within its provisions and it now applies to construction contracts including those that are not in writing. Adjudication clauses must still be in writing; otherwise the scheme for construction applies.

The Late Payment of Commercial Debts (Interest) Act 1998, Late Payment of Commercial Debts Regulations 2002 and 2013: These give businesses the statutory right to claim interest on late payments from other businesses. Statutory interest starts to accrue, if payment has not been received, on the day after the 'Relevant Day' and is calculated as 8% above the Bank of England base rate. New regulations amended

To supplement existing legislation measures, there have been several charters and voluntary measures such as the cross-industry Fair Payment Charter, the Prompt Payment Code and Construction Supply Chain Charter in recent years to try and improve the industries payment performance.

Reform and other measures to improve payment in the construction industry

In October 2017, the Government published the Pye Tait review; Retentions in the Construction Industry, BEIS Research Paper 17. The review sought to assess the costs and benefits of retentions and alternative mechanisms. It found that the average retention was 4.8%.

The report found that reasons for non-payment or late payment of retentions included:

- Disputes over defects.
- Contractors becoming insolvent.
- Non-payment in a higher tier of the supply chain.
- Contractors not asking for their retention money, with some Tier 3 companies pricing work to offset the retention costs, and others keen to maintain good relationships with their main contractor.
- This can result in higher overheads, poor relationships, constraints in growth and in some cases, insolvency.

Following the review, the government launched a consultation into 'the practice of cash retention under construction contracts'. In January 2018, following the collapse of Carillion, several main contractors backed a call to put an end to retention payments. Build UK, the Civil Engineering Contractors Association and the Construction Products Association provided a joint submission to the ongoing government consultation, stating that; 'The industry is fully committed to achieving zero cash retention and we believe that government must introduce legislation to ensure there is zero cash retention within the industry by no later than 2025.'

Despite this, the preference for the industry seems to still be focused on voluntary measures. In April 2019 it was found a host of companies – primarily tier one contractors – such as Balfour Beatty, Costain, Interserve and Laing O'Rourke had their membership of the Prompt Payment Code suspended for consistently missing payment targets.[6]

Other alternatives

[6] The Construction Index, *Late-paying construction companies suspended from Prompt Payment Code,* April 2019

Project Bank Accounts (PBA): One prominent solution, currently being adopted, is the use of project bank accounts, whereby the contractor and named members of the supply chain are paid out of a single account. In December 2017, the Welsh government announced that it would use project bank accounts on all building projects over £2m procured by government bodies from 1st January 2018.[7] And in February 2019, the Scottish Government announced that from 19 March, its thresholds would be reduced so that public bodies would have to include project bank accounts in tender documents for building contracts worth £2m or more and civil engineering projects worth £5m or more.[8] However, project bank accounts are rarely used outside the public sector and there are concerns as to their suitability on smaller projects (for example administration costs, gaps in knowledge, etc.)

Digitising Payment: The construction industry is currently in the process of digitising, optimising and integrating collaborative design, construction and maintenance processes through the adoption of Building Information Modelling (BIM) and data solutions. One thing that BIM has the potential to do is to digitise construction procurement and payment, which is still very much an analogue process. The government's Digital Built Britain strategy recognises the role digital payment has in improving productivity, driving out waste and encouraging more collaborative models of working, primarily as it provides transparency and trust.[9]

CIOB's position

We agree that whilst measures such as the Prompt Payment Code, Construction Supply Chain Payment Charter and Project Bank Accounts (PBA) have had a positive influence in improving payment practices, the number of construction contracts using these voluntary measures remain low. One of the primary reasons for this is could be a lack of support to adopt the above schemes which could be bureaucratic, particularly at SME contractor level.

We support the Build UK, Civil Engineering Contractors Association (CECA) and Construction Products Association (CPA) ambition to move towards zero cash retentions by the year 2025. There are clearly several significant benefits for the culture of the industry, its clients and stakeholders, which could be realised by removing retention, these are:

- Improved quality of completed works on construction projects, and increased assurance that any defects that do occur will be rectified appropriately, without the threat of unfair payment.
- An increase in working capital within the supply chain to support investment, productivity and growth.
- Increased collaboration and transparency in the construction industry, ensuring that any forms of security used against defects are appropriate and proportionate.

In light of this, we believe a legislative solution to abolish the practice of retention offers a game-changing opportunity for the industry. The joint Build UK, CECA and CPA response calls on the Government to legislate for zero cash retention by no later than 2025. The response also sets out an

[7] The Construction Index, *Welsh government mandates project bank accounts*, December 2017
[8] Scottish Government, *CPN 1/2019: Project Bank Accounts – Revised Thresholds and Procedures*, February 2019
[9] HM Government, *Digital Built Britain Level 3 Building Information Modelling - Strategic Plan*, February 2015

industry-led roadmap to assist the construction supply chain move towards a zero cash retentions system. Further information can be accessed here: https://builduk.org/priorities/improving-business-performance/retentions/