Cynulliad Cenedlaethol Cymru
Pwyllgor yr Economi, Seilwaith a Sgiliau
—
National Assembly for Wales
Economy, Infrastructure and Skills Committee

Ken Skates AM
Minister for Economy, Transport and North Wales

4 March 2020

Dear Ken,

Retention Payments in the Construction Sector

Last year the Economy, Infrastructure and Skills Committee and the Finance Committee held a joint evidence session to look at the use of retention payments in Wales, and the UK more widely.

The session was prompted by the Finance Committee's concerns based around the delays in paying retention monies to contractors and the effect this has on the supply chain. Particularly the effect on smaller sub-contractors who have satisfactorily completed their work without defects but often have to wait to receive their retention payment for various reasons.

The joint session considered the following:

- to what extent retentions are an issue for companies based and/or operating in Wales, including how issues might differ through the supply chain;
- whether there are any benefits to the use of retentions;
- alternatives to the use of retentions and what role the Welsh Government could play in developing and delivering those alternatives.

Cynulliad Cenedlaethol Cymru
Bae Caerdydd, Caerdydd, CF99 1NA
SeneddESS@cynulliad.cymru
0300 200 6565

National Assembly for Wales
Cardiff Bay, Cardiff, CF99 1NA
SeneddEIS@assembly.wales
0300 200 6565

The Committees did not issue a formal call for evidence, but publicised the work through Welsh news outlets, and received **seven consultation responses,** including from contractors and industry bodies. On 17 October 2019, we took **oral evidence** from the Specialist Engineering Contractors' (SEC) Group, Chartered Institute of Building Wales (CIOB), and the Federation of Master Builders (FMB). Following that session Members wanted to take further oral evidence specifically from Tier 1 contractors and the public sector, but a lack of witness availability led to this session being cancelled. However, the Committees did receive further written evidence from the **NHS Shared Services Partnership** (NWSSP), who had been willing to appear before us.

The Committees noted that the UK Government held a consultation on retention payments in the construction industry which closed in January 2018. The UK Government has said it will publish its response to the consultation in due course. We also received written evidence from the Scottish Futures Trust, and the Scottish Government, which is currently consulting on this issue.

The problems relating to retention payments are clearly entrenched and complex, and from this short piece of work and the limited range of evidence heard, the Committees are not in a position to recommend option(s) to resolve them.

However, some consistent messages emerged from the evidence that was gathered, which are outlined in the annex to this letter.

Members would welcome the Minister's view on the matter of retention payments, and what Welsh Government's intentions are to address serious concerns within the industry in Wales, taking account of consultation activities in other jurisdictions.

We look forward to your response.

Best regards,

Llyr Gruffydd AM
Chair
Finance Committee

Russell George AM
Chair
Economy, Infrastructure and Skills Committee

Annex A - Summary of evidence to joint Committee session

Impact of non-payment

- The 5 per cent deducted in retention payments is in effect used to support the cash flow of tier 1 contractors, and it can take between two to five years for retentions to be released. The retention payments system is a drain on the scarce resources of the overwhelming number of SMEs in the Welsh construction sector.
- The CIOB say many firms give up any expectation of receiving the payments. FMB research shows 5 per cent of members have had to withhold wages due to late or non-payment, and a 2014 survey revealed 12.5 per cent of payments being written off as bad debt.
- SEC Group have suggested that £700 million of cash retentions was lost over a three-year period to 2016 due to upstream insolvencies, and that over that period £7.8 billion of cash retentions was still owing. The FMB notes that following the collapse of Carillion, one FMB member lost £200,000 in unpaid contracts and another was forced to put their company into liquidation. The SEC Group Wales highlighted in its evidence that Dawnus owed £39 million to trade creditors, much of which would have comprised retention monies.

Inequality of protection

- There is inequality of protection for supply chain firms in the public sector: as Rudi Klein of SEC Group Wales pointed out, "public sector retentions are protected because public bodies don't go bust. So, if I'm a contractor dealing with a public body, I'm protected. On the other hand, if you're in the supply chain, you lose all of your moneys if the tier 1 goes bust."
- Retention payments may also be withheld from a sub-contractor for defects that are nothing to do with their part of a project, and conditions set out in the Housing Grants, Construction and Regeneration Act 1996 (as amended) ("the Construction Act") are not being complied with. The Scottish Futures Trust stated that changes to the Construction Act have, in many cases, actually extended the time an SME may wait for their retention monies to be released.
- The SEC Group Wales told Members that the "climate of fear" in the industry means that not only do supply chain firms not pursue their claim to their own retention monies, but they also do not claim the interest on those monies held back for years. One respondent from a construction sector SME described the adjudication process as "no better than a kangaroo court" and described SMEs as having "little

chance" defending themselves against the practices of the bigger companies.

Greater reliance on retention payments in Wales

- SEC Group said that there is a greater use of retention monies in Wales than in England and an over-reliance on retention payments: "every council, bar two in Wales, depends on retentions; they tend to use retentions either to add to their general expenditure or to use as working capital." The FMB say tier 1 contractors are making money by investing retention monies they are holding from supply chain firms, and the SEC Group's assertion in their written evidence that retention monies are being invested in the overnight money markets is a troubling claim.
- The practices described in evidence to Committee Members suggested a construction industry that operates in a dysfunctional way: FMB explained how the business model means that profit margins for tier 1 contractors are low or non-existent (Build UK's 2017 figure was -0.5 per cent), and so retention payments are highly incentivised.
- SEC Group also said it was "troublesome" that health authorities in Wales were deducting 10 per cent instead of the standard 5 per cent, and "that goes down the supply chain as well." Evidence from the NWSSP however said that for framework contracts retentions are only applied to the last 15 per cent of contracts, and that for third generation frameworks "the actual retention percentage deducted is, therefore, up to a maximum of 0.75 per cent, with half of the monies released at practical completion."

Questionable benefits

- Although the purpose of retention payments is to provide protection in the case that non-compliant work is not addressed, the SEC Group said that this perception was "more apparent than real", and "the disbenefits outweigh the benefits." SEC Group noted that the amount being held in retentions was often insufficient to deal with extensive defects should they arise. It pointed to concerns expressed by the New Zealand government prior to legislating in 2017 about the negative impact on the industry: "funding working capital from retentions can mask and reward poor performance and poor financial management practices", and also to Dame Judith Hackitt's 2018 report on building safety which said that "Payment terms within contracts (for example, retentions) can drive poor behaviours, by putting financial strain into the supply chain."

Alternative approaches

- Retention payments are also used in other countries worldwide, but a number of alternative approaches were noted, from project bank accounts (PBAs) to types of bonds, stakeholder accounts, parent company guarantees and trust funds. All appear to have pros and cons. The Scottish Government's evidence highlighted Retention Bonds, Performance Bonds and Parent Company Guarantees as alternatives to retentions, but the SEC Group said that retention bonds are not an alternative for small firms due to the prohibitive cost.
- The NWSSP pointed to other possible alternative approaches to the use of retentions, although noted they were not "without risk", and that "the traditional approach to retention perhaps still offers the best approach, as long as the retention percentages and methodologies are reasonably assessed and fairly applied".

Use of Project Bank Accounts (PBAs) in Wales

- From 1 January 2018, the Welsh Government committed to using PBAs on relevant contracts £2m or more.
- The CIOB noted that uptake of measures such as PBAs is low, suggesting that "one of the primary reasons for this could be a lack of support to adopt the above schemes which could be bureaucratic, particularly at SME contractor level."
- The CIOB also suggested that PBAs are rarely used outside the public sector and there are concerns as to their suitability on smaller projects.

Ring-fencing and legislative proposals

- Retention payments are widely used in other countries, including the USA, Canada, China, Australia and New Zealand, with examples in New South Wales, Canada and New Zealand of the introduction of 'ring-fencing' of retention monies in a separate bank account, or held 'in trust'. The SEC Group suggests that "most other jurisdictions… have legislation in place that ringfences cash retentions by requiring that they are placed in trust or in a stakeholder account until released".
- The SEC Group provided a copy of a proposed Bill which it developed in 2013, and additionally expressed support for a Private Members' Bill introduced in the House of Commons in January 2018, the Construction (Retention Deposit Schemes) Bill, which it says provides a "useful template". That Bill proposed to amend section 111 of the Construction Act to impose a mandatory retention deposit scheme on the parties and provided that failure to comply with those requirements would necessitate the refund of a cash retention to a

payee within seven working days from when the cash retention was withheld. However, the Bill's second reading was delayed on a number of occasions and its passage through Parliament ended in October 2019.

Role of digital

- The SEC Group has also sponsored the development of a digital platform to “protect retention money”, which would involve an industry-owned insurance fund to ensure retentions are released in full and on time. Retentions would be ring-fenced in a trust account, with an “industry-owned clearing house”. It suggests the scheme costs would be roughly £230 for every £100,000 of contract value, and a pilot is ready for testing.
- CIOB’s evidence also noted the prospect of enabling “digitising payment” through the adoption of Building Information Modelling (BIM) and data solutions, noting that payments in the industry are still “very much an analogue process.”