

FINAL BUSINESS AND REGULATORY IMPACT ASSESSMENT

1. Title of proposal

Amendments to the Scheme for Construction Contracts (Scotland) Regulations 1998¹ (the Scheme) and introduction of the Construction Contracts (Scotland) Exclusion Order 2011.

2. Purpose and intended effect

Context

Construction is a significant contributor to the Scottish economy, with £7.2 billion Gross Value Added (GVA) attributed to the construction sector in 2008. It contributes to improvements in the delivery of public services (such as health, education or transport), business productivity and standards of living and the natural environment.

In March 2010, there were 16,755 registered enterprises operating in the construction sector, representing 11% of all registered businesses operating in Scotland. The sector is also a significant source of employment: the seasonally adjusted Workforce Jobs series indicates that there were 182,500 jobs in the Scottish construction industry in 2011 Q1.

Objectives

Part 2 of the Housing Grants, Construction and Regeneration Act 1996 (the 1996 Act)² was designed to provide the construction sector with effective and fair payment practices and, in the event of dispute, access to a quick and relatively inexpensive adjudication process.

If construction contracts do not comply with the requirements of Part 2 of the 1996 Act, the relevant terms of the Scheme apply. Certain contracts are excluded from the application of Part 2 of the 1996 Act by the Construction Contracts (Scotland) Exclusion Order 1998³.

Amendments to the Scheme and a new Exclusion Order are necessary following changes to the payment and adjudication provisions in Part 2 of the 1996 Act so that the “suite” of construction contracts legislation in Scotland remains effective.

¹ <http://www.legislation.gov.uk/uksi/1998/687/contents/made>

² <http://www.legislation.gov.uk/ukpga/1996/53/part/II>

³ <http://www.legislation.gov.uk/uksi/1998/686/contents/made>, as amended by the Construction Contracts (Scotland) Exclusion Amendment Order 2006: <http://www.legislation.gov.uk/ssi/2006/513/contents/made>

Background

Construction contracts legislation

Part 8 of the Local Democracy, Economic Development and Construction Act 2009 (the 2009 Act)⁴ makes a number of changes to the payment and adjudication provisions in Part 2 of the 1996 Act (the relevant provisions are extended to Scotland by the use of a legislative consent motion).

These changes are largely technical and include:

- extension of Part 2 of the 1996 Act to oral construction contracts and to those that are partly oral and partly in writing;
- provision on when the allocation of the costs of adjudication is ineffective;
- provision enabling the adjudicator to correct a clerical or typographical error in his decision;
- changes to the current payment framework, including the prohibition of “pay when certified” clauses⁵ in construction contracts;
- clarification of the circumstances in which the payer must give notice to the payee if he intends to pay less than the amount due;
- improvement to the provisions relating to the right of a party to whom payment is due to suspend performance of his obligations under a construction contract.

Part 8 of the 2009 Act also makes changes to Scottish Ministers’ power to exclude specified contracts from the operation of Part 2 of the 1996 Act.

Rationale for Government intervention

As stated above, Part 2 of the 1996 Act was designed to provide the construction sector with effective and fair payment practices and, in the event of dispute, access to a quick and relatively inexpensive adjudication process. Providing a supportive environment for businesses contributes to the Scottish Government’s Wealthier and Fairer strategic objective and to sustainable economic growth in Scotland.

Whilst the 1996 Act has generally improved cash flow and dispute resolution, extensive consultation with the construction industry and its clients revealed a need for amendments to the legislation to make it more effective in achieving its objective. The amendments to Part 2 of the 1996 Act mean that consequential amendments to the Scheme and a new Exclusion Order are now necessary.

⁴ <http://www.legislation.gov.uk/ukpga/2009/20/part/8>

⁵ “Pay when certified” clauses are clauses which make the timing or entitlement to payment conditional on the issue of a payment certificate (for example from an architect or quantity surveyor) relating to the progress or completion of work under another contract in the same supply chain. For example, A contracts with B for the provision of a roof. B sub-contracts with C for the supply of roof tiles and makes payment to C conditional on the issue of a payment certificate under the contract between A and B which takes into account the extent to which work on the roof has been progressed or completed. The 2009 Act changes will prohibit such clauses.

3. Consultation

Within government

The following government agencies and departments have been consulted in the preparation of this Business and Regulatory Impact Assessment (BRIA):

- Better Regulation and Industry Engagement Branch, Scottish Government has provided advice on the preparation of this BRIA;
- Scottish Government Construction Procurement Policy Team and Capital and Risk Division have provided advice on construction contracts and PFI-type arrangements;
- Scottish Futures Trust has provided advice on PFI-type arrangements;
- Scottish Government Innovation and Industries Division has provided advice on the construction industry in Scotland;
- Justice Directorate, Scottish Government has provided advice on issues relating to adjudication;
- Legal Aid Team, Scottish Government has provided advice on the implications for the legal aid fund;
- Scottish Government Legal Directorate has provided advice on the legal issues raised in this consultation; and
- The Department for Business, Innovation and Skills has provided advice from UK Government's perspective⁶.

Public consultation

Public consultation on the proposed amendments to the Scheme and Exclusion Order and a partial BRIA took place from 7 February 2011 to 1 April 2011. We also consulted directly with stakeholders via the Scottish Construction Forum and the national advertising portal (Public Contracts Scotland) and via publication of a Scottish Procurement Policy Note⁷:

<http://www.scotland.gov.uk/Resource/Doc/116601/0113586.pdf>.

We received a total of eighteen responses to the consultation and have taken full account of these in finalising the changes to the Scheme and new Exclusion Order. Where respondents gave permission for their responses to be made public, these were published on the Scottish Government's consultation web pages on 13 May 2011⁸. We will publish an analysis of the responses shortly.

Business

Consultation with business on the proposed amendments to the Scheme and the Exclusion Order was conducted via the organisations represented on the industry-led Scottish Construction Forum. The aim of the Forum was to act as a point of contact between the construction industry, the Scottish Government and the Scottish Parliament and to advise at a strategic level on the actions required to promote

⁶ The Department for Business, Innovation and Skills is responsible for amending the equivalent Scheme and Exclusion Order for England undertook a similar consultation in March 2010: <http://www.bis.gov.uk/Consultations/construction-contracts-regulations-1998-amendments>.

⁷ The Scottish Government's Procurement and Commercial Directorate produces Scottish Procurement Policy Notes (SPPNs) on an ad hoc basis on current procurement policy issues. SPPNs are circulated widely to stakeholders and are also published on the Scottish Procurement and Commercial Directorate's website: www.scotland.gov.uk/Topics/Government/Procurement.

⁸ <http://www.scotland.gov.uk/Publications/2011/05/05104752/0>

innovation and excellence in the construction industry. Since 1 April 2011, the work of the Forum has been assumed by “Construction Scotland”⁹.

At the time of the consultation, the membership of the Scottish Construction Forum included:

- Balfour Beatty
- Hillhouse Quarry Group Ltd
- Erdc Group Ltd
- Keppie Design Ltd
- Scottish Building Federation
- Scottish Confederation of Associations of Specialist Engineering Contractors
- The Civil Engineering Contractors Association (Scotland)
- The National Specialist Contractors Council (Scotland)
- Union of Construction, Allied Trades and Technicians
- Construction Licensing Executive
- The Association for Project Safety
- ConstructionSkills Scotland
- Health and Safety Executive
- Quarry Products Association Scotland
- Edinburgh Napier University
- The Building & Construction Industry Forum
- Glasgow Caledonian University
- Scottish Construction Centre
- Scottish Enterprise (corresponding member)
- Directorate for Business, Scottish Government (observer)
- Scottish Procurement and Commercial Directorate, Scottish Government (observer)

We received five responses to the consultation from members of the Forum and have taken full account of these in finalising the changes to the Scheme and new Exclusion Order.

4. Options

Option 1 – amend the Scheme and introduce a new Exclusion Order

The amendments to Part 2 of the 1996 Act require corresponding amendments to the Scheme so that:

- provisions in the Scheme relating to the adjudicator’s fees and expenses apply subject to any valid¹⁰ agreement by the parties to the contrary;
- provision is made for the adjudicator to correct errors in his decision; and
- the Scheme reflects the new payment notice framework in the 1996 Act.

These amendments will ensure that where the Scheme applies¹¹, parties are encouraged to resolve disputes by adjudication and the resolution of disputes relating to payment is more effective.

⁹ <http://www.constructionscotland.org.uk/page.jsp?id=1569>

¹⁰ i.e. in accordance with new 108A(2) of the 1996 Act

The new Exclusion Order is required in order to exclude sub-contracts entered into by project companies in Private Finance Initiative (PFI) projects (known as “first tier PFI sub-contracts) from the application of new section 110(1A) of the 1996 Act which prohibits “pay when certified” clauses. This is necessary because such clauses are a key feature of sub-contracts entered into in PFI projects, driven by the risk allocation on such projects.

Option 2 – do nothing

As stated above, the relevant terms of the Scheme apply if construction contracts do not comply with the requirements of the 1996 Act. Failure to amend the Scheme following amendments to the 1996 Act would result in inconsistency between the corresponding provisions in the Scheme and the 1996 Act and impact on the effectiveness of the “suite” of construction contracts legislation in Scotland.

Failure to exclude sub-contracts entered into by project companies in PFI projects from the application of new section 110(1A) of the 1996 Act could impact on the viability and cost of such projects.

Sectors and groups affected

The following are likely to be affected by the amendments to the Scheme and the new Exclusion Order: the construction industry and its clients (both private and from the public sector); legal firms; adjudicators; the courts.

Benefits – option 1

The amendments to the Scheme and new Exclusion Order will ensure that the “suite” of construction contracts legislation in Scotland is effective.

The amendments will contribute to improving payment practices within the construction industry, reducing the administrative burden on parties to a construction contract and encouraging better cash flow.

Disputes between parties to construction contracts can jeopardise the timely delivery of construction projects, cause costs to escalate and threaten the viability of individual businesses. The amendments will also enhance the existing adjudication provisions where dispute arises.

Benefits – option 2

None. As stated above, failure to amend the Scheme would result in inconsistency between the corresponding provisions in the Scheme and the 1996 Act. Failure to exclude sub-contracts entered into by project companies in PFI projects from the application of new section 110(1A) of the 1996 Act could impact on the viability and cost of such projects.

Costs – option 1

The amendments to the Scheme are consequential to the changes introduced to Part 2 of the 1996 Act by Part 8 of the Local Democracy, Economic Development and Construction Act 2009. These changes will require the contract writing bodies to

¹¹ i.e. where a construction contract does not comply with the requirements of Part 2 of the 1996 Act

re-write standard forms of contract and make these available to the industry. This work has already commenced. In turn, parties to construction contracts will be required to familiarise themselves with the changes, in particular the new payment notice framework, supported by industry guidance. The impact assessment for the 2009 Act can be found at:

www.communities.gov.uk/documents/communities/pdf/1088220.pdf.

In our view, the amendments to the Scheme do not bring any additional costs beyond those which were included in that impact assessment.

Nor do we believe that there will be costs associated with the new Exclusion Order, given that it essentially maintains the status quo. Permitting “pay when certified” clauses in sub-contracts entered into by project companies in PFI projects means that the main contractor may have to pay its sub-contractors before having been paid itself and requires the main contractor to manage its cash flow accordingly. This reflects the commercial realities of PFI-type arrangements and allows current practice to continue.

Costs – option 2

Failure to amend the Scheme would mean that the benefits identified above in relation to option 1 (improved payment practices and more effective resolution of disputes) would not materialise.

As stated above, we believe that failure to exclude sub-contracts entered into by project companies in private finance initiative contracts from the application of new section 110(1A) of the 1996 Act could impact on the viability and cost of such projects.

5. Scottish Firms Impact Test

As stated above, consultation with Scottish firms on the proposed amendments to the Scheme and the new Exclusion Order was conducted via correspondence with the organisations represented on the industry-led Scottish Construction Forum.

This consultation highlighted that the costs associated with managing cash flow and with disputes can have a disproportionate impact on micro and small businesses. Such costs divert resources and can constrain the development of micro and small businesses and reduce their ability to compete.

We anticipate that the amendments to Part 2 of the 1996 Act and the Scheme will benefit micro and small businesses by:

- extending the 1996 Act to oral contracts and partly oral contracts;
- increasing access to adjudication in the event of a dispute;
- prohibiting contractual provisions which, prior to the dispute arising, allocate the costs relating to the adjudication of a dispute to one party (such provisions can make adjudication unaffordable for micro and small businesses);
- making the payment framework more transparent and giving micro and small businesses greater certainty as to the amount they will be paid and when;

- improving communication between the parties, facilitating better management of cash flow;
- giving subcontractors the right to initiate the payment process where the main contractor has failed to do so; and
- removing the ability of the main contractor to defer payment to a subcontractor until work under the contractor's contract with the client is certified.

We believe that excluding sub-contracts entered into by project companies in PFI projects (first tier PFI sub-contracts) from the application of new section 110(1A) of the 1996 Act which prohibits "pay when certified" clauses will not impact on micro and small businesses. Although "pay when certified" clauses will be permitted in contracts between the project company and the main contractor, they will not be permitted in contracts further down the supply chain which tend to involve micro and small businesses.

Competition assessment

In our view, the amendments to the Scheme and new Exclusion Order will not impact negatively on competition within the construction industry, which remains extremely competitive. We have applied the Office of Fair Trading's competition filter which confirms this assumption.

"Test Run" of business forms

The amendments to the Scheme and new Exclusion Order will not introduce any statutory business forms.

6. Legal Aid Impact Test

The Scottish Government's Legal Aid Team has confirmed that the amendments to the Scheme and new Exclusion Order will have a minimal impact on the legal aid fund.

7. Enforcement, sanctions and monitoring

It is for parties to a construction contract to ensure that the contract complies with the requirements of Part 2 of the 1996 Act. As stated above, construction contracts legislation encourages parties to resolve disputes by adjudication, where it is appropriate, rather than resorting to arbitration or litigation in the first instance.

The Scottish Government will work with Construction Scotland and UK Government to monitor the effectiveness of the construction contracts legislation and to identify any further improvements.

8. Implementation and Delivery Plan

The changes to the payment and adjudication provisions in Part 2 of the 1996 Act and the Scheme will come into force on 1 November 2011; the new Exclusion Order will come into force on the same date.

We have worked closely with the UK Government and the Welsh Assembly Government to ensure that the intended effects of construction contracts legislation remain consistent in Scotland, England and Wales and that implementation of the changes to the legislation is co-ordinated.

The contract writing bodies have already commenced work to re-write standard forms of contract in response to the changes to the legislation and industry guidance is being prepared.

In addition, we intend to issue a Scottish Procurement Policy Note to stakeholders to alert them to the changes to the legislation. This note will also be published on the Scottish Procurement and Commercial Directorate's website and the Public Contracts Scotland portal.

9. Post-Implementation Review

As previously stated, the Scottish Government will work with Construction Scotland and UK Government to monitor the effectiveness of the construction contracts legislation and to identify any further improvements.

A review of the effectiveness of the changes to Part 2 of the 1996 Act will be undertaken by UK Government within five years of the changes coming into force.

10. Summary and Recommendations

In summary, the changes to the construction contracts legislation will contribute to improving payment practices within the construction industry, reducing the administrative burden on parties to a construction contract and encouraging better cash flow. They will also enhance the existing adjudication provisions where dispute arises.

The amendments to the Scheme and a new Exclusion Order are necessary following changes to the payment and adjudication provisions in Part 2 of the 1996 Act so that the "suite" of construction contracts legislation in Scotland remains effective.

In our view, the amendments to the Scheme do not bring any additional costs beyond those which were included in the impact assessment undertaken by UK Government in relation to Part 8 of the 2009 Act. Nor do we believe that there will be costs associated with the new Exclusion Order, given that it essentially maintains the status quo.

We therefore intend to proceed with the amendments to the Scheme and a new Exclusion Order (option 1).

11. Declaration and publication

I have read the impact assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that

the benefits justify the costs. I am satisfied that business impact has been assessed with the support of businesses in Scotland.

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**Cabinet Secretary for Infrastructure and Capital Investment
June 2011**

Contact

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