



Amendments to Part 2 of the Housing Grants, Construction and Regeneration Act 1996

Impact assessment



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Impact assessment

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Contents

Summary: Intervention & Options	4
Summary: Analysis & Evidence	5
Evidence Base (for summary sheets)	6
Overview	6
Rationale for Government Intervention	7
Background	8
Current Proposals	8
Consultation	9
OPTIONS:-	10
Small Firms Impact Test	13
Equality Duties	15
Competition Assessment	16
Enforcement, Monitoring and sanctions	16
Implementation and delivery plan	16
Summary and recommendation	17
Specific Impact Tests: Checklist	18

Summary: Intervention & Options

Department:

Business Enterprise and Regulatory Reform (BERR)

Title:

Impact Assessment on Amendments to Part 2 of the Housing Grants, Construction and Regeneration Act 1996

Stage: Final

Version:

Date: 05 November 2008

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Available to view or download at:

<http://www.berr.gov.uk/sectors/construction/constructionact/page13956.html>

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What is the problem under consideration? Why is government intervention necessary?

Reducing the incidence of unfair payment practices in the construction industry. While the 1996 "Construction Act" has generally improved cash flow and dispute resolution under commercial construction contracts, it is ineffective in certain key regards. Extensive consultation with the industry and its clients over four and a half years has concluded that guidance will not adequately address the issues and that amendments to the existing legislation are required to ensure the Act is more effective in achieving its objective.

What are the policy objectives and the intended effects?

To improve the existing regulatory framework in order to:

- increase transparency and clarity in the exchange of information relating to payments to enable the better management of cash flow
- encourage the parties to resolve disputes by adjudication, where it is appropriate, rather than by resorting to more costly and time consuming solutions such as litigation and
- strengthen the right to suspend performance under the contract

What policy options have been considered? Please justify any preferred option.

- A. Targeted regulatory intervention (preferred option) –The Act is defective in certain key regards. Specific regulatory interventions allow us to rectify this and make it much more effective in achieving its aims while not unduly disturbing what is generally considered a helpful piece of legislation.
- B. Greater regulatory intervention.
- C. Do nothing

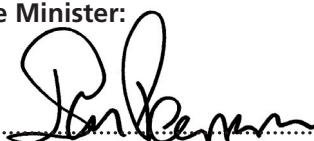
When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

Approximately three years after commencement of both primary legislation and secondary legislation (The Scheme for Construction Contracts) to allow the policy to 'bed down' and to judge whether the expected benefits have been realised.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options

Signed by the responsible Minister:



Date: 6 November 2008

Summary: Analysis & Evidence

Policy Option: A **Description:** Targeted Regulation

A

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups'	
	One-off (Transition)	Yrs		The one-off costs of targeted regulation include the costs of re-writing standard forms of contracts (see para 17). Costs and also benefits relate to the greater clarity and certainty we are introducing into the payment framework (see para 18).
	£42,000 approx	1		
	Average Annual Cost (excluding one-off)			
£649,000		Total Cost (PV) £691,000		
Other key non-monetised costs by 'main affected groups' Time taken to familiarise industry with new framework.				

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups'	
	One-off	Yrs		The main benefit of this option is the relaxation of the restriction on who is required to serve payment notices which will deliver an annual saving of around £6.5m .
	£0			
	Average Annual Benefit (excluding one-off)			
£6,480,000		Total Benefit (PV) £6,480,000		
Other key non-monetised benefits by 'main affected groups' Many commentators say there is considerable benefit to be gained from effective cash flow management in construction. Most recently work carried out for OGC identified improvements in payment practices which created clear entitlements (which our proposals seek to do) could save 1–1.5% on the average project or £1 to £1.5bn pa.				

Key Assumptions/Sensitivities/Risks

Price Base Year 2005	Time Period 1 yr	Net Benefit Range (NPV) £116,600–£35m	NET BENEFIT (NPV Best estimate) £5,831,000
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What is the geographic coverage of the policy/option?	GB			
On what date will the policy be implemented?	TBC			
Which organisation(s) will enforce the policy?	Courts			
What is the total annual cost of enforcement for these organisations?	£728,000 (Para.38 for calculation)			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	N/A			
What is the value of the proposed offsetting measure per year?	£N/A			
What is the value of changes in greenhouse gas emissions?	£N/A			
Will the proposal have a significant impact on competition?	No			
Annual cost (£–£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices)		(Increase – Decrease)	
Increase of	£649,000	Decrease of	£6,480,000
		Net Impact	–£5,831,000

Key: **Annual costs and benefits: Constant Prices**

(Net) Present Value

Evidence Base (for summary sheets)

Overview

1. Construction accounts for approximately nine% of national gross value added. But its economic importance is wider than that – well managed and successfully delivered construction projects can improve the delivery of public services (such as health, education or transport), improve business productivity (more productive factories and offices) and improve standards of living and the natural environment.
2. In Great Britain there are approximately 240,000 enterprises active in construction contracting and consulting, of which 99% are small or micro enterprises. The sector employs around 2 million people and a further 600,000 are self-employed. Characteristically profit margins in the industry are low and insolvencies are high compared to the economy as a whole. The supply team on a construction project often includes a large number of firms.

Size of firm (employees)	Number of firms
Micro (0–9)	220,360
Small (10–49)	16,290
Medium (50–249)	2035
Large (250+)	305

Part 2 of the Housing Grants, Construction and Regeneration Act 1996 ('The Construction Act')

3. The Construction Act has had an important role to play in improving the efficiency of construction supply chains since it came into force on 1 May 1998. The Act set a statutory baseline for acceptable contractual provisions in the construction industry with two main aims:
 - to ensure prompt cash flow improving efficiency and productivity and
 - to allow swift resolution of disputes by way of adjudication allowing projects to be completed without wasted profit and time in litigation
4. The Act currently achieves this by:
 - providing a statutory right for parties to a construction contract to refer disputes to adjudication;
 - providing a right to interim, periodic or stage payments, making clear when payments become due, their amount and a final date for payment
 - preventing the payer from withholding money from the 'sum due' after the final date for payment unless he has given a withholding notice

- providing a statutory right for the payee to suspend performance where a 'sum due' is not paid, or properly withheld, by the final date for payment
 - prohibiting "pay when paid" clauses which delay payment until it is received by the payer
5. The current statutory framework emerged from Sir Michael Latham's review of business in the industry in 1994. It is reflected in construction contracts.

Rationale for Government Intervention

6. The overriding reason for amending the Construction Act is to improve the performance of the UK construction Industry.
7. A partnership between Government and the construction industry over the last 15 years has delivered a clear programme for improving the performance and productivity of the industry. Recommendations to the industry and Government by Sir Michael Latham (Constructing the team 1994) and Sir John Egan (Rethinking Construction 1998) in the 1990s emphasised the need for integrated supply teams to focus on high quality and efficient delivery in a non-adversarial way. This requires collaboration and trust between contractors, subcontractors, clients, designers and consultants to deliver construction work on time and on budget and is hampered by a culture of blame, disputes and poor payment practices. In his report in 1998 Sir John Egan stated:

"The extensive use of subcontracting has brought contractual relations to the fore and prevented the continuity of teams that is essential to efficient working."

The "integrated team" approach outlined by Egan's Construction Task Force has been endorsed repeatedly by the National Audit Office. In its March 2005 report on Improving public services through better construction, NAO recommended:

"Unfair payment practices, such as unduly prolonged or inappropriate cash retention, undermine the principle of integrated team working and the ability and motivation of specialist suppliers to invest in innovation and capacity. Departments should have the appropriate visibility of the entire supply chain. Understanding how specialist sub contractors and particularly small and medium sized enterprises are engaged, evaluated and managed can contribute considerably to the achievement of value for money. For example, Departments should have in place effective and fair payment mechanisms... to provide more certainty to suppliers' payments dependent upon delivery to time, cost and quality."

Background

8. Following the announcement of a review of the Construction Act in the 2004 Budget, Sir Michael Latham was asked to bring the construction industry together to identify what improvements were needed to the legislation. Discussions about improving adjudication were relatively straightforward. Discussions about the operation of the payment provisions in the current legislation, whether these were working properly or might be improved, and if so how, were more difficult. The joint DTI/Welsh Assembly Government consultation on *Improving payment practices in the construction industry* in 2005 suggested compromise proposals to address some of the problems that prompted disagreement during Sir Michael Latham's review.
9. As the Construction Act also applies to Scotland and policy responsibility for the Act in Scotland and the Scheme for Construction Contracts (Scotland) Regulations 1998 is a matter for the Scottish Executive, similar consultation exercises were undertaken replicating the DTI/Welsh Assembly consultations. Therefore for the purposes of the Impact Assessment the facts and figures which follow are for Great Britain.
10. The current proposals have been developed following extensive consultation with the industry and its clients.

Current Proposals

We are proposing to:

- improve transparency and clarity in the exchange of information relating to payments to enable the better management of cash flow
- encourage the parties to resolve disputes by adjudication, where it is appropriate, rather than by resorting to more costly and time consuming solutions such as litigation and
- strengthen the right to suspend performance under the contract

We are proposing to do this by making the following amendments to the existing legislation:

- extending the Construction Act to oral construction contracts and to those which are partly oral and partly in writing.
- making provision for the costs of an adjudication. We will ensure that any agreement by the parties that one party is to pay all or part of the costs of an adjudication is only valid if made after the appointment of the adjudicator
- making provision for a "slip rule" in respect of an adjudicator's decision. We will put on a clear, statutory footing an adjudicator's ability to amend an obvious error in his/her decision
- making clear that a payment notice (a notice which sets out what is owed) must be served even where the amount owed is nil; removing restrictions on

who can serve such a notice (allowing a third party – e.g. an architect – or a payee to issue such a notice – currently all such notices must be issued by the payer); prohibiting “pay when certified clauses” (clauses which make payment conditional on extraneous events)

- limiting the effect of the House of Lords' decision in *Melville Dundas (in receivership) v George Wimpey UK Limited* as regards the circumstances in which a notice of the payer's intention to withhold a payment is not necessary
- strengthening the provisions relating to the right of a party to whom payment is due to suspend performance of his obligations under a construction contract.

11. These proposals are included as part of BERR's Simplification Plan and are supported by the Better Regulation Executive.
12. These proposals are intended to “fix” the failings to the existing framework to address specific issues that have arisen during the ten years the Construction Act has been in operation.

Consultation

13. The development of the proposed changes to the current legislation has involved extensive formal and informal consultation with the construction industry, its clients, other stakeholders and Government.

Within Government

14. We have had discussions with:
 - The Cabinet Office (Better Regulation Unit now called Better Regulation Executive and is now part of BERR)
 - Office of Government Commerce
 - HM Treasury
 - The Department for Communities and Local Government
 - Department for Constitutional Affairs and
 - Devolved Administrations

With industry

15. Consultation with the industry has included:
 - the review undertaken by Sir Michael Latham in 2004
 - the first consultation *Improving payment practices in the construction industry in 2005*
 - *The Analysis of Improving payment practices in the construction industry 2006*

- industry stakeholder events arranged by the DTI Construction Sector Unit in June 2005 and February 2006
 - industry stakeholder events arranged by the umbrella bodies during the 2005 consultation period and
 - a pre-consultation exercise on adjudication in autumn 2006
 - the second consultation *Improving payment practices in the construction industry in June 2007 and*
 - industry stakeholder event held at the BERR Conference Centre in July 2007
16. DTI (now BERR) also established a sounding board. Sounding board members did not represent specific sectors of the industry but were asked to assist in view of their personal knowledge, experience and access to industry networks. The sounding board has been invaluable in assisting with the preparation of the proposals. Its members were Richard Bayfield, Chris Dancaaster, Richard Haryott, Sir Michael Latham, Humphrey Lloyd QC and Peter Rogers CBE.
17. The various contract writing bodies will need to alter the standard forms of contract. As an example, the Joint Contracts Tribunal (JCT) has some 50 contracts to attend to and these would potentially need to be revised and updated as the transition was made from one statutory framework to another. The extent and nature of the regulation (and whether Counsel's opinion would need to be sought) would determine how long the transition would take. The shortest time has been roughly estimated at about 5 months stretching out to more than 12 months if the regulations were particularly complex or the changes radical. It is estimated that it costs on average £833 to update each contract template leading to a total cost of £41,650.

OPTIONS:

Option A – Targeted Regulation

Costs and Benefits

18. The costs and benefits of implementing the proposals under 'Targeted Regulation' is summarised in table 1 below.

Proposals	Cost (£m)	Benefit (£m)	Calculation
Targeted Regulation			
Removing restriction on who can serve a payment notice	0	£6,480,000	432,000 main contract payments per year of which 60% involve duplicate certification procedures. Average cost of issuing a certificate is £25. $432,000 \times 0.6 \times £25 = £6,480,000$ Range of costs £0.50 to £150 $432,000 \times 0.6 \times £0.5 = £129,600$ $432,000 \times 0.6 \times £150 = £38,880,000$
Clarity of the content of payment and withholding notices	£324,000	0	388,900 payments per year under contracts without certificates. Estimate of proportion of payments subject to abatement after deadline is one monthly payment every 2½ years. Average cost of issuing a withholding notice is £25. $388,900 \times £25 / 30 = £324,000$ Range of costs £0.50 to £150 $388,900 \times £0.5 / 30 = £6,480$ $388,900 \times £150 / 30 = £1,944,500$
A 'fall back' provision which allows the payee to submit a payment notice in default of the payer's notice after the payment due date.	0		This will: <ul style="list-style-type: none"> • improve communication between the parties and help to crystallise the debt • enable cash to flow down the supply-chain • enable contractor to plan cash flow and address poor performance and • potentially improve liquidity and reduce costs of servicing debt
Prohibiting payment by reference to other contracts	£325,000	0	13,000 payments under civil engineering payments include pay-when-certified clauses. Removal means that a payment or withholding notice will now be required at average cost of £25. $13,000 \times £25 = £325,000$ Range of costs £0.50 to £150 $13,000 \times £0.5 = £6,500$ $13,000 \times £150 = £1,950,000$
A statutory framework for the costs of the adjudication	0		Prevents the use of contract provisions on adjudication costs (i.e. requiring the party referring the dispute to adjudication to bear all the other party's costs) being used to prevent a party referring a dispute to adjudication.
Requirement for contracts to be 'in writing'	0		A large number of construction contracts contain orally agreed terms or variations. Extending the application of the Construction Act to oral and partly oral construction contracts makes adjudication more widely available. In addition, it had become common practice to challenge an adjudicator's jurisdiction on the basis that not all the contract was in writing as a way of frustrating the process.
Suspension of performance for non-payment	0		This proposal creates a statutory right for the payee to receive compensation for losses caused by the suspension. The payee will also have a sufficient length of time to remobilise on site. Threat of having to pay the additional costs of suspension incurred by the payee is intended to incentivise the payer to administer payment in a fair way.
Targeted total	£649,000	£6,480,000	Net benefit £5,831,000
Targeted ranges	£13,000– £3,894,500	£129,600– £38,880,000	Net benefit range £116,600–£34,985,500

19. The following are the notional average costs per firm from the proposed changes. They are arrived at by dividing the total costs by the number of firms.

	Cost per firm	No. of firms	Total cost
Micro	0.47	220,360	104,499
Small	9.12	16,290	148,619
Medium	73.89	2,035	150,177
Large	805.92	305	245,804
Total	2.72	238,990	649,100

Option B – Greater Regulatory Intervention

20. As the review of the Construction Act has progressed, a number of other proposals have been suggested which we have decided not to pursue. Option B – Greater Regulatory Intervention – assumes the implementation of the proposals in Option A and adds a number of other potential options made during the Review which we have considered carefully and have decided not to take forward. Their costs and benefits are described in Table 2.

Table 2			
Proposals	Cost (£m)	Benefit (£m)	Calculation
Greater regulatory Options			
Stage payment for materials off-site	0	£40,000	20 materials payments adjudications per year. Assumed that this change would reduce that number to 2. Cost of an adjudication is £20,000 $2 \times £20,000 = £40,000$
Preventing trustee stakeholder accounts	0	0	There is already case law outlawing the use of trustee stakeholder account agreements (Ferson Contractors v Levolux AT). Therefore passing a law saying it was illegal would serve no purpose.
Providing the adjudicator with immunity from 3 rd party claims	0	£52,000	On average 4 complaints are upheld at adjudication each year. Assume same number of third party actions and that such actions cost same as an enforcement £13,000. $4 \times £13,000 = £52,000$
Application of adjudicator independence provisions for all adjudications.	£100,000	0	Adjudicator would fail independence test on 5% of occasions. 1,940 adjudications per year therefore 100 failures per year. Estimate cost of replacing adjudicator is £1,000 $100 \times £1,000 = £100,000$
Greater regulatory Options Total	£100,000	£92,000	Net benefit – £8000
Targeted Net Benefit Range			£116,000 – £34,985,500
Less Greater regulatory Net Benefit Range (NBR)			£8000 – £8000
Overall NBR			£108,600 – £34,977,500

21. The following notional average costs per organisation as a result of the proposed amendments under this option are calculated by dividing total costs by number of firms.

	Cost per firm	No of firms	Total cost
Micro	0.55	220,360	120,598
Small	10.53	16,290	171,516
Medium	85.17	2,035	173,314
Large	930.07	305	283,673
Total	3.13	238,990	749,100

Option C – Do Nothing

23. It is not viable to maintain the legislation as it stands as, for instance, the original objectives of the 1996 Act are being undermined by:

Risks:

- exploitation of 'loop-holes' stopping the flow of money through the supply-chain.
- lack of clarity relating to payment resulting in adverse effects on cash flow
- increased litigation
- disputes under construction contracts were threatening the viability of individual businesses and eventually would undermine the long-term health of the construction industry

Costs:

There are therefore costs involved in maintaining the status quo and it was concerns about the current position which led the Chancellor, in the 2004 Budget, to announce a review of the Construction Act. Our discussions with industry have confirmed that there would continue to be a significant cost to the industry from maintaining the status quo.

Benefits:

The main benefit, for some in the industry, of maintaining the legislation as it stands would be no increase in costs. However, following consultation with industry, it is clear that all agree that some change is required, particularly in the current economic climate.

Small Firms Impact Test

24. The proposed amendments will apply to all construction contracts within the scope of Part 2 of the Housing Grants, Construction and Regeneration Act 1996.

25. The legislation applies to contracts for construction work and professional services including mechanical, electrical, civil engineering and groundworks. A table showing some key statistical data on these sectors for Great Britain is set out below. These cover 2006 as this is the latest data available.

Great Britain (2006)			
	Construction Contracting	Construction Professional Services	Total % of Whole Economy
Number of Enterprises (VAT only)	186,040	15,400	12.7%
% of small or micro-enterprises	98.9%	98.2%	
Total Turnover (£m)	161,919	12,121	6.8%
Gross Value Added (£m)	63,044	7,212	8.7%
% of output funded by the public sector ¹	28%	27%	
Average Employment ²	1,348,088	141,641	5.7%
Number of company insolvencies ³	1,927	Not available	13.9%

1. Based on ONS Quarterly Inquiry of Construction Activity and CIC Survey of Construction Professional Services.
2. Employees only
3. Available for contracting only

Small firms impact test

26. BERR invited stakeholders of all sizes to voice their concerns/views either through their federations, trade associations or as individuals. There has been strong support from representatives of small firms for the BERR proposals. An example of this is a quote from the Federation of Master Builders (FMB) who said:

“The FMB strongly supports efforts by BERR to improve payment practise in the construction industry and commend the years of hard work and commitment of the department, without which these proposals would have been lost, to the detriment of the whole industry.

FMB strongly supports the proposals and is of the view that they will bring about genuine improvements to payment practices in the industry”

27. Given this general industry context, engagement of small firms, at all points in the supply chain, has been fundamental to the development of these proposals.
28. There have been a numerous stakeholder events during the Construction Act review. Those attending have included construction trade associations whose main membership consists of small firms and other industry stakeholders. The National Specialist Contractors Council and the Specialist Engineering Contractors Group in particular have been very helpful in ensuring that representatives from SMEs attended these events (and in encouraging firms from within their membership to respond to the March 2005 consultation exercise). The purpose of these events has been to encourage those who

would be affected by the proposals to voice their concerns and come up with suggestions for amending the Construction Act.

29. Likewise, support was also forthcoming for the proposal to “introduce a fallback provision should the payer not issue the advance notice of payment (Section 110(2) Notice)”.
30. The cost of monitoring cash flow, negotiating credit as well as the financing costs and administration, information and legal cost involved in disputes can bear disproportionately on smaller businesses. Not only does this constrain development by increasing relative costs and reducing the ability of small businesses to compete but it can also divert resources from training, innovation and management.
31. The survey also reported that 31% of construction firms have had to resort to the courts as a result of late payment.
32. The benefits of the proposed amendments to small and micro businesses are:
 - introducing greater transparency and clarity into the payment framework to facilitate better management of cash flow – “crystallizing the debt”
 - increasing access to a simple mechanism for resolving disputes
 - improving communication between payer and payee on what will be paid and when
 - encouraging prompt administration and communication of payment and improving the efficiency and productivity in the industry and
 - enabling the parties to continue to work together effectively to deliver high quality construction projects on time and on budget

Equality Duties

33. After initial screening as to the potential impact of this policy/regulation on race, disability and gender equality it has been decided that there will not be a major impact upon minority groups in terms of numbers affected or the seriousness of the likely impact, or both.
34. The proposed amendments to the Construction Act will have the following benefits:
 - improving the operation of the existing legislation by introducing greater clarity and transparency and reducing disincentives to use adjudication where appropriate
 - help to maintain a level playing field in a competitive market with a large proportion of small firms and
 - underpin existing best practice in the industry

35. The proposed amendments will also make the system fairer – providing the often smaller parties to construction contracts (the sub-contractors) with greater certainty about what they will be paid and when. Where the parties disagree as to the amount to be paid, the proposed amendments will make it easier to refer the dispute to adjudication – a quick (28-day) dispute resolution regime. They will better enable contractors to plan cash flow, address poor performance, and potentially improve liquidity and reduce the costs of servicing debt. They are intended to benefit small businesses in particular.

Competition Assessment

36. The construction industry is extremely competitive. There is no dominant firm in the construction sector. Many firms report very low margins. Competition is healthy to the point of sometimes being extremely fierce affecting profitability.
37. Similarly, there is no small key group of dominant firms in any sub-sector other than perhaps some very small specialist. The legislation does not set up barriers to entry to any sectors of the construction industry and is unlikely to affect the size of firms or number, though it may reduce the churn brought about by the combination of insolvencies and new firms being established.

Enforcement, Monitoring and sanctions

38. BERR is not proposing to change the enforcement mechanisms introduced through the original legislation. The main enforcement mechanism for the legislation other than the courts or arbitration is the adjudication process, which the legislation provides. The decision of the adjudicator is binding on the parties and enforceable through summary judgement in court. The Technology and Construction Court (England and Wales) and Court of Session (Scotland) reported 56 construction enforcement cases in the last year at an average cost of £13,000 totalling £728,000.
39. The only sanction being introduced is where an application for payment becomes due if the payer fails to issue a payment notice. No other sanctions are proposed.

Implementation and delivery plan

40. We are proposing to introduce the amendments through a Bill.

Summary and recommendation

41. This package of measures strikes a fine balance between:

- the need to improve the effectiveness of the Construction Act by:
 - improving the transparency and clarity in the exchange of information relating to payments to enable the parties to construction contracts to better manage cash flow and
 - encouraging the parties to resolve disputes by adjudication, where it is appropriate, rather than resorting to more costly and time consuming solutions such as litigation
- the important principle of not unduly upsetting the compromise between all sectors of the construction industry which underpinned the introduction of the original legislation in 1996

42. It is recommended that the proposed regulatory changes be proceeded with.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	Results in Evidence Base?	Results annexed?
Competition Assessment	Yes	
Small Firms Impact Test	Yes	
Legal Aid	N/A	N/A
Sustainable Development	N/A	N/A
Carbon Assessment	N/A	N/A
Other Environment	N/A	N/A
Health Impact Assessment	N/A	N/A
Race Equality	Yes	N/A
Disability Equality	Yes	N/A
Gender Equality	Yes	N/A
Human Rights	N/A	N/A
Rural Proofing	N/A	N/A

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