

| | |
|---|---|
| Title: Revision of the Scheme for Construction Contracts (England and Wales) Regulations 1998 Construction Contracts (England) Exclusion Order 2011 Lead department or agency: Business, Innovation and Skills Other departments or agencies: | Impact Assessment (IA) |
| | IA No: BIS0146/BIS0093 |
| | Date: 16/05/11 |
| | Stage: Final |
| | Source of intervention: Domestic |
| | Type of measure: Secondary legislation |
| | Contact for enquiries: Michael McDermott 0207 215 3722 |

Summary: Intervention and Options

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

Coordination failures between construction contractors and sub-contractors cause commercial disputes with an estimated financial cost of around £40m in 2010. Disputes also impact negatively on both project delivery and firms in the supply-chain. The current legislation, Part 2 of the Housing Grants, Construction and Regeneration Act 1996 (the Construction Act) sets out certain requirements for construction contracts which mitigate the costs of such disputes. However, a number of weaknesses have been identified with the legislation and following extensive consultation with industry stakeholders, measures were identified to 'fix' these weaknesses to yield further costs savings to business. The relevant measures were introduced at Part 8 of the Local Democracy, Economic Development and Construction Act 2009 ('the 2009 Act').

What are the policy objectives and the intended effects?

To improve and deregulate the existing regulatory framework to minimise costs of adjudication and regulatory burdens to contractors and sub-contractors. The recommended amendments to the secondary legislation seek to:

- Increase transparency and clarity in the exchange of information relating to payments to enable the better management of cash flow and more effective dispute resolution;
- Encourage the parties to resolve disputes by adjudication, where it is appropriate and timely; and
- Strengthen the right to suspend performance under the contract.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 1 - Do nothing:

The de-regulatory amendments and cost savings made to the primary legislation by the 2009 Act will not be realised unless consequential changes are made to the underpinning secondary legislation. The cost of maintaining the status quo is to continue with the defective legislation threatening the viability of individual businesses and the long-term health of the industry.

Option 2 - Amend the Secondary legislation underpinning the Construction Act to reflect the changes introduced to the legislation by the 2009 Act; and introduce a new Construction Contracts Exclusion Order. This is the preferred option. This will deliver a saving to business of approximately £259mn, in combination with the primary legislative changes.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 10/2016

What is the basis for this review? PIR. **If applicable, set sunset clause date:** Month/Year

Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?

Yes

SELECT SIGNATORY Sign-off For final proposal stage Impact Assessments:

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) the benefits justify the costs.

Signed by the responsible SELECT SIGNATORY:  Date: **14/6/2011**

Summary: Analysis and Evidence

Policy Option 1 Do Nothing

Description:

| Price Base Year | PV Base Year | Time Period Years | Net Benefit (Present Value (PV)) (£m)0 | | |
|-----------------|--------------|-------------------|--|---------|------------------|
| | | | Low: 0 | High: 0 | Best Estimate: 0 |

| COSTS (£m) | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | Total Cost (Present Value) |
|---------------|---|--|----------------------------|
| Low | 0 | 0 | 0 |
| High | 0 | 0 | 0 |
| Best Estimate | 0 | 0 | 0 |

Description and scale of key monetised costs by 'main affected groups'

No monetised costs.

Other key non-monetised costs by 'main affected groups'

The costs of maintaining the status quo are continued escalation of disputes under construction contracts that may eventually threaten the viability of individual businesses and undermine the long-term health of the construction industry. In addition, the benefits which are expected to arise from the amended primary legislation will not be realised.

| BENEFITS (£m) | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | Total Benefit (Present Value) |
|---------------|---|--|-------------------------------|
| Low | 0 | 0 | 0 |
| High | 0 | 0 | 0 |
| Best Estimate | 0 | 0 | 0 |

Description and scale of key monetised benefits by 'main affected groups'

No monetised benefits from no change to status quo

Other key non-monetised benefits by 'main affected groups'

Key assumptions/sensitivities/risks

Maximum of 8 lines

Discount rate (%)

N/A

| | | | | |
|--|--------------|---------|--------------------------|-----------------------------|
| Direct impact on business (Equivalent Annual) (£m): | | | In scope of OIOO? | Measure qualifies as |
| Costs: £0 | Benefits: £0 | Net: £0 | Yes | OUT |

Summary: Analysis and Evidence Policy Option 2 (Preferred Option)

Description: Amend the Secondary legislation underpinning the Construction Act to reflect the changes introduced to the legislation by the 2009 Act; and introduce a new Construction Contracts Exclusion Order.

[NOTE: The costs below are presented for the primary and secondary legislation. See Overview for more details.]

| Price Base Year 2010 | PV Base Year 2010 | Time Period Years 10 | Net Benefit (Present Value (PV)) (£m) | | | |
|---|-------------------|--|---|-----------------------------|--------------------------------------|------|
| | | | Low: £196mn | High: £317mn | Best Estimate: £259mn | |
| COSTS (£m) | | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | | Total Cost (Present Value) | |
| Low | | £3.5m | £0.588mn | | £8.6mn | |
| High | | £13.8m | £0.88mn | 1 | £21.4mn | |
| Best Estimate | | £6.9m | £0.735 | | £13.3mn | |
| Description and scale of key monetised costs by 'main affected groups' | | | | | | |
| <p>The one-off costs of targeted regulation include the costs of re-writing standard forms of contracts and the requirement that industry read the guidance prepared that explains the changes. The range relates to the amount of time required to read and understand the guidance issued from 30mins to 2hrs with a best estimate of 1hr. Costs and also benefits relate to the greater clarity and certainty we are introducing into the payment framework.</p> | | | | | | |
| Other key non-monetised costs by 'main affected groups' | | | | | | |
| Time taken to familiarise industry with new framework. | | | | | | |
| BENEFITS (£m) | | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | | Total Benefit (Present Value) | |
| Low | | Optional | £25.2mn | | £217.4mn | |
| High | | Optional | £37.9mn | | £326mn | |
| Best Estimate | | | £31.5mn | | £271.8mn | |
| Description and scale of key monetised benefits by 'main affected groups' | | | | | | |
| <p>One example of the annual benefits from the legislative changes is the removal of the requirements to issue duplicate payment notices. In the case where the contract provides for 3rd party certification of the work (by for example an architect or engineer), a separate payment notice issued by the payer will no longer be required. This measure will save the industry in the region of £6m per annum.</p> | | | | | | |
| Other key non-monetised benefits by 'main affected groups' | | | | | | |
| <p>Many commentators say there is considerable benefit to be gained from effective cash flow management in construction. Work carried out for OGC identified improvements in payment practices which created clear entitlements (which the amended primary legislation does) could save 1-1.5% on the average project or £1bn to £1.5bn pa.</p> | | | | | | |
| Key assumptions/sensitivities/risks | | | | | Discount rate (%) | 3.5% |
| <p>Sensitivity analysis has been applied to key assumptions:</p> <p>Sensitivity analysis has been used for the cost of issuing the payment certificate. The cost of issuing the certificate can vary among contractors. The average cost of £25 came from the Improving payment practices in the construction industry (June 2007) consultation. We have therefore assumed a range of +/- 10%, i.e. a total of 20% sensitivity to address this in the table of costs and benefits at paragraph 35 on page 13.</p> <p>- proportion of adjudication cost spent determining the amount of the dispute when it is not clear: The time can vary because of the complexity of the issues relating to time and amount of payment. In some instances it might be quite simple in others it might be more complicated. We have therefore assumed a range of +/- 10% i.e. a total of 20% sensitivity to address this in the table of costs and benefits analysis at at paragraph 35 on page 13.</p> | | | | | | |
| Direct impact on business (Equivalent Annual) £m): | | | In scope of OIOO? | Measure qualifies as | | |
| Costs: £1.5mn | Benefits: £31.5mn | Net: £30m | Yes | OUT | | |

Enforcement, Implementation and Wider Impacts

| | | | | | |
|---|---|------|--|---------------|--------------|
| What is the geographic coverage of the policy/option? | England | | | | |
| From what date will the policy be implemented? | 01/10/2011 | | | | |
| Which organisation(s) will enforce the policy? | The Courts | | | | |
| What is the annual change in enforcement cost (£m)? | None | | | | |
| Does enforcement comply with Hampton principles? | Yes | | | | |
| Does implementation go beyond minimum EU requirements? | N/A | | | | |
| What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent) | Traded: | | Non-traded: | | |
| Does the proposal have an impact on competition? | No | | | | |
| What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable? | Costs: 100 (See overview for details) | | Benefits: 100 (See overview for details) | | |
| Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price) | Micro 16% | < 20 | Small 23% | Medium 23% | Large 38% |
| Are any of these organisations exempt? | No | No | No | No | No |

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

| Does your policy option/proposal have an impact on...? | Impact | Page ref within IA |
|--|--------|--------------------|
| Economic impacts | | |
| Small firms | Yes | 21 |
| Competition | Yes | 24 |
| | | |
| Statutory equality duties¹ Statutory Equality Duties Impact Test guidance | Yes | 23 |
| | | |
| Environmental impacts | | |
| Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance | Yes/No | |
| Wider environmental issues Wider Environmental Issues Impact Test guidance | Yes/No | |
| | | |
| Social impacts | | |
| Health and well-being Health and Well-being Impact Test guidance | Yes/No | |
| Human rights Human Rights Impact Test guidance | Yes/No | |
| Justice system Justice Impact Test guidance | Yes/No | |
| Rural proofing Rural Proofing Impact Test guidance | Yes/No | |

¹ Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

| | | |
|---|--------|--|
| Sustainable development | Yes/No | |
| <u>Sustainable Development Impact Test guidance</u> | | |

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessments of earlier stages (e.g. Consultation, Final, Enactment) and those of the matching IN or OUTs measures.

| | Reference material |
|---|---|
| 1 | <i>Improving Payment practices in the construction industry: Consultation on proposals to amend Part II of the Housing Grants Construction and Regeneration Act 1996 and Scheme for Construction Contracts (England and Wales) Regulations 1998 : March 2005</i> |
| 2 | <i>Improving Payment practices in the construction industry: Analysis of responses to the Consultation on proposals to amend Part II of the Housing Grants, Construction and Regeneration Act 1996 and the Scheme for Construction Contracts (England and Wales) Regulations 1998: January 2006</i> |
| 3 | <i>Improving Payment practices in the construction industry: 2nd Consultation on proposals to amend Part II of the Housing Grants, Construction and Regeneration Act 1996 and the Scheme for Construction Contracts (England and Wales) Regulations 1998 – June 2007</i> |
| 4 | <i>Improving Payment practices in the construction industry stakeholder event to discuss the second consultation on proposals to amend Part II of the Housing Grants, Construction and Regeneration Act 1996 and the Scheme for Construction Contracts (England and Wales) Regulations 1998 – July 2007</i> |
| 5 | <i>Improving Payment practices in the construction industry: Analysis of responses to the 2nd Consultation on proposals to amend Part II of the Housing Grants, Construction and Regeneration Act 1996 and the Scheme for Construction Contracts (England and Wales) Regulations 1998</i> |
| 6 | 2008 Impact Assessment - Amendments to part 2 of the Housing Grants, Construction and Regeneration Act 1996 http://www.communities.gov.uk/documents/communities/pdf/1088220.pdf |
| 7 | The Local Democracy, Economic Development and Construction (LDED) Act 2009 |
| 8 | Consultation on Amendments to the Scheme for Construction Contracts (England and Wales) Regulations 1998: March 2010 |

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) Discounted prices

| | Y ₀ | Y ₁ | Y ₂ | Y ₃ | Y ₄ | Y ₅ | Y ₆ | Y ₇ | Y ₈ | Y ₉ |
|----------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Transition costs | 0.042 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Annual recurring cost | 0.7 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 |
| Total annual costs | 0.7 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 |
| Transition benefits | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Annual recurring benefits | 31.6 | 30.5 | 29.5 | 28.5 | 27.5 | 26.6 | 25.7 | 24.8 | 24.0 | 23.2 |
| Total annual benefits | 31.6 | 30.5 | 29.5 | 28.5 | 27.5 | 26.6 | 25.7 | 24.8 | 24.0 | 23.2 |

* For non-monetised benefits please see summary pages and main evidence base section

Annual profile costs and benefits - (£m) constant prices

| | Y ₀ | Y ₁ | Y ₂ | Y ₃ | Y ₄ | Y ₅ | Y ₆ | Y ₇ | Y ₈ | Y ₉ |
|---------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Transition costs | 12345 | | | | | | | | | |
| Annual recurring cost | | 12345 | 12345 | | | | | | | |
| Total annual costs | | | | | | | | | | |
| Transition benefits | | | | | | | | | | |
| Annual recurring benefits | | | | | | 12345 | 12345 | 12345 | 12345 | 12345 |
| Total annual benefits | | | | 12345 | 12345 | | | | | |

Version of GHG guidance used:

| Sector | Emission Changes* (MtCO2e) - By Budget Period | | Emission Changes (MtCO2e) - Annual Projections | | | | | | | | | | | | | | | | | |
|---------------------------|--|------------------|--|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|---|--|
| | CB I; 2008-2012 | CB II; 2013-2017 | CB III; 2018-2022 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | | |
| Power sector | Traded | 0 | 0 | | | | | | | | | | | | | | | | | |
| | Non-traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| Transport | Traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| | Non-traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| Workplaces & Industry | Traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| | Non-traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| Homes | Traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| | Non-traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| Waste | Traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| | Non-traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| Agriculture | Traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| | Non-traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| Public | Traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| | Non-traded | 0 | 0 | 0 | | | | | | | | | | | | | | | | |
| Total | Traded | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | |
| | Non-traded | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | |
| Cost effectiveness | % of lifetime emissions below traded cost comparator | | | | | | | | | | | | | | | | | | | |
| | % of lifetime emissions below non-traded cost comparator | | | | | | | | | | | | | | | | | | | |

* Important note: Please enter net emission savings as positive numbers and net emission increases as negative numbers.

Evidence Base (for summary sheets)

Overview

1. The legislative changes that help reduce the costs of disputes between contractors involve an interrelated package of primary and secondary legislation. In many cases, it is difficult to separate the costs and benefits between the primary and secondary changes because there is a single, simplified impact on construction contracts. Because of this, and the fact that the amendments to the secondary legislation are wholly contingent on the primary legislative changes, the original Impact Assessment for the primary legislation² included costs and benefits from both sets of legislative changes.
2. New evidence and procedural guidance since the previous Impact Assessment, means that it is appropriate to update all the costs and benefits for the combined package of primary and secondary legislation. The Impact Assessment therefore presents the costs and benefits calculations supporting the Local Democracy Economic Development and Construction Bill which received Royal Assent in November 2009 ('the 2009 Act'), but which has not yet been commenced, and changes to the Scheme for Construction Contracts secondary legislation, which are entirely consequential to the changes made in the 2009 Act. The costs and benefits presented in this document should therefore **replace** those presented in the previous Impact Assessment, rather than be considered in addition.
3. The analysis shows that the preferred option, in combination with the primary legislative changes, will deliver a net benefit to business of approximately £259mn over a ten year period. For transparency, the detail on the costs and benefits attributable to each set of legislative changes is provided in Table 2.

Size of the industry

4. The legislation applies to contracts for construction work including mechanical, electrical, civil engineering and groundworks. Construction accounts for over 8% of GVA and in Great Britain there are nearly 300,000 construction enterprises of which over 90% are small or micro businesses employing approximately 1.5m people³.
5. Coordination failures between construction contractors and sub-contractors cause commercial disputes with an estimated financial cost of around £40m in 2010. Disputes also impact negatively on both project delivery and firms in the supply-chain. Existing legislation (Part 2 of the Housing Grants, Construction and Regeneration Act 1996 (the Construction Act)) sets out certain requirements for construction contracts which mitigate the cost of such disputes. However, a number of weaknesses have been identified with the legislation and following extensive consultation with industry stakeholders, measures were identified to address these weaknesses to yield further cost savings to business. The relevant measures were introduced at Part 8 of the Local Democracy, Economic Development and Construction Act 2009 ('the 2009 Act').
6. The market failures at hand are the principal-agent relationship between contractors and sub-contractors, the conflict of interests between them, and the tendency of contractors to exhibit moral hazard. The economic activity within the construction sector involves numerous principal-agent relationships between a main contractor and sub-contractor, in which both have incentives to behave according to their own self interest. For example, the main contractor may want a contract for the lowest price, but a sub-contractor will want to achieve the highest price to maximise his profits. Having agreed a contract price, construction contractors often dispute the value of post contract variations. The specific failures addressed by the proposed amendments include:

² 2008 Impact Assessment - Amendments to part 2 of the Housing Grants, Construction and Regeneration Act 1996 <http://www.communities.gov.uk/documents/communities/pdf/1088220.pdf>

³ Finalised 2008 ABI Data

- Exploitation of 'loop-holes' that prevent the flow of money through the supply-chain; and.
 - lack of clarity relating to payment resulting in adverse effects on sub-contractors ability to manage cash flow
7. Disputes under construction contracts threaten and compromise the affordability and timely delivery of construction projects and the viability of individual businesses. This undermines the long-term health of the construction industry.
8. The 2009 Act's provisions will:
- improve access to adjudication and reduce the costs of the process; and
 - improve the exchange of information relating to payment to enable parties to construction contracts to better manage cash flow, introducing greater clarity and transparency and removing administrative burdens.
9. For the measures introduced in the 2009 Act to be effective, consequential changes need to be made to the secondary legislation underpinning the Construction Act i.e. the Scheme for Construction Contracts (England and Wales) Regulations 1998.

How the Legislation works

10. This impact assessment is concerned with 3 pieces of legislation which work together to create a statutory framework for construction contracts. The framework is as follows:
- The Construction Act requires construction contracts to do certain things. It does not generally specify how, leaving that for the parties to agree freely in contract.
 - The Exclusion Order can limit the scope of the application of the Act where the Secretary of State deems fit. The Secretary of State has the power to exclude all or part of a specific type of contract from the application of the Act.
 - Where a contract has failed to give proper effect to a requirement of the Construction Act, the relevant part of the Scheme for Construction Contracts (England and Wales) Regulations 1998 ("the Scheme") is implied into the contract. This ensures that parties to a construction contract continue to benefit from the protections and rights the Act provides.

BACKGROUND

11. Since coming into force on 1 May 1998, a number of concerns have been raised about the effectiveness of the Construction Act. In 2003/04, the then Cabinet Office, Better Regulation Executive carried out a review of the construction sector. One of the review's conclusions was that there was a need to review the "Construction Act" to identify how it could be improved. The Chancellor announced this review in his Budget Statement in 2004.
12. Extensive and prolonged consultation with the industry, in 2005, 2007 and 2008, confirmed that, while delivering a number of important benefits, the Act was defective in certain key respects which could only be dealt with through amendments to the primary legislation. These issues are addressed in the Local Democracy Economic Development and Construction Act 2009 ('the 2009 Act').
13. Before the Act can come into force consequential changes must be made to the secondary legislation i.e. the Scheme for Construction Contracts (England and Wales) Regulations 1998.

Part 2 of the Housing Grants, Construction and Regeneration Act 1996 (“the Construction Act”)

14. The Construction Act sets out a statutory framework for key aspects of construction contracts (for example on payment communication and dispute resolution). Generally, the Act requires these to be implemented through the construction contract.
15. These include:
 - Providing a statutory right for parties to a construction contract to refer disputes to adjudication⁴
 - 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; and
 - Prohibiting the pay when paid clauses which delay payment until it is received by the payer

The Scheme for Construction Contracts (England and Wales) Regulations 1998

16. Where the contract omits to deal with an issue, or does so in a way which does not comply with the Construction Act, a ‘fall back’ is required so that the contract continues to comply. That is the function fulfilled by the Scheme for Construction Contracts (England and Wales) Regulations 1998 (SI 1998/649).
17. Where a contract is defective in a specific regard, the relevant part of the Scheme is “pasted” in. This means that the defect is rectified but the remainder of the contract terms continue as agreed between the parties.
18. The 2009 amendments to the primary legislation which the Scheme will give effect are also included in the Department’s simplification plan. The costs and benefits from the primary legislation will not take hold until the secondary legislation is amended in line with the changes. The consequential amendments to the Scheme were subject to consultation in March 2010.
19. The industry and its contract writing bodies are currently engaged in an intensive round of redrafting to ensure that the industry’s standard forms of contract reflect the changes introduced by the 2009 Act so that they are ready for autumn 2011.

The Construction Contract (England and Wales) Exclusion Order 1998 (SI/649)

20. The extensive consultation process and subsequent more detailed discussions with the PPP Forum have identified a particular issue with the specific operation of PFI contracts and one of the changes introduced by the 2009 Act. To enable this to be dealt with – and to allow future flexibility – the 2009 Act amended the Secretary of State’s existing exclusion order making powers so that it could be applied proportionately. The power in the 1996 Act was broad and unspecific (i.e. a specific type of contract is either covered by the Act or it is not). The amended

⁴ Adjudication is a statutory right under the existing 1996 Construction Act. It is one of the remedies. The amendments in the 2009 Act deals with weaknesses and inefficiencies in the existing statutory adjudication process.

power in the 2009 Act allows the Secretary of State to exclude specific contract types from all or part of the Construction Act.

Background to this issue

21. The Construction Act prevents the use of “pay when paid” clauses in construction contracts as this was a commonly used contractual mechanism to delay payment to the supply-chain. Some firms in the industry have avoided the effect of this by making payment dependent on the issue of a certificate (e.g. a valuation of the work by the client’s agent) under the superior contract. The 2009 Act closes this loophole by preventing any contract term which makes payment conditional on the performance of an obligation under a superior contract.

22. In traditional construction contracts, this amendment to the 1996 Act places an annual cost on the industry of £325,000⁵ as it requires the issue of a notice by the contractor to a sub-contractor setting out what will be paid and when where a contractor is currently able to rely on a notice issued under his contract with the client. Requiring the issue of such a notice is however of significant benefit to small and micro firms in construction supply chains in terms of the greater clarity and certainty of cash flow which it will deliver by requiring that they are directly notified what they would be paid and when it would be paid.

Basis for the exercise of the Exclusion Order making process

23. Different circumstances exist in contracts between pfi Special Purpose Companies (SPC) and the Construction sub-contractor than those which prevail in traditional construction sub-contracts. The SPC’s contract with the public sector authority and the SPC’s contract with its construction contractor is a standard one developed by Government. While payment under these contracts can depend on the issue of a certificate under the SPC’s contract with the public sector authority, issues around clarity and certainty are effectively dealt with in that standard form of contract. Furthermore, a different incentive structure exists in pfi contracts than that which applies in more traditional forms of contracting. The Construction Contractor is in almost all cases part of the SPC – along with the FM contractor and the organisation providing finance. It is therefore to the direct benefit of the construction contractor to limit the amount of capital in the SPC. Removing the need to provide a contingency for funding a payment from the SPC to the construction contractor reduces the amount of capital required by the SPC and therefore the cost of capitalising it to the construction contractor.

24. The Construction Contracts (England and Wales) Exclusion Order 1998 already excludes pfi head contracts (i.e. the contract between the public authority and the SPC) from the entirety of the 1996 Act. The new Exclusion Order will extend that so that it also excludes the pfi construction contract from the application of the clause which prevents a party to a construction contract making a payment dependent on the performance of obligations under a superior contract. Based upon data from the treasury (pfi in procurement March 2011), this will affect approximately 36 contracts in 2011/12.

Problem under consideration

25. The conflict of interests that occurs between contractors and sub-contractors often leads to disputes. A DTI survey estimated that there were 1,750 adjudications in 2005 in England and Wales at an average financial cost of £20,000 per adjudication⁶. Inflating these costs to 2010 means that the total financial cost⁷ of adjudication in England and Wales can be estimated at £40m per year.

⁵ Figure comes from *Improving payment practices in the construction industry: June 2007*

⁶ *Improving payment practices in the construction industry: June 2007*

⁷ Total economic cost would need to include additional costs such as the opportunity cost of time invested by both parties and the cost of appeal procedures.

26. Contracts between contractors and sub-contractors can mitigate such disputes and costs, but conflicting interests also mean that both parties will to manipulate the contracts to suit their views. The main contractor can be in a dominant position in any contractual arrangement which can work against the sub-contractor.

Rationale for Government Intervention

27. The central problem at hand is the **principal-agent relationship** between contractors and sub-contractors, the **conflict of interests** between them, and tendency of the sub-contractor to exhibit **moral hazard**. The economic activity within the construction sector involves the interaction between many sets of contractors over long periods of time. This typically involves numerous principal-agent relationships between a main contractor and sub-contractor, in which both have incentives to behave according to their own self interest. For example, the main contractor may want a contract delivered at the lowest price, but a sub-contractor may have an incentive to increase price and his profit. Both might seek to do this through contract variation post award.
28. Contractual clauses that might prevent or mitigate such disputes are not agreed because of conflicting interests between parties. Improved clarity in contractual arrangements between contractors and sub-contractors can minimise such coordination failures and the burdens and costs that result.
29. The Construction Act passed in 1996 set out a statutory framework to address issues relating to co-ordination failure between contractors. Following extensive consultation with industry stakeholders in 2005 and 2007 measures to amend the Construction Act were developed which streamlined the legal requirements to prevent areas which historically caused dispute whilst minimising burdens on both sets of contractors. These amendments were passed in primary legislation in 2009 but require changes to accompanying secondary legislation to become active. The specific amendments to the legislation are described in table 1 below.

Table 1: Changes to the Construction Act contained within 2009 amendments

| Measure (s) included in the 2009 Act | Why change is necessary |
|--|---|
| Removing restriction on who can serve a payment notice | The current statutory framework can create, in certain circumstances requirements to serve a duplicate notice. This measure removes that duplication allowing anyone who is named in the contract to issue the payment notice (currently only the payer can) |
| Clarity of the content of payment and withholding notices | The current statutory framework can fail to provide a clear explanation of the amount due. The measure provides the payee with details of what they will be paid and how that amount (even if that amount is Zero) has been calculated subject to any subsequent amendment. |
| 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. | Provides a default mechanism (i.e. it allows the payee to issue the notice if the payer doesn't) thereby allowing the speedy "crystallisation" of a debt. |
| Prohibiting payment by | The Construction Act prevented the use of "pay when |

| | |
|---|--|
| reference to other contracts | paid" clauses in construction contracts. Some firms in the industry have avoided the effect of this by making payment dependent on the issue of a certificate (e.g. a valuation of the work by the client's agent) under the superior contract. We have therefore closed this loophole by preventing any contract term which makes payment conditional on the performance of an obligation under a superior contract. Although, this will place an annual cost on the industry of £325,000 as it will require the issue of a payment notice by the contractor to a sub-contractor setting out what will be paid and when where a contractor is currently able to rely on a notice issued under his contract with the client. It is however of significant benefit to small and micro firms in construction supply chains in terms of the greater clarity and certainty of cash flow which it will deliver. |
| A statutory framework for the costs of the adjudication | The current legislation is silent on adjudication costs which allows parties to include contractual terms to create a disincentive to use adjudication e.g. by requiring the sub-contractor to pay all the costs of the adjudication irrespective of the decision. |
| Requirement for contracts to be 'in writing' | 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 and increasing cost. This removes the problem. |
| Suspension of performance for non-payment | <p>This proposal makes more equitable the statutory right for the payee to receive compensation for losses caused by the suspension.</p> <p>The payee will also have a sufficient length of time to remobilise on site. This makes it easier for the payee to suspend (or threaten to suspend) performance</p> <p>Threat of having to pay the additional costs of suspension incurred by the payer is intended to incentivise the payer to administer payment in a fair way.</p> |

Policy Objective

30. To amend the existing regulatory framework and remove burdens in order to:

- Increase transparency and clarity in the exchange of information relating to payments to enable the better management of cash flow and more effective dispute resolution;
- 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.

| Contractual clause | Effect |
|---|---|
| Contractual clause: The contractor shall be liable for any delay in the completion of the work. | Effect: The contractor is liable for any delay in the completion of the work. |
| Contractual clause: The contractor shall be liable for any delay in the completion of the work, unless the delay is caused by the employer's fault. | Effect: The contractor is liable for any delay in the completion of the work, unless the delay is caused by the employer's fault. |
| Contractual clause: The contractor shall be liable for any delay in the completion of the work, unless the delay is caused by the employer's fault or by force majeure. | Effect: The contractor is liable for any delay in the completion of the work, unless the delay is caused by the employer's fault or by force majeure. |
| Contractual clause: The contractor shall be liable for any delay in the completion of the work, unless the delay is caused by the employer's fault or by force majeure, or by the contractor's fault. | Effect: The contractor is liable for any delay in the completion of the work, unless the delay is caused by the employer's fault or by force majeure, or by the contractor's fault. |
| Contractual clause: The contractor shall be liable for any delay in the completion of the work, unless the delay is caused by the employer's fault or by force majeure, or by the contractor's fault, or by the contractor's fault. | Effect: The contractor is liable for any delay in the completion of the work, unless the delay is caused by the employer's fault or by force majeure, or by the contractor's fault, or by the contractor's fault. |

Description of options considered

Option 1 – Do nothing

31. The market failures at hand are the principal-agent relationship between contractors and sub-contractors, the conflict of interests between them, and the tendency of contractors to exhibit moral hazard. The economic activity within the construction sector involves numerous principal-agent relationships between a main contractor and sub-contractor, in which both have incentives to behave according to their own self interest. For example, the main contractor may want a contract delivered at the lowest cost, but a sub-contractor may have an incentive to increase cost so they undertake more paid work. The specific failures addressed by the proposed amendments include:
 - Exploitation of 'loop-holes' stopping the flow of money through the supply-chain; and.
 - lack of clarity relating to payment resulting in adverse effects on sub-contractors cash flow
32. These failures were confirmed by evidence gathered from *Improving payment practices in the construction industry* consultations in addition to representations from various sectors of the construction industry.
33. The costs therefore of maintaining the status quo is to fail to deliver the de-regulatory and simplification benefits accredited to these measures under the construction contracts which may eventually threaten the viability of individual businesses and undermine the long-term health of the construction industry.

Option 2- Amend the Scheme for Construction Contracts (England and Wales) Regulations 1998 and introduce a Construction Contracts (England and Wales) Exclusion Order 1998

34. The legislative changes that help reduce the costs of disputes between contractors involve an interrelated package of primary and secondary legislation. In many cases, it is difficult to separate the costs and benefits between the primary and secondary changes because there is a single, simplified impact on construction contracts. For this reason, and for consistency, the same approach as the original Impact Assessment has been adopted i.e. treating the legislative changes as a single package and using a counterfactual without any of the legislative amendments.
35. New evidence and procedural guidance since the previous Impact Assessment, means that it is appropriate to update all the costs and benefits for the combined package of primary and secondary legislation. The Impact Assessment therefore presents the costs and benefits calculations supporting the Local Democracy Economic Development and Construction Bill which received Royal Assent in November 2009 ('the 2009 Act'), but which has not yet been commenced⁸, and changes to the Scheme for Construction Contracts secondary legislation, which are entirely consequential to the changes made in the 2009 Act. The costs and benefits presented in this document should therefore **replace** those presented in the previous Impact Assessment, rather than be considered in addition.
36. We are also introducing a new Construction Contract (England and Wales) Exclusion Order to exempt certain contracts from a specific aspect of the Act. These amendments will bring significant benefits to small and micro firms in the construction supply-chains in terms of greater

⁸ This is because it is practical to introduce both sets of legislative changes as a single set of changes to the status quo.

clarity and certainty of cash flow which it will deliver. The detail of how the costs and benefits are calculated for each amendment is presented below.

37. This is because the consequential changes to secondary legislation are required for the changes in the primary legislation to come into effect. Some costs and benefits have been updated where appropriate in line with further data and evidence. We are presenting, in table 2 below, the costs for primary and secondary because the costs and benefits from both sets of legislation will not come into effect without the amendments to the secondary.
38. The various contract writing bodies will need to alter their 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 Counsels 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 about £42k.
39. The new regulations will require industry to familiarise itself with the new requirements and protocols through guidance that has been prepared explaining the changes. Discussions with industry stakeholders confirm that this should take no more than one hour⁹. Using Office of National Statistics data, the average hourly rate for a construction manager is approximately £23 per hour¹⁰. If we assume that one person from each of the 300,000 enterprises reads through the Guidance, the cost to industry equates to approximately £6.9m. In order to take into account the fact that it may take some companies more or less time than the 1hr estimated, we provide a range based on all companies taking just 30 minutes in a best case, or a relative worst case that it could take 2hrs per enterprise. The range of familiarisation costs in this instance is £3.5m - £13.8m. Our best estimate though is £6.9m as discussed above as this is based on information received through informal consultation with industry experts.
40. The calculations below result in a central case annual benefit from Option 2 of £31.5mn¹¹. For clarity, this is not directly comparable against the £40mn figure for the estimated cost of adjudications because not all of the £31.5mn annual benefit comes from saved adjudication costs. Around £7mn (£63mn over the 10 year appraisal period) comes from the removal of a duplicative restriction form which is a saving on 60% of all payments made between contractors. If you take off the £7mn from the £31.5mn you get approximately £24mn saved from an estimated £40mn adjudication costs - so adjudications are still estimated to cost around £16mn per year even with these changes.

Table 2: Ongoing Costs and Benefits of the individual changes to the primary and secondary legislation¹². Figures presented are for the aggregate costs and benefits over the 10 year appraisal period.

| Measures included in the 2009 Act | Details of Legislative change | Cost (£) (10 year NPV) | Benefit (£) (10 year NPV) | Calculation |
|---|--|------------------------|--|---|
| 1. Removing restriction on who can serve a payment notice | Change to Primary. No change required to secondary legislation. | 0 | £63mn (Range £50.6mn - £75.9mn) | Costs: No costs, as removes duplicative certificates. Benefits: 432,000 ¹³ main contract payments per year of which 60% ¹⁴ involve duplicate |

⁹ Informal consultation with several private sector industry stakeholders: May 2011

¹⁰ Data comes from the Office of National Statistics Annual Survey of Hours and Earnings (ASHE) 2010 (£19.11p/h), uprated by 21% to take account of non-wage labour costs, as per general BIS practice.

¹¹ The annual benefit is assumed as that achieved in 2010.

¹² All figures have been rounded to the next 0.5 million.

¹³ Monthly Inquiry of Contracts and New Orders, BERR, 2005

| | | | | |
|--|---|-----------------------------------|----------------------------------|---|
| | | | | <p>certification procedures. Average cost of issuing a certificate is £25¹⁵</p> <p>2005 costs and benefits inflated to 2010, discounted over 10 years.¹⁶</p> <p>A 20% sensitivity analysis has been used for the cost of issuing the payment certificate. The cost of issuing the certificate can vary among contractors. The average cost of £25 came from the Improving payment practices in the construction industry (June 2007) consultation. We have therefore assumed a range of +/- 10%, i.e. a total of 20% sensitivity to address this.</p> |
| 2. Clarity of the content of payment and withholding notices | Change to Primary. Minor consequential changes to Secondary | £3.1mn (Range £2.5mn - £3.8mn) | £57mn (Range £43mn - £64.5mn) | <p>This helps clarify the scope of the debt/payments owed/or not owed by both parties.</p> <p>Costs: 388,900¹⁷ payments per year under contracts without certificates. Estimate of proportion of payments subject to abatement after deadline is one monthly payment every 2½ years¹⁸ Average cost of issuing a withholding notice is £25¹⁹.</p> <p>A 20% sensitivity analysis has been used for the cost of issuing the payment certificate. The cost of issuing the certificate can vary among contractors. The average cost of £25 came from the Improving payment practices in the construction industry (June 2007) consultation. We have therefore assumed a range of +/- 10%, i.e. a total of 20% sensitivity to address this</p> <p>Benefits: Makes adjudication process simpler reducing costs: Total estimated adjudications (1,750) multiplied by proportion of adjudication cost spent determining the time and amount of the dispute when it is not clear (50%²⁰) multiplied by the Average cost of the dispute (£20,000). <u>NOTE: The total benefit from clarity is £170mn. This benefit is equally split between 2, 3 and 4, which all work to clarify the terms of the adjudication.</u></p> |

¹⁴ Improving Payment Practices in the Construction Industry: consultation on proposals to amend Part II of the Housing Grants Construction and Regeneration Act 1996 and Scheme for Construction Contracts (Scotland) Regulations 1998, Scottish Executive, 2005

¹⁵ Figure comes from responses to Improving payment practices in the construction industry June 2007

¹⁶ Excel spreadsheet attached explaining the inflation rate rates used

¹⁷ Monthly Inquiry of Contracts and New Orders, BERR, 2005

¹⁸ Improving Payment Practices in the Construction Industry: consultation on proposals to amend Part II of the Housing Grants Construction and Regeneration Act 1996 and Scheme for Construction Contracts (Scotland) Regulations 1998, Scottish Executive, 2005

¹⁹ Ibid

²⁰ Based on consultations with private sector adjudicators on May 2011

| | | | | |
|---|---|---|--|--|
| | | | | <p>2005 costs and benefits inflated to 2010 and discounted over 10 years. NB:However, the annual average cost of adjudication of £20,000 and the number of annual adjudications of 1,750 both came from data in the June 2007 Improving payment practices in the construction industry consultation.</p> <p>Proportion of adjudication cost spent determining the amount of the dispute when it is not clear. The time can vary because of the complexity of the issues relating to time and amount of payment. In some instances it might be quite simple in others more complicated. We have therefore assumed a range of +/- 10% i.e. a total of 20% sensitivity to address this.</p> |
| 3. 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. | Change to Primary. No change required to secondary legislation | 0 | £57mn (Range £45.5mn - £68.3mn) | <p>Costs: None because payees would already have a payment notice as business as usual</p> <p>Benefits: Makes adjudication process simpler reducing costs: Total estimated adjudications (1750) multiplied by the proportion of adjudication cost spent determining the time and amount of the dispute when it is not clear (50%²¹) multiplied by the Average cost of the dispute (£20,000) <u>NOTE: The total benefit from clarity is £170mn. This benefit is equally split between 2, 3 and 4, which all work to clarify the terms of the adjudication.</u></p> <p>2005 costs and benefits inflated to 2010, discounted over 10 years. NB:However, the annual average cost of adjudication of £20,000 and the number of annual adjudications of 1,750 both came from data in the June 2007 Improving payment practices in the construction industry consultation</p> <p>Proportion of adjudication cost spent determining the amount of the dispute when it is not clear. The time can vary because of the complexity of the issues relating to time and amount of payment. In some instances it might be quite simple in others more complicated. We have therefore assumed a range of +/- 10% i.e. a total of 20% sensitivity to address this.</p> |

²¹ Survey of private sector adjudicators – May 2011

| | | | | |
|---|--|--|--|---|
| <p>4. Prohibiting payment by reference to other contracts</p> <p>(Main contractors have to issue their own certificate of work)</p> | <p>Change to Primary.</p> <p>No change required to secondary legislation</p> | <p>£3.1mn</p> <p>(Range £2.5mn - £3.8mn)</p> | <p>£57mn</p> <p>(Range £45.5mn - £68.3mn)</p> | <p>Costs: DTI statistics from 2007 consultation, page 39.</p> <p>13,000²² 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. 13,000x£25</p> <p>A 20% sensitivity analysis has been used for the cost of issuing the payment certificate. The cost of issuing the certificate can vary among contractors. The average cost of £25 came from the Improving payment practices in the construction industry (June 2007) consultation. We have therefore assumed a range of +/- 10%, i.e. a total of 20% sensitivity to address this.</p> <p>Benefits: Makes adjudication process simpler reducing costs: Total estimated adjudications (1750) multiplied by the proportion of adjudication cost spent determining the time and amount of the dispute when it is not clear (50%²³) multiplied by the Average cost of the dispute (£20,000) <u>NOTE: The total benefit from clarity is £170mn. This benefit is equally split between 2, 3 and 4, which all work to clarify the terms of the adjudication.</u></p> <p>2005 costs and benefits inflated to 2010, discounted over 10 years. NB:However, the annual average cost of adjudication of £20,000 and the number of annual adjudications of 1,750 both came from data in the June 2007 Improving payment practices in the construction industry consultation</p> <p>Proportion of adjudication cost spent determining the amount of the dispute when it is not clear. The time can vary because of the complexity of the issues relating to time and amount of payment. In some instances it might be quite simple in others more complicated. We have therefore assumed a range of +/- 10% i.e. a total of 20% sensitivity to address this.</p> |
| <p>5. Change to Exclusion Order. This enacts the same provision</p> | <p>Change to Primary.</p> <p>Change required to secondary</p> | <p>0</p> | <p>£0.211mn</p> <p>(Range £0.17mn - £0.25mn)</p> | <p>Costs: No costs.</p> <p>Benefits: 36²⁴ PFI contracts in 2011/12 multiplied by</p> |

²² Monthly Inquiry of Contracts and New Orders, BERR, 2005

²³ Survey of private sector adjudicators May 2011

²⁴ HMT statistics on PFI, March 2011

| | | | | |
|--|--|---|-----------------------------------|--|
| as (4) but in FI contracts | legislation | | | <p>12 monthly payments per year, multiplied by cost of certification between SPC and Main contractor = £50²⁵ (as part of the SOPC SPC contracts are more sophisticated hence assumed double that of average contract)</p> <p>2005 costs and benefits inflated to 2010, discounted over 10 years.</p> <p>A 20% sensitivity analysis has been used for the cost of issuing the payment certificate. The cost of issuing the certificate can vary among contractors. The average cost of £25 came from the Improving payment practices in the construction industry (June 2007) consultation. We have therefore assumed a range of +/- 10%, i.e. a total of 20% sensitivity to address this .</p> |
| 6. A statutory framework for the costs of the adjudication (Inequitable share of adjudication costs discourages adjudication) | Change to Primary. Minor consequential changes to Secondary | 0 | Unquantified | <p>Costs: None as no additional requirements.</p> <p>Benefits: These benefits are extremely difficult to quantify. The change gives parties the flexibility to seek less costly arrangements for the adjudication than those contained in the initial agreements entered in advance of a dispute. Such agreements can act as a disincentive to the use of adjudication.</p> <p>Illustrative example; If 10% of adjudications came to more flexible arrangements, saving 10% then total benefit = £396,000 (2010 prices). We do not have robust evidence for these assumptions, hence they not included.</p> |
| 7. Requirement for contracts to be 'in writing' | Change to Primary. Minor consequential changes to Secondary | 0 | £20mn (Range £16.4-24.6mn) | <p>The effect of the change means that the legislation can be applied to oral and partly oral contracts. Inclusion of oral clauses in contracts will reduce challenges to disputes.</p> <p>Costs: No cost to parties. Change to scope of contracts.</p> <p>Benefits: Total estimated adjudications (1750) multiplied by proportion of adjudication that are challenged (40%²⁶) multiplied by expected saving of a challenge (15%²⁷) multiplied by average cost of challenge (£20,000).</p> <p>20% sensitivity considered on saving of a challenge</p> |

²⁵ Improving Payment Practices in the Construction Industry: Second consultation on proposals to amend Part II of the Housing Grants Construction and Regeneration Act 1996 and Scheme for Construction Contracts (England and Wales) Regulations 1998, DTI, June 2007

²⁶ Ibid

²⁷ Ibid

| | | | | |
|--|---|--|---|---|
| | | | | 2005 costs and benefits inflated to 2010, discounted over 10 years. NB:However, the annual average cost of adjudication of £20,000 and the number of annual adjudications of 1,750 both came from data in the June 2007 Improving payment practices in the construction industry consultation |
| 8. Suspension of performance for non-payment | Change to Primary. No change required to secondary legislation | 0 | £17mn (Range £13.6mn - £20.5mn) | <p>Costs: None as no additional requirements.</p> <p>Benefits: Total estimated adjudications (1750) multiplied by proportion of adjudications saved by threat of walking out (5%²⁸) multiplied by expected saving of a challenge (15%²⁹) multiplied by average cost of challenge (£20,000).</p> <p>2005 costs and benefits inflated to 2010, discounted over 10 years. NB:However, the annual average cost of adjudication of £20,000 and the number of annual adjudications of 1,750 both came from data in the June 2007 Improving payment practices in the construction industry consultation</p> <p>20% sensitivity considered on proportion of adjudications saved by threat of walking out</p> |
| Targeted total | | £6mn (Range £5.1 - £7.6mn) | £271 mn (Range £217.4 - £326.1mn) | Net benefit £265mn (Range £212.4 - £318.5mn) |

²⁸ 2008 analysis of the consultation responses to Improving Payment Practices in the Construction Industry: Second consultation on proposals to amend Part II of the Housing Grants Construction and Regeneration Act 1996 and Scheme for Construction Contracts (England and Wales) Regulations 1998, DTI, June 2007

²⁹ Improving Payment Practices in the Construction Industry: Second consultation on proposals to amend Part II of the Housing Grants Construction and Regeneration Act 1996 and Scheme for Construction Contracts (England and Wales) Regulations 1998, DTI, June 2007

Wider Impacts

Small firms impact test

41. (BERR) (now BIS) 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 Construction measures. 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”

42. 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.
43. 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 was to encourage those who would be affected by the measures to voice their concerns and come up with suggestions for amending the Construction Act.
44. 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.
45. 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 adjudication – the 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.

Waiver from the Micro-Business Moratorium Exemption

46. The measures covered by this impact are deregulatory and therefore a waiver from the micro-business moratorium is being sought / will be claimed.
47. The measures are of particular benefit to micro-businesses in construction supply chains which exist throughout the supply chain as they will improve cash flow and dispute resolution. Over 90% of firms in the sector are micro. The measures which we anticipate will be particularly beneficial are:
 - Allowing the construction act to apply to oral contracts (This will prevent the challenge, or threat of challenge, that a dispute cannot be taken to adjudication as the contract is wholly in writing and therefore not within scope of the Act. Micro businesses are more likely to orally vary their contracts)
 - Preventing "unfair" agreements on cost allocation under adjudication (This will prevent a larger business requiring in contract that a micro-business in its supply chain must pay all the legal and other costs of all the parties to an adjudication thereby making it impossible to adjudicate small disputes)
 - Giving the sub-contractor the right to initiate the payment process where the payer has failed to do so. (This will allow a micro firm to establish a right to payment which may not otherwise have existed)
 - Removing the ability of a main contractor to rely on the certification of work under his contract with the client to determine the timing and amount of payment to the sub-contractor. (This will provide much greater transparency about the timing and amount of payment and therefore allow micro-firms to better manage their cash flow)
48. As this impact assessment demonstrates these measures are also those which remove the greatest regulatory burden.
49. As evidenced in the 2008 Impact Assessment, the cost to micro firms of the measures introduced under the Construction Act are negligible.

Equality Duties

50. 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.
51. The 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.
52. The 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 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

53. 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.

54. Similarly, there is no small key group of dominant firms in any sub-sector other than perhaps some very small specialists. 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

55. BIS 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.
56. 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.

Summary and recommendation

57. 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.
58. It is recommended that the proposed regulatory changes be proceeded with.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. If the policy is subject to a sunset clause, the review should be carried out sufficiently early that any renewal or amendment to legislation can be enacted before the expiry date. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

| |
|---|
| <p>Basis of the review: A Government commitment to undertake a review of the effectiveness of the changes to the Construction Act on the basis of the review.</p> |
| <p>Review objective: The objective of the review would be to ensure that the changes to the legislation were effective in improving certainty and clarity.</p> |
| <p>Review approach and rationale: The review would be to scan stakeholders views as to the effectiveness or otherwise of the changes made to the legislation. The reason being that we would not want to raise expectations that the Act would be subject to the sort of extensive and in-depth review we have just undertaken but would nevertheless want some assessment of its effectiveness.</p> |
| <p>Baseline: The baseline would be the number of disputes adjudicated. Number of disputes being referred to the courts for final judgements and payment days as well as a "satisfaction" survey.</p> |
| <p>Success criteria: Would expect to see an increase in the number of disputes adjudicated and a decrease in the number of adjudications being referred to the courts. Adjudication amendments should see a reduction in payment days. Also expect to see the costs of adjudication come down.</p> |
| <p>Monitoring information arrangements: Continue to work with the Construction Umbrella Bodies Adjudication Task Group (CUBATG) to gauge whether the adjudication amendments have had the necessary impact. Also continue to monitor the survey work on adjudication being by industry and academia e.g. the Adjudication Reporting Centre at Glasgow Caledonian University.</p> |
| <p>Reasons for not planning a review: [If there is no plan to do a PIR please provide reasons here]</p> |