

Summary: Intervention & Options

Department: Business Enterprise and Regulatory Reform (BERR)	Title: Impact Assessment of Part 2 of the Housing Grants, Construction and Regeneration Act 1996 and the Scheme for Construction Contracts (England and Wales) Regulations 1998 (The Scheme) and the Scheme for Construction Contracts (Scotland)	
Stage: Partial	Version:	Date: 4 July 2008
Related Publications:		

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?
Extensive consultation with the construction industry has identified that while the Construction Act has improved cash flow and dispute resolution under construction contracts it is ineffective in certain key regards.

The consultation also concluded that guidance would not adequately address the issues.

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
- Improve the right to suspend performance under the contract.

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

- a. Do Nothing
- b. Extensive Regulatory intervention.
- c. Targeted regulatory intervention (preferred option)

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?
Approximately three years time to allow the policy to 'bed down' and to judge whether the expected benefits have been realised.

Ministerial Sign-off For SELECT 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:

Summary: Analysis & Evidence

Policy Option A:	Description: Extensive Regulatory Intervention
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups'. Construction industry and its non-domestic clients. If an adjudicator fails the independence test, replacing that person will cost £100,000 (calculations shown in table following paragraph 17).		
	One-off (Transition)			
	£ 25,000			
	Average Annual Cost (excluding one-off)	£749,000	£774,000	
Other key non-monetised costs by 'main affected groups' More extensive intervention into parties freedom of contract. Cost of time taken to understand changes must be greater for more extensive intervention. Current Act works well. Not seeking to upset the existing balance.				

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' Construction industry and its non-domestic clients.		
	One-off Yrs			
	£0			
	Average Annual Benefit (excluding one-off)	£6,572,000	Total Benefit (PV) £6,572,000	
Other key non-monetised benefits by 'main affected groups' The construction industry will benefit to the tune of £1m as a result of the amendments proposed to the Adjudication framework; and the Contractors/sub-contractors will benefit to the tune of £5.8m as a result of the amendments proposed to the payment framework.				

Key Assumptions/Sensitivities/Risks

Price Base 2006	Time Period 1yr	Net Benefit Range (NPV) £108,600-35m	NET BENEFIT (NPV Best estimate) £- £8,000
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What is the geographic coverage of the policy/option?	England & Wales			
On what date will the policy be implemented?	N/A			
Which organisation(s) will enforce the policy?	The Courts			
What is the total annual cost of enforcement for these organisations?	£728,000			
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 £0.69	Small £11	Medium £95.08	Large £909.13
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices)			Increase	
Increase of	Decrease of	£ 6,572,000	Net Impact	-£5,823,000

Summary: Analysis & Evidence

Policy Option B:	Description: Targeted Regulation
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COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups'. Construction industry and its non-domestic clients. See paragraph 15 for explanation of one-off costs of updating standards contract forms. The Average annual cost relates to the costs of clarifying content and withholding notices see table following paragraph 23.
	One-off (Transition)	Yr	
	£25,000	1	
	Average Annual Cost (excluding one-off)		
	£ 649,000		Total Cost (pv) £674,000
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 costs by 'main affected groups' Savings resulting from proposal to prevent unnecessary duplication of payment notices see table following para 23.
	One-off	Yr	
	£ 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' The construction industry will benefit to the tune of £1m as a result of the amendments proposed to the Adjudication framework; and the Contractors/sub-contractors will benefit to the tune of £5.8m as a result of the amendments proposed to the payment framework.			

Key Assumptions/Sensitivities/Risks

Price Base 2006	Time Period 1 yr	Net Benefit Range (NPV) £116,600-£35m	NET BENEFIT (NPV Best estimate) £5,830,000
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What is the geographic coverage of the policy/option?	England & Wales			
On what date will the policy be implemented?	N/A			
Which organisation(s) will enforce the policy?	The Courts			
What is the total annual cost of enforcement for these organisations?	£728,000			
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 £0.60	Small £9.53	Medium £82.37	Large £788
Are any of these organisations exempt?	No	No	No	No

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

Overview

1. Construction is one of the pillars of the national economy and accounts for 8.7% 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. There are approximately 200,000 enterprises active in construction contracting and consulting in England and Wales, of which 99% are small or micro enterprises. The sector employs approximately 2 million people. 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)	175,650
Small (10-49)	14,855
Medium (50-249)	1,865
Large (250+)	315

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

3. The Construction Act has had a large 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 all 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 UK construction industry over the last 15 years has delivered a clear programme for improving the performance and productivity of the UK construction 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 current 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 argument during Sir Michael Latham's review.

9. The analysis of *Improving payment practices in the construction industry* was published in January 2006. It set out several proposals to address problems with the operation of the Construction Act while rejecting other proposals made during Sir Michael Latham's review. The final list of proposals consists of seven measures:

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
- improve the right to suspend performance under the contract.

We are proposing to do this by:

- 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. For instance, relevant amendments 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 and will provide that the parties to a construction contract should be jointly and severally liable for the adjudicator's own fees.
- Making provision for a "slip rule" in respect of an adjudicator's decision i.e. putting on a clear, statutory footing an adjudicator's ability to amend an obvious error in his/her decision.
- Prohibiting the parties from agreeing that determinations of interim or stage payment amounts cannot be contested.
- Amending the current payment framework by, for instance, clarifying the existing requirement to serve a payment notice (a notice determinative of the amount owed); removing restrictions on who can serve such a notice (e.g. 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 payments 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.
- Improving the provisions relating to the right of a party to whom payment is due to suspend performance of his obligations under a construction contract."

These proposals are included as part of BERR's Simplification Plan and are supported by the Better Regulation Executive.

10. This is not wholesale reform. These proposals are intended to be light touch and proportionate amendments to the existing framework to address specific issues that have arisen during the ten years the Construction Act has been in operation.

Consultation

11. 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

12. 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

13. 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.

14. 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 Dancaster, Richard Haryott, Sir Michael Latham, Humphrey Lloyd QC and Peter Rogers CBE.

15. Potentially, the various contracting bodies would also need to alter the large number of standard forms of contract. As an example, the Joint Contracts Tribunal (JCT) has some 30 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 £25,000.

Options:

Option 1 – Do Nothing

16. It is not viable to maintain the legislation as it stands as the original intentions of the 1996 Act are being undermined by:

Risks:

- lack of clarity relating to payment resulting in adverse effects on cash flow
- Increased litigation
- Uncertainty over the industry's ability to deliver projects on time and on budget (e.g. Wembley, Cross Rail etc.)
- Disputes under construction contracts were threatening the viability of individual businesses and eventually would undermine the long-term health of the construction industry
- Large numbers of small/micro companies – the lifeblood- of the industry going out of business
- Detrimental effect on GDP
- Exploitation of 'loop-holes' stopping the flow of money through the supply-chain.

Costs:

The existing statutory framework has a cost. Doing nothing means that the industry will continue to bear this cost and not receive the full benefit it should. Following the various discussions with industry stakeholders, aware that there are numerous costs to the industry of maintaining the legislation as it stands. The most obvious being the increased costs of projects as a result of the failure to complete on time and on budget.

The other key cost is that of individual businesses going out of business which can undermine the longer-term health of the construction industry not least because small/micro businesses are the lifeblood of the industry. There is very limited benefit in persevering with a statutory framework which several consultations have confirmed is defective in a certain key regards.

Benefits:

The main perceived benefit, for some in the industry, of maintaining the legislation as it stands would be no increase in costs. However, following the consultations with industry, this is not a viable option.

Option 2 - Extensive Regulatory Intervention

17. The other option which is not being pursued is that of a more 'extensive regulatory intervention'. As the review of the Construction Act has progressed, some proposals have been suggested which, in our view, would undermine the compromises that were reached in 1996 or would fundamentally alter the existing statutory framework which also seeks, so far as practicable to intervene as little as possible in the parties 'freedom of contract'. Throughout the review process, we have been mindful of the finely balanced compromise that was struck by the original legislation. Our guiding premise therefore has been only to intervene where the legislation has shown to not have delivered its original objective. We have only intervened in ways which do not undermine the existing structure of the legislation. Such proposals that we do make are targeted interventions to "fine tune" the existing statutory framework.

Risks:

- amendments which would fundamentally undermine the compromise which was reached in the 1996 Act
- undermine the existing structure of the legislation
- a more interventionist package would be out of step with the objective of 'fine tuning' to improve the way the legislation operates and was therefore not seen as a realistic option
- the Construction Act works well and more extensive intervention could undermine the benefit it already delivers.

Costs:

Following a more regulatory route would be to fundamentally change the Construction Act and the contracts it regulates - at the very least this would impose considerable transitional burdens on the industry and its customers. Table 1 shows workings behind the costs and benefits of this option.

Table 1

Proposals	Benefits	Costs
Section 111 Withholding notices	No estimate of prevalence so it is impossible to estimate the benefits	Consultation found that cost of change would be negligible but no estimates were provided of how often such disputes arise
Cross-contract set off		Consultation provided no evidence of cost. Currently, parties are able to set-off claims against other contracts. Removing parties ability to do this would entail costs to parties as they sought other ways to obtain this insurance.
Pay-when-paid		Consultation provided no evidence of cost
Stage payment for materials off-site	There are currently 20 adjudications per year relating to materials payments. Assumed that this change reduced these to 18, the average cost of an adjudication is £20,000. $2 * £20,000 = £40,000$.	Some additional costs would be expected. This would centre on costs associated with establishing a right to title etc.
Preventing trustee stakeholder accounts	Improved cash flow.	Possibly reduced protection in cases of insolvency
Adjudicator immunity from third party claims	On average 4 complaints are upheld at adjudication each year. Assume same number of third party actions and that such action costs same as an enforcement £13,000. $40 * £13,000 = £52,000$.	Lack of consensus from respondents meant that this proposal was not being pursued any further. There is also the cost to the third party of not being able to recover a claim from an adjudicator to consider. To a considerable extent, this would neutralise any benefit.
Application of adjudicator independence provisions to all adjudications		Adjudicator would fail independence test on 5% of occasions. If there are 1,940 adjudications per year, this would result in 100 failures. Estimated cost of replacing an adjudicator is £1000 $100 * £1,000 = £100,000$

Proposals	Benefits	Costs
Prevention of unnecessary duplication of payment notices – this will allow a notice or certificate from a third party to act as a Section 110 (2) payment notice.	<p>A significant reduction in the number of payment notices that need to be issued by the payer. Annual saving to the UK construction industry as a result of the revised payment framework is estimated to be £6.5m</p> <p>432,000 main contracts payments per year of which 60% involve duplicate certification procedures. Average cost of issuing a certificate is £25</p> <p>$432,000 * 0.6 * £25 = £6,480,000$</p>	<p>There are no additional costs expected as a result of this proposal.</p>
Clarity of the Content of Payment and Withholding Notices	<p>Our proposal creates a clear connection between the information in the section 110(2) notice and that required to withhold payment in accordance with section 111. This will remove unnecessary duplication in the system as we understand some payers routinely submit both a payment notice and a withholding notice at present where only one is necessary.</p> <p>Our proposal sets out a framework where a withholding notice should take the form of a revised payment notice. This single format creates clarity and simplicity, though in places additional information is required.</p>	<p>DTI statistics revealed that there were 388,900 payments per year under contracts without certificates. Using this as a baseline, it is estimated that the proportion of payments subject to abatement after deadline is one monthly payment every 2_ years. Average cost of issuing a withholding notice is £25</p> <p>$388,900 * £25 / 30 = £324,100$</p>
Preventing ‘pay when certified’	<p>Improves the predictability of cash flow and provides the supply-chain with a degree of certainty about what sum they will receive and when.</p>	<p>By way of indication of the level of costs, DTI statistics suggest that 13,000 civil engineering sub-contracts include pay-when-certified clauses. Removal means that a payment or withholding notice will now need to be issued by the payer at an average cost of £25</p> <p>$13,000 * £25 = £325,000$</p>
Total	<p>£6,572,000 Benefit -£5,823,000 Net Benefit</p>	£749,000

18. Following a more regulatory route would be to change fundamentally the Construction Act and the contracts it regulates. At the very least this would impose considerable transitional burdens on the industry and its customers. For instance the large number of standard forms of contract (as an example the Joint Contracts Tribunal has some 30 contracts) would need to be revised extensively as the transition was made from one statutory framework to another with the resultant additional costs and disruption that entails.

19. The average costs per organisation is calculated by dividing total costs by number of firms. So for the Extensive option please see table below.

	Average Cost per firm	No. of firms	Total cost
Micro	0.69	175,650	122,063
Small	11.00	14,855	163,337
Medium	95.08	1,865	177,323
Large	909.13	315	286,376
Total	3.89	192,685	749,000

Option 3 - Targeted Regulation

20. Numerous consultations with industry stakeholders have led to the conclusion that guidance alone without enforcement will not change the behaviour of the industry and that targeted regulation is the most appropriate legislative tool to use to address any failure in the operation of construction contracts.

21. To implement the proposals developed to amend the Act, we have chosen to use 'targeted regulation' i.e. to intervene where it is clear that the legislation is not meeting the original objectives effectively. The effect of this approach is to 'fine tune' rather than re-invent the existing statutory framework.

22. Through this approach we have identified a package of legislative measures to address weaknesses and improve the clarity of operation and effectiveness of the existing legislation. Many of these measures are technical and have low regulatory impact.

Costs and Benefits

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

Proposals	Benefits	Costs
<p>Prevention of unnecessary duplication of payment notices – this will allow a notice or certificate from a third party to act as a Section 110 (2) payment notice.</p>	<p>A significant reduction in the number of payment notices that need to be issued by the payer.</p> <p>Annual saving to the UK construction industry as a result of the revised payment framework is estimated to be £6.5m</p> <p>432,000 main contracts payments per year of which 60% involve duplicate certification procedures. Average cost of issuing a certificate is £25</p> <p>$432,000 * 0.6 * £25 = £6,480,000$</p>	<p>There are no additional costs expected as a result of this proposal.</p>
<p>Clarification of the requirement that a section 110(2) payment notice should be served</p>	<p>Payment notices are an important tool in ensuring early communication of payments made or proposed to be made.</p> <p>The benefit of this proposal is that the payee has greater certainty about what they will be paid and when.</p> <p>The benefit of this is in cash flow management. It is not possible to quantify the saving from improved cash-flow management.</p>	<p>Some minimal additional costs where the notice is now required where entire payment is abated.</p>

Proposals	Benefits	Costs
<p>Clarity of the Content of Payment and Withholding Notices</p>	<p>Our proposal creates a clear connection between the information in the section 110(2) notice and that required to withhold payment in accordance with section 111. This will remove unnecessary duplication in the system as we understand some payers routinely submit both a payment notice and a withholding notice at present where only one is necessary.</p> <p>Our proposal sets out a framework where a withholding notice should take the form of a revised payment notice. This single format creates clarity and simplicity, though in places additional information is required.</p>	<p>DTI statistics revealed that there were 388,900 payments per year under contracts without certificates. Using this as a baseline, it is estimated that the proportion of payments subject to abatement after deadline is one monthly payment every 2_ years. Average cost of issuing a withholding notice is £25</p> <p>$388,900 * £25 / 30 = £324,100$</p>
<p>Clarity of the sum due</p>	<p>By introducing much greater transparency about the sum due by providing a statutory definition. This will:</p> <ul style="list-style-type: none"> ■ improve communication between the parties; ■ 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. 	<p>There will be an additional cost which will be borne by the payer as the existing Section 110(2) payment notice does not make it clear whether the payer needs to account for abatements and/or set-offs.</p>
<p>Preventing 'pay when certified'</p>	<p>Improves the predictability of cash flow and provides the supply-chain with a degree of certainty about what sum they will receive and when.</p>	<p>By way of indication of the level of costs, DTI statistics suggest that 13,000 civil engineering sub-contracts include pay-when-certified clauses. Removal means that a payment or withholding notice will now need to be issued by the payer at an average cost of £25</p> <p>$13,000 * £25 = £325,000$</p>

Proposals	Benefits	Costs
Improving the right to suspend performance	<p>This proposal creates a 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.</p> <p>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.</p>	<p>This proposal does not introduce any overall increase in costs. It simply shifts the costs between parties.</p>
Introduction of a statutory framework for the costs of the adjudication	<p>Greater access to adjudication for all. Preventing the use of contract clauses on “costs” will prevent them being used as a barrier to adjudication.</p>	<p>There are no additional costs to the industry. The proposal simply sets out a framework on how existing costs can be dealt with.</p>
To prevent the application of “final and conclusive” clauses to interim payment disputes	<p>The joint DTI / CIC survey of adjudicators found that 50% of adjudication disputes relate to interim payments while the remainder relate to final payments or other matters. The survey also found that resolving payment disputes at the interim stage reduced the cost of adjudication by approximately 10%, or £2,000. This means that approximately 965 adjudications in Great Britain relate to interim payments. If adjudication of interim payments was encouraged by increasing the number that may be disputed from 456,500 to 536,000 (i.e. by 17.5%), this would represent an additional 165 interim payment adjudications. Compared to adjudication of the final account, this would result in an approximate reduction in the average cost of £341,000 or £175 per adjudication on average. Any arbitration or litigation cases that were also averted would increase this figure.</p>	<p>There will be a cost associated with paying for adjudication on contracts where this would currently not be possible. We believe this is more than offset by the benefits which accrue to successful project delivery from early resolution of disputes. It was the original intention of the Act that adjudication was a right.</p>
Total	£6,480,000 Benefit £5.831,000 Net Benefit	£649,100

This represents an £8,000 benefit over the 'Extensive Regulatory' option.

24. The average cost per firm was arrived at by dividing the total costs by the number of firms.

	Average Cost per firm	No. of firms	Total cost
Micro	0.60	175,650	105,752
Small	9.53	14,855	141,511
Medium	82.37	1,865	153,628
Large	787.65	315	248,109
Total	3.37	192,685	649,000

The improvements to the adjudication framework are estimated to save the construction industry £1million per annum in aggregate or £600 on average per adjudication (3% of the total cost of the adjudication) in England and Wales. This is broken down in the following table:

Adjudication benefits

1. Removing requirement that Act applies only to contracts in writing		Total
England and Wales	100 claims per year for enforcement 15% relate of whether contract was in writing Average cost £12,500 Therefore current cost is $100 * 15\% * £12,500$	£187,500
Scotland	10 claims per year for enforcement Therefore current cost is $10 * 15\% * £12,500$	£18,750
Sub Total		£206,250
2. Prohibiting agreements that interim and current stage payments will be conclusive		
England and Wales	Resolving payment disputes at the interim stage reduces costs by approximately 10% (£2,000) compared to resolving at the final stage 50% of adjudication disputes relate to interim payments – about 875 per year Currently 85% of interim payments may be referred to adjudication Increasing this to 100% suggests an additional 154 adjudications at interim payment rather than final payment stage Saving	£35,000
Scotland	An additional 14 adjudications at interim payment Saving	£35,000
Sub Total		£343,000

3. Introduction of a statutory framework for the costs of adjudication		
England and Wales	Cost of adjudication is £20,000 - £15,000 to parties and £5,000 to adjudicator Agreements that referring party pay all costs of adjudication occur in 3% of cases 1,750 adjudications per year If half of costs are unfairly allocated then $1,750 * 3% * £10,000$	£525,000
Scotland	80 adjudications per year $180 * 3% * £10,000$	£54,000
Sub Total		£579,000
Total	E&W £1,020,500 + Scot £107,750	£1,128,250

Small Firms Impact Test

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

26. 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 2004 as this is the latest data available.

	Construction Contracting	Construction Professional Services	Total % of Whole Economy
Number of Enterprises	183,100	16,760	10.1
% of small or micro enterprises	98.9%	98.2%	
Total Turnover	£148,800m	£10,000m	7.0
Gross Value Added	£52,000m	£6,000m	8.1
% of output** funded by public sector	28%	27%	
Average Employment	1,291,000	133,000	6.1
Total Net Capital Expenditure	£3,190m	£160m	4.2
Number of company insolvencies	1,733	Not available	13.5*

* Based on contracting only

** Based on DTI output survey for contracting and CIC survey of construction professional services

Engagement of Small firms

27. As with the previous consultation, BERR has once again invited stakeholders of all sizes to voice their concerns/views either through their federations, trade associations or as individuals.

28. 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.

29. There have been a number of stakeholder events during the last eighteen months. 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.

30. Among the many proposals considered, was whether “the payment framework under the Construction Act would benefit from the inclusion of a definition of what should constitute an adequate mechanism for payment?” The responses received to this suggestion indicated it would provide clarity for smaller firms and make clear on what date payment was due.

31. 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)”.

32. 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.

33. Late payment is a particular issue for all in construction, particularly among SMEs. This is borne out from the most recent Small Business Survey, which reported that 46% of construction firms saw late payment as a major obstacle. It was also reported in the same survey that late payment also significantly had a detrimental impact on cash flow.

34. The survey also reported that 31% of construction firms have had to resort to the courts as a result of late payment.

35. The benefits of the proposed amendments to small and micro businesses are:

- introducing greater transparency and clarity into the payment framework to assist in the management of cash flow
- 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 improve 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.

Equity and Fairness

36. The gender mix of the UK construction industry is generally accepted as being dominated by white males, with women and ethnic minorities being under-represented.

37. According to the 2006 Labour Force Survey, there are approximately 800,000 self-employed individuals working in the UK construction industry of whom approximately 25,000 are black and minority ethnic or 3% of the total self-employed.

38. The proposed amendments to the Construction Act affect contracts between businesses and self employed individuals. They will apply equally to all businesses and individuals drawn from all ethnic groups, age groups and to men and women alike. Our proposals are unlikely to have a greater impact on any group as compared to another. The amendments all put in place regulatory reform that will remove burdens by:-

- 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.

39. These amendments 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

40. 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.

41. 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

42. 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.

43. 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

44. We are proposing to introduce the amendments through a Bill. Following an assessment of the responses to the consultation on the proposed amendments, we will introduce legislation as soon as parliamentary time is available.

Summary and recommendation

45. 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 upsetting the compromise between all sectors of the construction industry which underpinned the introduction of the original legislation in 1996.

46. 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	N/A	N/A
Disability Equality	N/A	N/A
Gender Equality	N/A	N/A
Human Rights	N/A	N/A
Rural Proofing	N/A	N/A

Annexes