THE PAYMENTS MINEFIELD

A REVIEW OF PAYMENTS WITHIN THE UK CONSTRUCTION INDUSTRY
BY CE FUNDING AND FINANCE GROUP - APRIL 2016

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FOREWORD >>>

The construction industry has a history of delayed payment and late payment. The way in which the industry has evolved over a number of decades so that prime contractors sub-contract a substantial part of their work, the generally fragmented nature of the industry and the relatively small size of many of the market participants means that the ability to delay payment is relatively great and the ability to demand timely payment is relatively limited.

A distinction must be made between delayed payment and late payment. The latter is when the payment is made after it is contractually due, but depending on the relative size and bargaining power of the counterparties and the potential for future business the entity not receiving payment may often be reluctant to pursue legal remedies, quite apart from the costs and uncertainties involved. In addition the contracts themselves may entitle the payer a very long period before they are obliged to pay a sub-contractor, and in these situations there may be little difference in reality between a late payment and a delayed payment.

The practice of delaying payment is exacerbated by the comparatively bespoke nature of the industry's projects. This means that there is the potential for a significantly greater number of disputes than in e.g. the car industry, as the need to carefully check the fulfilment of contractual obligations is recognised and provides the potential for substantial prevarication.

This and the tendering system mean that participants in any given project can come from a number of sources and whilst the advantages of the establishment of a vertically integrated supply chain is recognised by some market participants, it is always a challenge to bring together the large number of parties that are required to complete any given project where a number of them may have not worked with each other before.

ABOUT CONSTRUCTING EXCELLENCE
Constructing Excellence is the single organisation charged with driving the change agenda in construction.

We exist to improve industry performance in order to produce a better built environment.

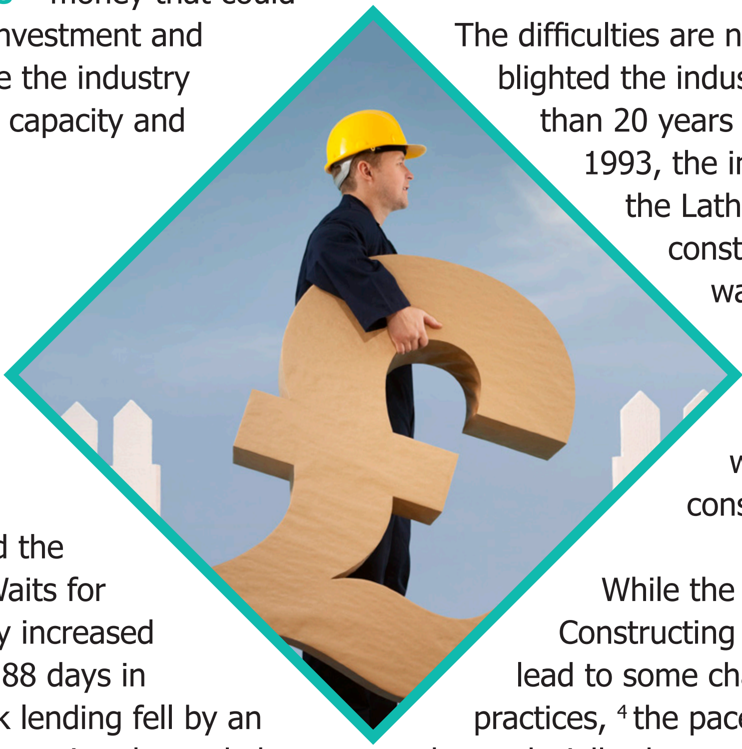
We are a cross-sector, cross-supply chain, member led organisation operating for the good of industry and its stakeholders.

"...a distinction must be made between delayed payment and late payment..."

UK construction, as an area of commerce, is unique in the extremely high level of disaggregation and fragmentation within its supply chains. **Small businesses which dominate construction on average spend 130 hours each year, at an average cost of £1,500 per business, chasing payment, while incurring £180 million in debt interest charges** – money that could otherwise be used for investment and growth[1] at a time where the industry desperately needs both capacity and innovation.

A 2015 study by the Asset Based Finance Association found that **construction firms were having to wait, on average, over 15 weeks to receive payment**, and the delays were growing. Waits for payment in this industry increased 22% in five years from 88 days in 2008.[2] In addition, bank lending fell by an average of 38% in construction, but only by 5% elsewhere.

These areas of uncertainty and the lack of standardisation enable larger market players to withhold payment for longer than is sometimes possible in other industries, although the issue of late payment is a widespread phenomenon. Research by R3[3] found that late payment is a primary or major factor in one-in-five corporate insolvencies. The research also found that around half of UK businesses had had invoices paid late by customers in the previous six months.



Andrew Tate, the R3 vice-president, said: "Late payment puts unnecessary strain on a business' cash flow, increasing the risk of insolvency. Despite government guidelines and business campaigns, late payment still remains all too common. Businesses know how much it costs others to chase down debts, and feel they can still get away with it."

The difficulties are not new – they have blighted the industry for decades. More than 20 years ago, in December 1993, the interim report of the Latham review of UK construction industry was published; this document, Trust and Money, underlined that little of either was evident in UK construction.

While the full Latham Report, Constructing the Team (1994) did lead to some changes in payment practices, [4] the pace of change has been glacially slow – evolution rather than revolution.

Since 2004, some **19 separate payment initiatives (charters, codes, regulations, etc.) have collectively failed to resolve the problem** – launched in April 2014, the Construction Supply Chain Payment Charter, for example, gained just 10 industry signatories in its first two years.[5]

However, as the UK government continues to apply its broad Construction 2025 strategy[6] to be more strategic about infrastructure planning, reduce industry fragmentation, and improve procurement and collaboration and, in the spirit of austerity, getting more for less, it has put a new emphasis on reducing late payment in particular – and it has recently toughened its approach still further in the recent Government Construction Strategy 2016-20[7].

The construction industry is particularly vulnerable to these issues, given the availability of credit (or rather lack of it), and pressures on margins. The low profit margins of the contracting and construction industry generally and particularly of many of the prime contractors does not help in this respect. Constructing Excellence held a workshop at Pinsent Masons on 10th February 2016 to explore these issues further, both to try to understand better the reasons why they occur and the consequences of delayed and late payment and also the degree to which through technological and other means the industry is in a position to change attitudes and behaviours.

Speakers at the event included Cliff Jones, Head of the NHS Construction Procurement team Senior Policy and Performance Manager for the Department of Health's ProCure 21+ and 22 framework, Rob Driscoll, Head of Commercial and Legal at the Building Engineering Services Association (BESA), and Colin Hardman an Associate Director at the accountants Smith & Williamson, as well as Rob Taylor from the Environment Agency, Paul Bamforth of Oracle Textura, the payments software company and Madoc Batcup, Chair of the Funding & Finance Group at Constructing Excellence, and Managing Partner of Synaps Partners LLP. The event was facilitated by Kevin Thomas Chair of the CE Collaborative Working.

Late payment is a problem across British business, but it particularly affects smaller businesses, as the chart indicates:-

Average proportion of invoices paid late, by size of company with late payments

[1] All examples given in Building a Responsible Payment Culture: A Discussion Paper (December 2013), BIS.gov.uk., p.9
[2] Asset Based Finance Association, Late Payment: An Analysis by Sector, 2015.
[3] The insolvency trade body

“...industry needs to be proactice on payment issues...”

As a background it was recognised that while delayed and late payment can be for a variety of reasons, there are two major ones are:

1 There is a genuine dispute as to what is owed, given the job done, the materials delivered or the services provided.

2 One party is using its superior bargaining position to enhance its cashflow at the expense of the other party. For example, this can result in a subcontractor using its own resources (including bank borrowing) to complete its obligations only to then wait while the prime contractor which may have already received payment from the client refrains from paying for a substantial further length of time.

This has a number of consequences, including the sub-contractors financing a significant part of a project, at their own higher level of cost, and estimates range from between 40-60% to as high as 90%+ of a project’s cost being financed in this way.

There is also a higher likelihood of subcontractors getting into financial difficulties as a consequence of delayed or payment, and a cautious or even a contentious, rather than collaborative, relationship between the various parties who will tend to rely on legal rights and obligations and relative bargaining strengths rather than project priorities when variations have to be made.

All this can increase delay, uncertainty and costs and as a consequence of this it is clear that clients have a significant interest in improving the current situation, and ensuring not only that payment is not late, but also that it is not unduly delayed and the supply chain gets paid on time.

There are a number of ways that this can be done, often in conjunction with one another. They all involve greater transparency.

1. Client involvement in the payment process

Cliff Jones, head of construction procurement of the NHS frameworks ProCure 21+ and ProCure 22 defined prompt payment as “everyone paying what they are due at the earliest time – as soon as it is due (or earlier) – without delay.” In his view, good practice starts at the top with the client who should also ensure their contractors do the same – but, importantly, it should not just be up to the client. “Industry needs to be proactive on payment issues too,” he said, recognising that the impacts of late payment can ripple both up and down a project’s supply chain, and, if it results in a company insolvency, it can also ripple across multiple projects.

The ProCure frameworks enable the NHS to look at payment behaviour several layers down the supply chain enabling them to monitor and manage payment behaviour.

[4] The 1994 Latham Report promoted partnering approaches and the New Engineering Contract, and heavily influenced the Housing Grants, Construction and Regeneration Act 1996, outlawing ‘pay-when-paid’ terms.
[5] The 10 signatories to the Prompt Payment Code included two trade associations.
[6] The Construction 2025 strategy was published in July 2013.

2. Project bank accounts

In their guidance note the UK government has defined Project Bank Accounts (PBAs) as follows – "A Project Bank Account (PBA) is a ring-fenced bank account from which payments are made directly and simultaneously by a client to members of his supply chain. PBAs have trust status which secures the funds in it and can only be paid to the beneficiaries – the supply chain members named in the account. Payments out of the PBA are made simultaneously to all parties. The account is held in the names of trustees; likely to be the client and lead contractor (but could also be members of the supply chain)."[10]

The Environment Agency and Highways England, for example, are among several UK government clients that are using project bank accounts (PBAs) to change payment practices on their projects.[11]

Over £10bn-worth of UK government projects are already operating PBAs, with the Environment Agency's Rob Taylor describing PBAs to the Constructing Excellence forum as "a form of collaboration system." PBAs and associated new models of construction procurement[12] were just part of the Construction 2025 strategy effort to overhaul outdated UK practices, which commits to deploying "collaborative procurement techniques that "... promote fair payment".[13]

3. Construction Payment Management software

Paul Bamforth of Textura explained the important advantages of a software payment system which significantly automates the processes that have to be gone through to enable payment to be authorised.

By adding clarity to the requirements for and the implementation of the payment, and facilitating the monitoring and management of the process and the payment status, it reduces the potential for operational excuses, such as the absence of authorising personnel, loss of paperwork etc. as well as delays in respect of disputes.

By making the payment process much more transparent and in a user friendly format it also enhances the ability to finance such payments through third parties.

[7] Infrastructure and Projects Authority (March 2016), Government Construction Strategy 2016-20.
[8] https://www.r3.org.uk/index.cfm?page=1114&element=21410
[10] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/62117/Project-Bank-Accounts-briefing.pdf
[11] Read Textura Europe blog post, Digitising Project Bank Accounts, September 2015.
[12] Guidance on new models of construction procurement, published in January 2014, covers two stage open book, cost led procurement, and integrated project insurance.

"...there was little incentive for paying companies to speed up the process..."

At the CE workshop a wide ranging group discussion rehearsed a number of the reasons advanced for and against late payment.

The reasons for prompt payment included:

- Prompt payments are themselves a driver for change. It changes culture and behaviour, generates trust, attracts supply chain support, and encourages collaborative working
- Cashflow is the lifeblood of the industry. Prompt payment reduces financial costs, collection costs, general administrative overhead and dispute resolution costs
- Facilitates investment, providing more certain returns and processes

The reasons in respect of delaying payment included:

- Contract terms have not been met, e.g. product not correct, design issues, defects, proper paperwork not submitted, other disputes
- Items delivered too early, or not included in the programme
- Year-end 'window dressing', payer has cashflow issues, other investment opportunities for the cash
- Behavioural issues, larger companies are in a position which enables them to retain cash, low margins which encourage cash retention and delayed payment provides payers additional bargaining ability with the supply chain

In essence it was clear that these payment practices had grown up because there was little incentive for paying companies to speed up the process, and few consequences if they failed to do so.

The benefit of slow payment mainly accrues to a relatively small number of larger companies who are in a position to dictate terms while the disbenefit is felt right across the supply chain, and by the sector as a whole in its ability to function effectively. The role of the government in changing behaviours is likely to be very important, for example the impact of the Public Contract Regulations 2015 which require all public sector organisations to pay undisputed invoices in 30 days and ensure this payment term is passed down the supply chain.

The advent of greater transparency and the reputational risk of being known as a bad payer in the market is likely to change behavioural practices, and in this respect compulsory open reporting and public league tables on payment from October 2016[14] may also drive behavioural change within contractors. In this case sunlight may well be the best disinfectant.

The major technological changes on the horizon for the construction industry may also have an effect. Madoc Batcup referred to the trend of building offsite and the greater use of manufacturing techniques in the construction industry. As a larger and larger proportion of projects is constructed/manufactured offsite and assembled in a relatively brief timeframe at the project site itself, and as Building Information Modelling programmes are increasingly adopted, there will be increased certainty at an earlier stage in respect of the compliance of

[13] The 2016 Strategy (p.10) talks about the role of PBAs in improving the financial position of construction SMEs, reducing the risk of insolvency which can in turn limit the capacity of the market to deliver good value.
[14] The relevant section of the Small Business, Enterprise and Employment Act 2015 came into force in April 2016.

components, more in line with the practice in e.g. the automotive or aerospace industries, thereby reducing the scope for errors and disputes and facilitating further transparency in the process.

Real-time financial data flows need to be part of the procurement and payment processes where data bases can be interrogated by different market participants as required. The onset of the internet of things will represent further challenges for the use of IT in the built environment on an ongoing basis, and it is vital therefore that the integration and effective use of digital technology as part of the construction process, including payment processes, is embraced as one of the key first steps in this process.

Accelerating the industry adoption of digital payment processes will reduce cost and enhance value for the reasons stated above, as well as helping to enhance better behaviour, and increasing trust and collaboration.

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Conclusion

Current industry payment practices reflect the significant scope for disputes in projects, many of which are non-standardised, payment procedures which are laborious, often paper-based and/or non standardised and susceptible to error and dispute, and a lack of transparency, and an unequal bargaining position given the small size of many of the industry's participants, resulting in a reluctance to enforce timely payment.

Transparency in payment procedures through using bank account approaches which enable the monitoring of actual payment practices, are capable of changing behaviour. However these may only be suitable for larger projects where the client has the wish and the capability of monitoring and managing the behaviour of its supply chain, often when it is contemplating a series of projects.

The adoption of construction payment software which can standardise payment procedures and approaches and provide up-to-date and reliable information is likely to be a key component in driving behavioural change, as it can be relevant to any size of project across the industry, but there also needs to be the catalyst of government support so that good practice can be celebrated and bad practice exposed.

The fintech industry has provided both a tool for implementing good practice and a means to expose bad practice. It is for the industry, client and suppliers alike to seize this opportunity to locate the payment mines and to clear the payment minefield.

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