

Title: Retention Payments in the Construction Industry IA No: BEIS021(C)-16-IM RPC Reference No: RPC-3456(2)-BEIS Lead department or agency: Department for Business, Energy and Industrial Strategy Other departments or agencies: None	Impact Assessment (IA)		
	Date: 07/09/2017		
	Stage: Consultation		
	Source of intervention: Domestic		
	Type of measure: Primary legislation		
Contact for enquiries: constructionpayment.consultations@beis.gov.uk			

Summary: Intervention and Options	RPC Opinion: GREEN
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Cost of Preferred (or more likely) Option: Preferred option to be confirmed following consultation

Total Present Value	Net Present Value	Business Net Present Value	Net cost to business per year (EANDCB in 2014 prices)	One-In, Three-Out In Scope	Business Status	Impact	Target
£m		£m	£m		Qualifying provision		

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

A retention is a percentage of the contract payment value which is held by the construction customer. Half is released at project completion. The other half is released following the expiry of a defects liability period. Holding retention money is a long established way of providing insurance for the effective delivery of construction work. However, there are a number of issues associated with how retentions work in practice. There is evidence of frequent late and non-payment of retention monies, and that some of this is for unjustified reasons. Qualitative evidence gathered suggests that unjustified late and non-payment of retention monies appears to a significant cause of issues associated with the practice of holding retentions within the construction sector, and this occurs due to issues around misaligned incentives, market power, information failures, potentially ineffective dispute resolution and inefficient allocation of insolvency risk. There are a number of existing measures which aim to tackle payment issues, but none tackles issues around the practice of retentions directly. The Government is examining whether intervention is needed to reduce the incidence of unjustified late-payment and non-payment of retentions, to therefore help improve cash flow in the construction supply chain and reduce costs.

What are the policy objectives and the intended effects?

The issue under consideration is whether intervention would reduce some of the identified problems associated with the practice of retentions.

The policy objective is to reduce:

- the incidence of unjustified late payment of retentions; and
- the incidence of unjustified non-payment of retentions (for the purpose of this Impact Assessment money unpaid due to upstream insolvencies has been included within this).

This will have the impact of improving cash flow through construction supply chains. The extent of reduction and time frame in which this will be achieved will be determined by the package of measures which are taken forward as a result of the consultation exercise. We intend to use the consultation to gather evidence to support a clear and measureable objective.

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

We are consulting on 3 policy options:

Option 0: Do nothing. A number of existing measures are in operation which tackle payment issues but none of which directly tackles issues arising from the practice of retentions

Option 1: Promote greater awareness of existing statutory requirements to improve the communication of the timing and amount of retention payments

Option 2: Create a “retention deposit scheme” to hold retention money in a separate ring-fenced account, protecting the money where there is an insolvency and reducing the incentive to unjustifiably delay or withhold payment when due.

Will the policy be reviewed? It will/will not be reviewed. **If applicable, set review date:** Month/Year

Does implementation go beyond minimum EU requirements?	N/A			
Are any of these organisations in scope?	Micro Yes	Small Yes	Medium Yes	Large Yes
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)	Traded: N/A		Non-traded: N/A	

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: 05/09/2017

Summary: Analysis & Evidence

Policy Option 1

Description: The Government and the Construction Leadership Council (CLC) work with relevant industry representative bodies to improve industry understanding of the impact of the 2011 amendments on retention payments.

FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m) N/A		
			Low: N/A	High: N/A	Best Estimate: N/A

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	N/A	N/A	N/A
High	N/A	N/A	N/A
Best Estimate	N/A	N/A	N/A

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

It has not been possible to monetise the costs of Option 1 at the consultation stage. More evidence needs to be gathered from industry in order to be able to monetise costs in the Final Impact Assessment.

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

One-off cost to industry bodies and Government of producing and communicating guidance. Option 1 would bring forward the date from which those businesses which hold retentions and are affected by the existing information failure become familiar with the 2011 amendments of the Construction Act, and begin to issue payment notices, incurring the associated costs. There would be a reduction in how long some construction customers are able to hold on to retentions and benefit from using this as trade credit. There would also be a negligible one-off cost from bringing forwards when such businesses need to familiarise themselves with the guidance on how the 2011 Construction Act reforms relate to retentions.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	N/A	N/A	N/A
High	N/A	N/A	N/A
Best Estimate	N/A	N/A	N/A

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

It has not been possible to monetise benefits of Option 1 at the consultation stage. More evidence needs to be gathered from industry to be able to monetise costs in the Final Impact Assessment.

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

Option 1 would bring forward the date from which those businesses affected by the existing information failure become familiar with what the 2011 amendments of the Construction Act mean for payment of retentions, delivering reduced late payment through improved clarity and certainty of cash flow for construction contractors, and reduced adjudication costs. Option 1 could also reduce exposure of these contractors to upstream insolvency to some extent, as an indirect result of retentions being held for a shorter period of time before payment.

Key assumptions/sensitivities/risks

Discount rate (%)

3.5%

There is a risk that some construction customers may respond to the part of the 2011 amendments, which prohibits payment by reference to another contract, by lengthening their defects liability period. This has the potential for providing greater certainty on when payment is due but lengthening the period of time that contractors and sub-contractors have to wait for it.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: N/A
Costs: N/A	Benefits: N/A	Net: N/A	

Summary: Analysis & Evidence

Policy Option 2

Description: Create a “retention deposit scheme” to hold retention money in a separate ring-fenced account, protecting the money in the event of an insolvency and reducing the incentive to unjustifiably delay or withhold payment when it is due.

FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -10.99	High: -4.07	Best Estimate: -6.55

COSTS (£m)	Total (Constant Price)	Transition Years	Average (excl. Transition)	Annual (Constant)	Total (Present Value)	Cost
Low	4.1	1	228.5			1971.1
High	11.0		228.5			1978.0
Best Estimate	6.5		228.5			1973.6

Description and scale of key monetised costs by ‘main affected groups’

There will be contract change costs for contract writing bodies (incomplete evidence on this indicates an initial estimate of £0.04m). There will be a one-off familiarisation costs to construction contractors (£3.9m), insolvency practitioners (£2.5m) and secured creditors who lend to those holding retentions (£0.05m). There will be a transfer of insolvency risk and potential cost away from construction contractors with retentions held to other creditors owed money by those holding retentions – it is estimated that 90% of this cost will impact other businesses (£1770.3m over 10 years) and 10% will impact Government and employees (£196.7m over 10 years).

Other key non-monetised costs by ‘main affected groups’

There will also be familiarisation costs to repeat construction clients, but it has not been possible to monetise this cost. Insolvency practitioners may need to incur additional system change costs as a result of the changes. There will be a cost to those holding retentions from being unable to use the retention money elsewhere in their business, such as to improve cash flow which may require credit from other sources which is likely to incur a cost. However, this cost would represent a transfer to the lending institutions they then borrow from. There will be a range of administration fees and burdens for business and Government associated with putting retentions in a retention deposit account. We intend to use consultation to gather further evidence on the scale of these impacts.

BENEFITS (£m)	Total Transition (Constant Price)	Transition Years	Average Annual (excl. Transition)	Annual (Constant Price)	Total Benefit (Present Value)
Low	0	1	228.5		1967.0
High	0		228.5		1967.0
Best Estimate	0		228.5		1967.0

Description and scale of key monetised benefits by ‘main affected groups’

There would be a transfer of risk and cost in the event of insolvency from construction contractors with retentions held to other creditors (approximately £1967.0m over 10 years) – i.e. construction contractors with retentions held will get the retention that they are due in the event of insolvency (but this will be at the expense of other creditors to the business holding the retention).

Other key non-monetised benefits by ‘main affected groups’

Holding retentions in a deposit scheme will remove the ability of the party using the retention to use it as an extended source of trade credit, potentially reducing incentives for late-payment and non-payment and benefiting those with retentions held from them. We intend to use consultation to explore the possible impacts of holding retention in trust on incentives and unjustified late/non-payment.

Key assumptions/sensitivities/risks	Discount rate (%)	3.5%
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It has been assumed in the analysis that all retentions will need to be held in trust, therefore we intend to use consultation to determine what level of threshold may be suitable. Many costs and benefits are, therefore, likely to be overestimated. There could be a lack of appetite for private sector providers to come forward as retention deposit scheme operators. A value or contracting “tier” threshold could mean that this is not benefiting parts of the sector that need it most. There is a risk that Option 2 could increase the possibility of insolvency for those companies which hold retentions. There may be a risk that this could increase their cost of borrowing. These are risks we intend to investigate further through consultation.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: -20.5
Costs: 191.6	Benefits: 212.2	Net: 20.5	

Evidence Base (for summary sheets)

Background

Overview

1. A retention is a percentage of the contract payment value which is held by the construction customer. Half is released at project completion. The other half is released following the expiry of a defects liability period. Holding retention money is a long established way of providing insurance against project defects. However, anecdotal evidence and research has identified a number of issues associated with how retentions work in practice.
2. The aim of this document is to provide the Government's initial assessment of the rationale for intervention, and possible options that are being considered for mitigating the issues associated with retentions in the construction payment (namely unjustified non-payment and late payment). It also provides a detailed assessment on the costs and benefits of the policy and the regulatory impact (the Equivalent Annualised Net Direct Costs to Business). Through consultation we will aim to improve Government understanding of the strength of rationale for intervention, and the costs and benefits of the options being considered.
3. This consultation stage Impact Assessment largely draws on evidence from the research project "Retentions in the Construction Industry", conducted by Pye Tait (2017) on behalf of the Department for Business, Energy and Industrial Strategy, in order to develop the evidence base on the use of retentions in the construction sector in England. This had the following core objectives:
 - Establish a robust definition of a 'retention' in the construction sector;
 - Determine the extent to which retentions are used, as well as the rationale and legal position in relation to their use;
 - Assess the costs, benefits and other impacts of the use of retentions on the construction sector and on the UK economy as a whole;
 - Identify the alternatives to retentions and the rationale for these; and
 - Ascertain the costs and benefits of alternatives to retentions should these be implemented more widely across the construction sector
4. This consultation stage Impact Assessment (IA) will be published alongside a wider consultation document on payment practices in the construction sector that will be used to inform the Post Implementation Review for 2011 reforms to the "Construction Act" (Revision of the Scheme for Construction Contracts (England and Wales) Regulations 1998 Construction Contracts (England) Exclusion order 2011). It applies across England and on business-to-business contracts only.
5. The remainder of this section provides background information on the construction sector, the practice of retentions, and outlines the problem Government is looking to address by intervening in the construction industry.

The construction industry overview

1. In 2014, construction contracting¹ contributed over £85 billion to the UK economy in value added, comprised of 270,602 businesses and had a sector turnover of over £216 billion.²
2. This impact assessment looks at policy options that would directly apply to England. In 2014, the construction contracting sector in England contributed approximately £72 billion in value added, comprised of approximately 229,060 businesses and had a sector turnover of approximately £188 billion.³

¹ Defined by SIC codes 41-43

² All statistics taken from ONS Annual Business Survey (UK non-financial business economy 2015 provisional results), current prices. At the time of writing 2014 was the latest year data was available for England.

3. The construction market is broad and diverse covering infrastructure (social and economic), house building, commercial, industrial and repair maintenance and improvement (RMI). Arguably there is no one construction sector but a range of specialist sub-sectors which can be very different from each other and can be characterised by different supply chain relationships, at times driven by the business models of the client organisation.
4. The industry typically contracts on a project-by-project basis, with complex supply chains being formed as a result of competitive tendering to deliver a specific project and then breaking up. While there are some examples of large, repeat and expert clients adopting a genuinely strategic approach to their supply chain, many of the industry's customers in the private and public sector are occasional or contract for a single project. Therefore, it is usually the case that business-to-business relationships between the client and the industry, and through the supply chain, are transactional with decisions taken on an immediate or short term basis.
5. The construction supply chain is highly fragmented. Research undertaken for BIS in 2013⁴ provided an insight into the complexity of supply chain management and the degree of spend aggregation. For instance, for a main contractor to have 50 to 70 Tier 2 suppliers and sub-contractors is not uncommon.
6. Construction firms are relatively undercapitalised compared with firms across the rest of the UK economy. According to research by UCL, "this is most especially the case for tier 1 contractors and for large contractors. Undercapitalisation both puts firms at more risk of financial failure and limits their ability to invest in business models requiring injections of capital"⁵.
7. This can drive a reliance on trade credit. The same UCL report noted that, "as a whole, construction firms take much more trade credit (from their suppliers) as a proportion of their balance sheet than do firms in the rest of the economy. They also give much more credit to their customers as a proportion of their balance sheet [...] Tier 1 firms were found to be net receivers of trade credit, whereas tier 2 firms were found to be large net providers of trade credit"⁶. In effect, larger businesses further up the supply chain obtain credit from the – typically smaller – firms they contract with.
8. Retentions are a contractual means of holding a supplier's money for an extended period.

Retentions overview

9. Cash retention is a percentage of the payment value (typically 5%) which is held by the customer. Half is released at project completion. The other half is released following the expiry of a defects liability period (typically 12 months, though 24 months in the house building sector) which is agreed between the parties to a contract.
10. It has not been possible to produce a precise point estimate for the total amount held in retentions in the construction sector in England over the course of a given year. Instead we use a range of £3.2 billion to £5.9 billion, with a central value of £4.5 billion (in 2015 prices). A range has been used to reflect the fact that the central estimate relies on a number of assumptions and there is uncertainty around this figure. **Box 1** outlines the rationale for this range and how these estimates have been calculated.

³ aGVA and Turnover data – ONS Annual Business Survey (UK non-financial business economy: 2014 regional results). Number of Enterprises – ONS UK Business: Activity, Size and Location (2014), current prices. At the time of writing 2014 was the latest year data was available for England.

⁴ BIS Research paper No 145 Supply Chain Analysis into the Construction Industry October 2013

⁵ Trade credit in the UK Construction Industry: An empirical analysis of construction contractor financial positioning and performance, UCL, July 2013

⁶ Ibid.

Box 1: Value of retentions held in the construction sector as a whole

As outlined by Pye Tait (2017), a previous report into retentions published by the Trade and Industry Committee in 2002 multiplied sector Gross Value Added (GVA) by an average retention percentage of 5% to produce an estimate for the total amount held in retentions over the course of a year. It highlighted, however, that it is challenging to produce a point estimate as there would also be outstanding retention monies from previous years, to be added to this estimate, and that there would furthermore be some reduction in the resulting figure, reflecting the amount of retention recovered in that year.

Retentions are a proportion of contract value, therefore, we believe that sector turnover is a more appropriate basis for estimating the total amount held in retentions over the course of a given year.

Multiplying construction sector turnover by the average typical retention percentage (4.85%) shows the total amount held in retentions over the course of a given year if all construction contracts had retentions held on them. However, it is known from the Pye Tait research, that retentions are not held by all construction customers or on all construction contracts. A high level estimate of the total amount held in retentions should take these two factors into account, but requires certain assumptions, which need to be explained. The best information available on which to base assumptions are the results from the Pye Tait research which show that:

- around a quarter of contractors surveyed did not have not had any experience of retentions in the last three years; and
- of the three-quarters of contractors with experience of retentions, contractors say retentions are not held on an average of 35% of all their current contracts.

We use these results to make the following assumptions:

- a. The proportion of contractors with experience of retentions over the last three years (75%) approximates to the proportion of contractors with experience of retentions in a given year;
- b. the proportion of current construction contracts with retentions held⁷ (65%), approximates to the proportion of construction contracts with retentions held over the course of a year;
- c. the number of construction contractors without experience of retentions is proportionate to the value of construction turnover that is not covered by retentions;
- d. the number of construction contracts not covered by retentions is proportionate to the value of construction turnover that is not covered by retentions;
- e. the proportion of construction customers using retentions and the proportion of their contracts with retentions held stays constant over time (i.e. reflects the snapshot from the Pye Tait research).

It is felt that these assumptions are reasonable given the available evidence. However, given that they are uncertain, we propose to test them via the consultation and through stakeholder engagement.

The assumptions give an illustrative estimate for the total amount held in retentions over the course of a year, through multiplying total sector turnover (approximately £188 billion in 2014) by:

- the average typical retention percentage (4.85%);
- 75% and 65% (to reflect the fact that not all construction contractors have experience of retention, and retentions are not held on all construction contracts).

⁷ Amongst those with experience of retentions in the last three years

This gives an estimated total amount held in retentions of the course of a year of approximately £4.4 billion in 2014 prices (£4.5 billion in 2015 prices).

To reflect the fact that this is based on a number of assumptions and the degree of uncertainty, sensitivity analysis has been conducted. This gives a range of £3.2 billion - £5.9 billion, with a central estimate of £4.5 billion, in 2015 prices. A wider range (20%) has been applied to the assumption on the proportion of contractors with experience of retentions. This reflects the greater uncertainty around how the proportion of contractors with experience of retentions over the last three years translates to the proportion in one year. This range also reflects the uncertainty around how proportion of contractors and contracts relates to contract value.

Table: Estimated total amount held per year in retentions

	Assumptions				Illustrative estimate for the total amount held in retentions across the construction sector in England over the course of a year	
	Proportion of contractors with experience of retentions	Proportion of their contracts with retentions held	Average typical retention percentage	Sector turnover (£billions, 2014 prices)	£2014 prices, millions	£2015 prices, billions
Central	75%	65%	4.85%	£187.5	£4.4	£4.5
Lower	60% (central - 20%)	59% (central -10%)	4.85%	£187.5	£3.2	£3.2
Higher	90% (central + 20%)	72% (central -10%)	4.85%	£187.5	£5.9	£5.9

Subject to stakeholder engagement, we intend to use consultation to explore whether this is an appropriate methodology and estimate for the total amount held in retentions over the course of a year.

11. Holding retention money is a long established way of providing an incentive for suppliers of construction work to mitigate defects, they also offer “insurance” to construction clients in the case that contractors do not complete work or return to fix defects. See **Box 2**.

Box 2: Retentions as “insurance” against defects”

- **Incentivise timely completion of work, and act as a warranty against poor quality work:** contractors will not get their retention monies until work is completed without defects, strengthening incentives to complete work quickly and to a high standard.
- **Encourage contractors to return to fix any defects:** contractors will not get their full retention monies until all project defects have been rectified, strengthening incentives for them to quickly return to fix defects. There is a cost to contractors from returning to fix defects, as it involves additional resource, and may also prevent them to moving on to new work. Without retention they do not have a direct financial incentive to return and fix defects. Retentions impose a direct cost on not returning to fix defects.
- **Can be used to fund works required to fix defects in the event that the contractor did not return to rectify these:** Retention payments reduce the risk to the customer as the retention monies can go towards the cost of having to pay another contractor to come back and fix any

defects, In the event that the original contractor did not return to fix these.

12. Research into retentions conducted by Pye Tait (2017)⁸ found that there is a need within the construction sector to have some form of insurance against defective work to offer security to clients and main contractors, through creating an incentive for contractors to produce outputs to a high quality standard, remedy any defects which may arise, and to complete the work in a timely fashion.
13. Glenigan's 2016 KPIs, show that over a quarter (27%) of clients interviewed rated the impacts of defects at project handover at or below 7 out of 10 (10 representing zero defects). Further, the same survey indicated that almost 60% of projects (for the combined design and construction phases) came in late. The construction phase alone overran on 45% of projects.⁹
14. Survey evidence gathered by Pye Tait (2017) indicates retentions are the most common adopted form of "insurance" against defects used in the construction sector. However, their use is not universal across the construction sector. Instead, the majority of customers of construction work make a calculated decision as to whether to hold a retention, and also sometimes the value of retention held.
15. Pye Tait found that around three-quarters of contractors surveyed had experience of retentions in the last three years (either with retentions held and/or holding retentions). Of these, contractors say retentions are held on an average of 65% of all their current contracts. This means that in 35% of their current contracts amongst surveyed contractors with experience of retentions, on average, no retentions are held, with risks mitigated through other means.
16. Clients surveyed report a greater use of retentions compared with contractors; 85% of clients surveyed have used retentions on all or some of their contracts over the last three years. Clients with experience of holding retentions during the last three years say that retentions are used on an average of 78% of all their current construction contracts.

Problem under consideration

17. It can be the case that quality is only apparent after construction work has been completed. Therefore a mechanism is required to mitigate these risks and help ensure effective project delivery. Retention is currently the most commonly used mechanism to provide this insurance. However, there are also a range of issues with retentions as they work in practice.
18. There is substantial variation in the experiences of contractors with retentions, meaning that it is challenging to draw generalised conclusions on their impacts. However, research conducted by Pye Tait (2017) identified a number of issues associated with the practice, including frequent late and non-payment of retention monies, retention money lost due to insolvency, increased project costs, and weakened supply chain relationships. These are outlined in more detail below.

a. Unjustified late payment and non-payment

19. Alongside a wealth of anecdotal evidence and several surveys by trade bodies with a close interest in a particular aspect of the argument, Pye Tait (2017) research indicates that there is frequent late and non-payment of retentions.
20. Survey evidence gathered by Pye Tait shows that **late payment** of retentions appears to be commonplace, with around 71% of contractors surveyed with experience of having retentions held in the last three years

⁸ Pye Tait. (2017). 'Retentions in the Construction Industry'

⁹ Glenigan (2016) UK industry performance report: based on UK construction industry Key Performance Indicators <https://www.glenigan.com/email-marketing/kpi-report-2016>

reporting that they have experienced delays in receiving retention monies over this period.¹⁰ Average delays at each tier of the supply chain are multiple months long. The extent of average delay is significantly longer for tier 2 and 3 contractors compared to tier 1 contractors.

21. Evidence gathered by Pye Tait also indicates that a high proportion of contractors have experienced **non-payment** of retention monies. For example, the majority (65%) of tier 3 contractors surveyed with experience of having retentions held in the last three years had experienced partial or full non-payment of retentions monies.
22. Significant proportions of retention monies are not being fully repaid, and it is significantly more likely that retentions are not repaid either fully or partially to tier 2 and 3 contractors, than tier 1 contractors. For example, evidence indicates that tier 1 contractors surveyed¹¹ did not receive retentions back in full upon practical completion on approximately 11% of all their contracts over the last three years¹². In comparison, tier 2 and 3 contractors surveyed¹³ did not receive retention money back in full upon practical completion in around 36% of all their contracts over the past three years.¹⁴
23. It is not known, however, what proportion of this late and non-payment of retention monies is for genuine reasons (for instance, the failure of a supplier to return promptly to correct defects), and what proportion is for unjustified reasons (for instance, non-payment because of a pending payment from another client or because a contractor retained monies for longer than specified in contract terms). Late payment and non-payment being more prevalent further down the supply chain could be for genuine reasons, for example, a reflection of higher instance of defects or work more frequently overrunning on tier 2 and tier 3 contracts. Alternatively, the fact that the extent of late payment is higher for tier 2 and 3 contractors, compared to tier 1s, could support the UCL research conclusion that larger businesses further up the supply chain obtain credit from the – typically smaller – firms they contract with. This could be particularly damaging for small firms in construction supply chains who, denied that money, would be unable to invest in capacity and capability. This is particularly the case given the small profit margins in the construction contracting sector. KPMG analysis in 2014 indicated an average margin among contractors of just in excess of 1%.¹⁵
24. Survey data gathered by Pye Tait (2017) provides some evidence for particular types of unjustified late or non-payment, and the qualitative gathered from workshops and interviews also indicates that *unjustified* late and non-payment of retentions appears to be a significant cause of issues associated with the practice of holding retentions within the construction sector. However, they found that it was not possible to use the survey evidence gathered to measure what proportion of late and non-payment counted by the survey was justified within contract terms and what proportion is unjustified.
25. As explained by Pye Tait in their report, it is challenging to measure the extent to which late or non-payment of retentions is for justifiable reasons. This is because opinions as to what constitutes ‘justifiable’ or ‘unjustifiable’ can differ depending on the contractor or client perspective. For example, if a contractor who has not had their retention released by the client thinks that the construction work was completed to

¹⁰ In relation to the time for which retentions are actually held after practical completion, compared to the time for which they were intended to be held.

¹¹ To avoid double-counting and to satisfy the conditions of the statistical tests conducted, Pye Tait only included those businesses participating in their contractor survey that operate on one tier only and that provided data on both the number of contracts held over the past three years and the number of instances of non-payment in full upon practical completion.

¹² i.e. including those that did and did not have retentions held

¹³ To avoid double-counting and to satisfy the conditions of the statistical tests conducted, Pye Tait only included those businesses participating in their contractor survey that operate on one tier only and that provided data on both the number of contracts held over the past three years and the number of instances of non-payment in full upon practical completion, in this analysis.

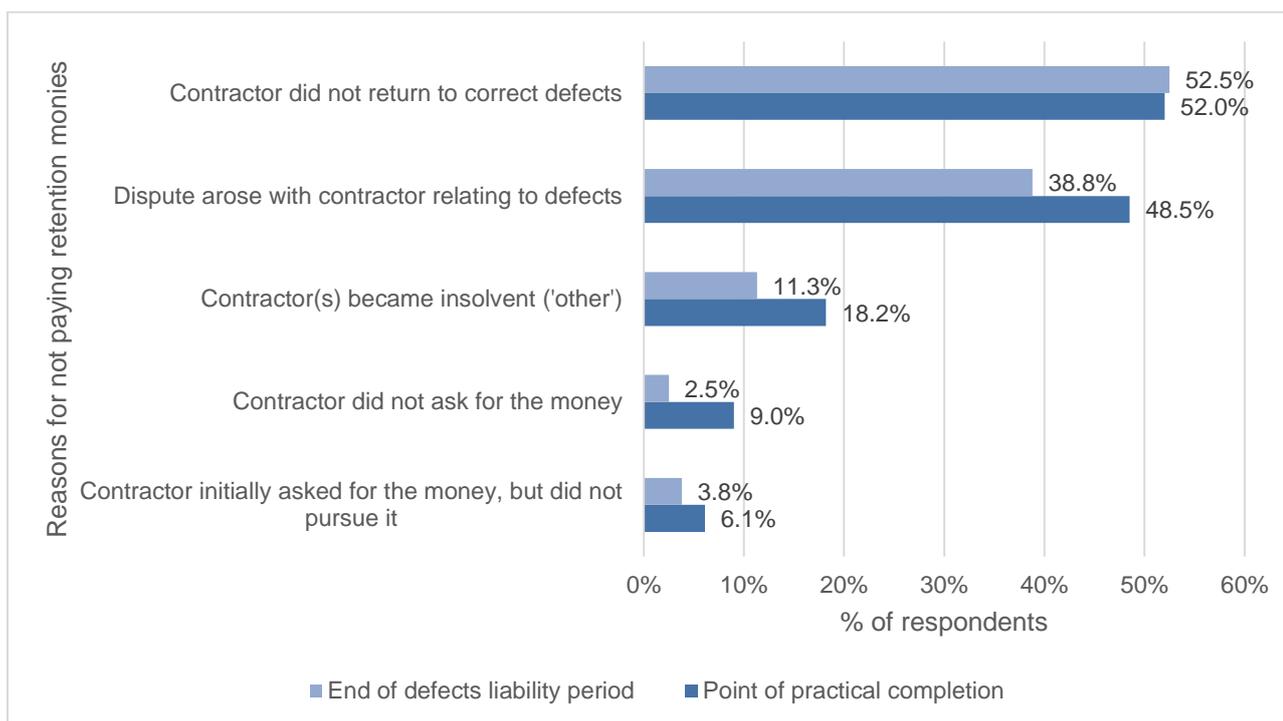
¹⁴ Tier 2 contractors did not receive retentions back in full upon practical completion in 37% of all their contracts, while tier 3 contractors did not receive retentions back in full upon practical completion in 35% of all their contracts. However, this difference is not statistically significant.

¹⁵ http://kpmg.co.uk/creategraphics/09_2014/Construction_Barometer/index.html#4/z

standard, but the client does not then they will have different opinions, when asked, on whether the non-payment was justified or unjustified.

26. Figure 1, 2 and 3 below, taken from the Pye Tait research, provide details of reasons given by clients and contractors surveyed for why retention monies have not been paid. This indicates that there are a range of reasons why retention monies are not being paid, some justified¹⁶, some unjustified¹⁷, but many others are not clear cut. For example, it is not clear from this survey data alone whether if a 'dispute arose with a contractor relating with defects', the client was correct and the money should have been withheld or whether the work had been completed to the standards set out in the contract and the retention should have, therefore, been released.

Figure 1: Reasons why retention monies were not repaid by clients (client views)¹⁸



101 respondents¹⁹

Figure 2: Reasons why retention monies were not repaid by tier 1 contractors (tier 1 contractor views)²⁰

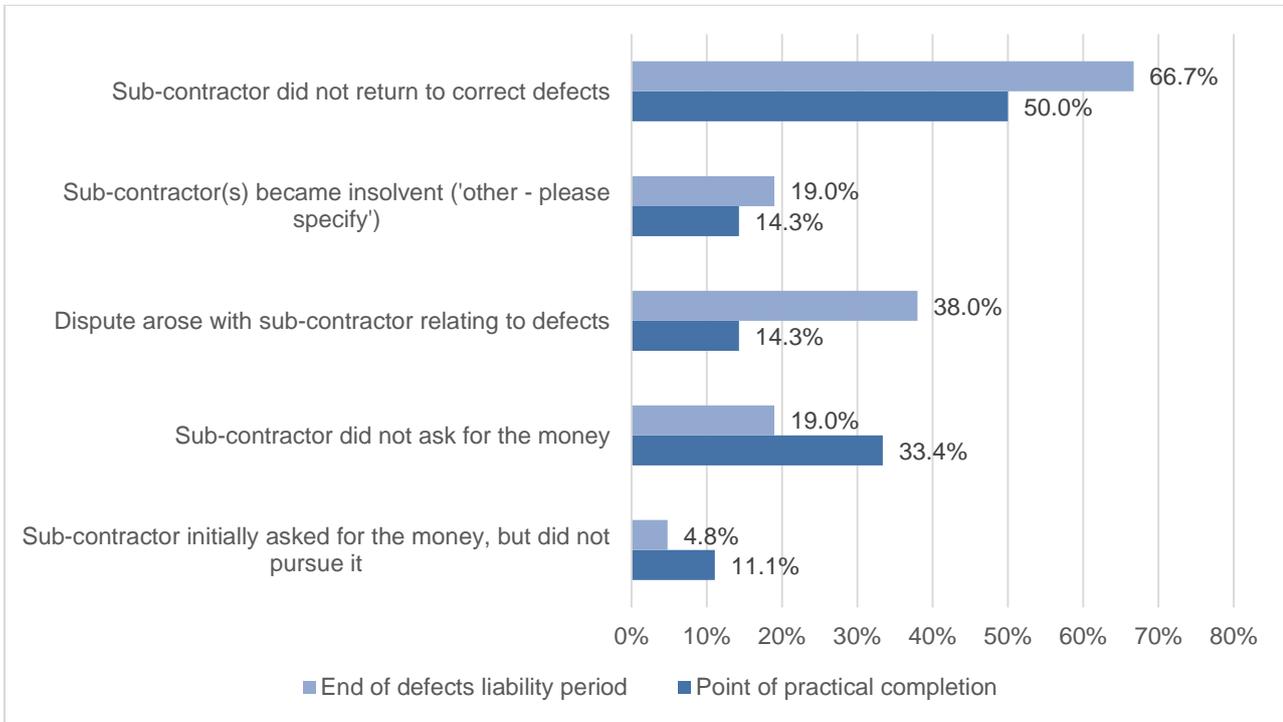
¹⁶ For example, the contractor not returning to correct defects.

¹⁷ For example, a main contractor declining to pay the retention to their subcontractor as the client had not released their retention to them. This is unjustified as 2011 amendments to the 'Construction Act' prevent any contract term which makes payment conditional on the performance of obligations under a superior contract.

¹⁸ Pye Tait. (2017). 'Retentions in the Construction Industry'

¹⁹ Respondents could select more than one response

²⁰ Pye Tait. (2017). 'Retentions in the Construction Industry'

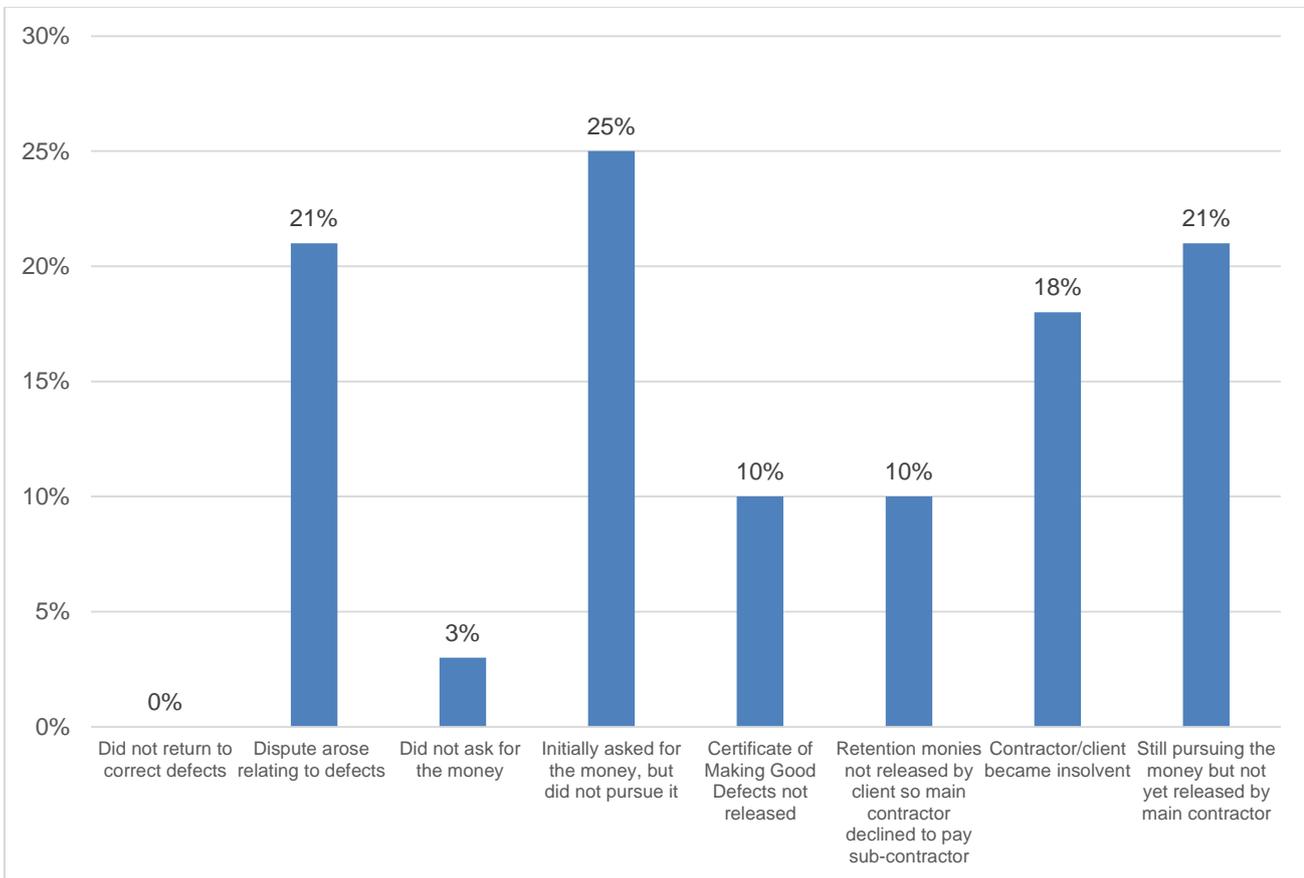


27 respondents²¹

Figure 3: Reasons why retention monies were not paid to sub-contractors (sub-contractor views)²²

²¹ Respondents could select more than one response

²² Pye Tait. (2017). 'Retentions in the Construction Industry'



127 respondents²³

27. Subject to levels of stakeholder engagement, through consultation we intend to gather views from industry on how much of this late and non-payment of retentions is down to retentions being used for their intended purpose and how much is unjustified. However, it will be challenging to draw robust conclusions from this because opinions as to what constitutes 'justifiable' or 'unjustifiable' can differ depending on the contractor or client perspective. This is highlighted in the Pye Tait research and also discussed in more detail under 'Option 0'.

b. Weakened working relationships

28. The Pye Tait research found evidence that the practice of retentions can weaken working relationships between clients and contractors, and throughout the construction supply chain.

29. There is substantial variation in the experiences of contractors with retentions, meaning that it is challenging to draw generalised conclusions on their impacts. However, Pye Tait found that when respondents to the survey were asked to select from a list of potential impacts of the practice of holding retentions, two of the most frequently cited were:

- **For contractors: weakened relationships throughout the construction supply chain.** Qualitative evidence also gathered indicates that can stem from tensions that can arise as a result of delayed or non-payment of retention monies, and by the perception further down the supply chain that retentions are used by main contractors to boost cash flow or act as a means of facilitating discounts.
- **For main contractors: weakened relationships with their clients.** Qualitative evidence also gathered indicates that this can stem from delays in receiving retention monies

²³ Respondents could select more than one response. The four options on the left were listed as options in the questionnaire. The remaining four options were coded from the 'other – please specify' option

30. Qualitative evidence gathered by Pye Tait from interviews with clients and contractors further indicates that retentions can cause 'lack of trust' in the construction sector and damage supply chain relationships. In particular, some respondents reported that the time and effort required to obtain retention monies owed can exasperate this impact on supply chain relationships.

c. Higher costs

31. There is substantial variation in the experiences of contractors with retentions, meaning that it is challenging to draw overall conclusions on their net impacts. However, when respondents to the Pye Tait survey were asked to select from a list of potential impacts of the practice of holding retentions, two of the other most frequently cited responses were:

- **For contractors: higher business overheads where retentions are held against their contracts.** Qualitative evidence also gathered indicates that this may be as a result of time incurred pursuing retention monies owed, and also potentially higher borrowing fees or overdraft charges because of money being removed from cash flow.
- **For clients: costs of construction projects may be higher.** Evidence gathered from another part of the survey indicates that a proportion of contractors increase tender prices to offset the retention. Around 40% of clients surveyed think overall project costs are higher because of retentions, and 18% of contractors say they increase tender prices by an amount equal to or higher than the retention. This will have an impact for wider economy, if reduces competitiveness and or increases client costs.

32. In addition to increasing project costs this is also a potential issue for the sector because, if contractors increase the cost of projects to offset the costs of retentions this also undermines the purpose of retentions to act as an incentive for to complete work to a high standard, that defects will be remedied, and that projects will finish in their allocated time.

d. Constraints to business growth in the construction sector

33. Retentions provide free credit to those clients and main contractors holding retentions. However, this represents a transfer from the construction supply chain. This can place constraints on the supply chain ability to grow and invest.

34. There is substantial variation in the experiences of contractors with retentions, meaning that it is challenging to draw generalised conclusions on their impacts. However, when respondents to the Pye Tait survey were asked to select from a list of potential impacts of the practice of holding retentions, one of the most frequently cited was that business growth of contractors may be constrained. Contractor business growth may be constrained if they have less readily available working capital where monies are held in retention. There would also be an impact for the economy as a whole if construction sector business growth is obstructed.

35. Qualitative evidence that Pye Tait gathered from focus groups and interviews also indicated that, for some contractors, having retentions held from them can weaken their balance sheets through adding aged debt, and that this can impact on their capacity to borrow or cost of borrowing. These costs may be passed on to clients to offset the higher overheads.

Rationale for intervention

36. There can be a number of market failures associated with the practice of cash retentions and their late and non-payment.

Misaligned incentives and market power

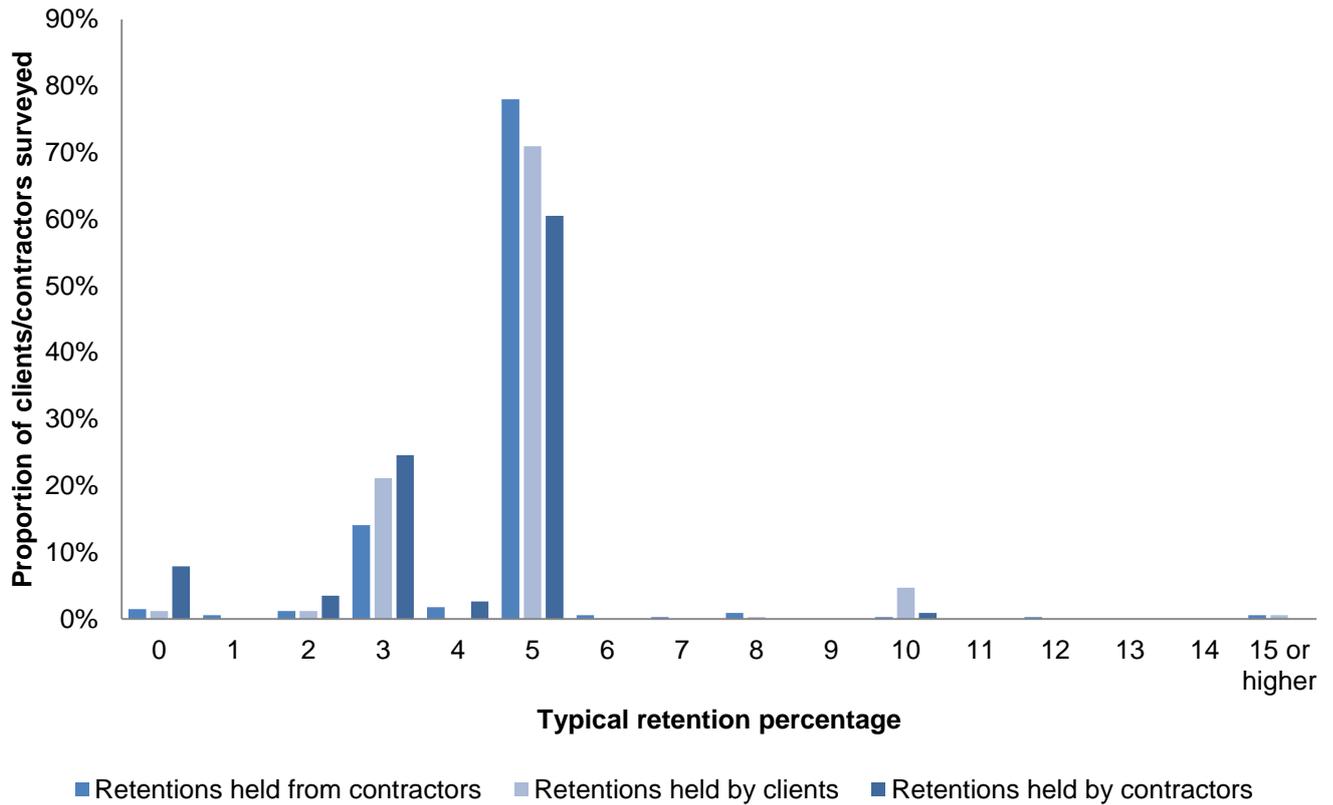
37. As outlined in **Box 2** above, one purpose of retentions is to increase contractor incentives to complete work on time and without defects, and to return to fix any defects that may arise. However, retentions introduce a different set of issues around misaligned incentives.
38. There are principal-agent relationships between clients, contractors and sub-contractors and conflicts of interest between them, for example:
- It will be the customer's role to decide whether defects have been mitigated and pay the retention. However, for clients and contractors holding retentions, there can be clear incentives to hold on to as much cash as possible for as long as possible - for them it is free working capital or money they can earn interest on. This contrasts with the interests of the contractor who is owed the retention money – who will benefit from prompt payment.
 - There can be clear incentives for construction customers to manage retention payments in ways that are beneficial to them - for them it is a source of trade credit to bolster working capital or money they can earn interest on, as well as a way of reducing their project risk. Retentions are a contractual means of holding on to money for extended periods. There may be incentives to set contract terms that enable them to hold on to a higher retention for longer. However, terms which are beneficial to them are likely to be harmful to those from whom they are holding retentions, as they have to wait longer for full payment.
39. Market power of some large clients, main and large tier 2 contractors means that they may be able to manage retention payments in ways which are beneficial to them and harmful to those from whom they are holding retentions. This could be done in two ways:
- **Retention terms:** construction customers may have the market power to set contract terms which are beneficial for them, and which acts as insurance for their risks, but is damaging for the cash flow of downstream contractors.
 - **Late payment and non-payment:** using market power to hold on to retention monies for longer than they should be or not paying retention monies back when it is due.

Contract terms

40. Anecdotal evidence provided to BEIS has indicated that some construction clients, and to a lesser extent main and large tier 2 contractors set retention contract terms which are beneficial to them and harmful for those from whom they are holding retentions. They can do this is by holding a higher retention rate than that which fairly reflects the risk of the project, or by holding on to retentions for longer than necessary as this benefits them by boosting their cash flow. This can have damaging impacts for businesses in the supply chain who are subject to cash retention as this can constrain their cash flow, constraining inhibiting their potential to invest - for instance in growth, in plant and equipment, in training and development or in apprenticeships. This is also likely to be damaging for supply chain relationships.
41. However, data collected by Pye Tait found that the majority of contractors and clients surveyed with experience of retentions in the last three years²⁴ report a typical retention of 5% of contract value. There are instances of much higher retentions being held but these appear to be rare. This is shown in Figure 4.

²⁴ Either holding retentions or having them held

Figure 4: Proportion of construction contractors and clients surveyed reporting each 'typical' retention value

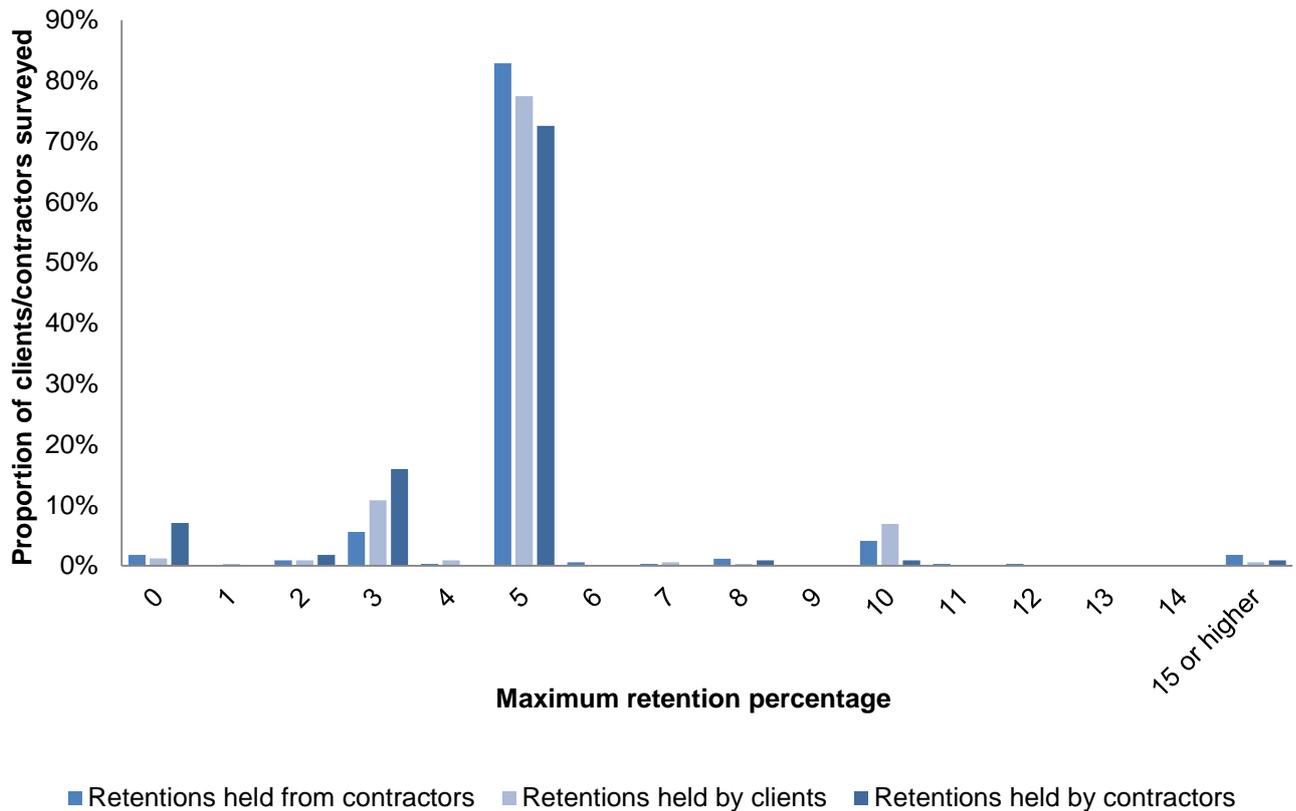


Source: BEIS analysis of Pye Tait survey data²⁵

42. Pye Tait also asked clients and contractors participating in the survey to provide information on the minimum and maximum retention percentages held on their current contracts. Data on maximum retention percentages held also indicates that although retention percentages higher than 5% are sometimes held, and there are instances of much higher retention percentages being held (for example, one client reported a maximum retention for 100%), this appears to be rare. See Figure 5.

²⁵ Sample size: Typical 'retention held from contractors' 341, 'retentions held by clients' 341, 'retentions held by contractors' 114

Figure 5: Proportion of construction contractors and clients surveyed reporting each maximum retention percentage on current contracts

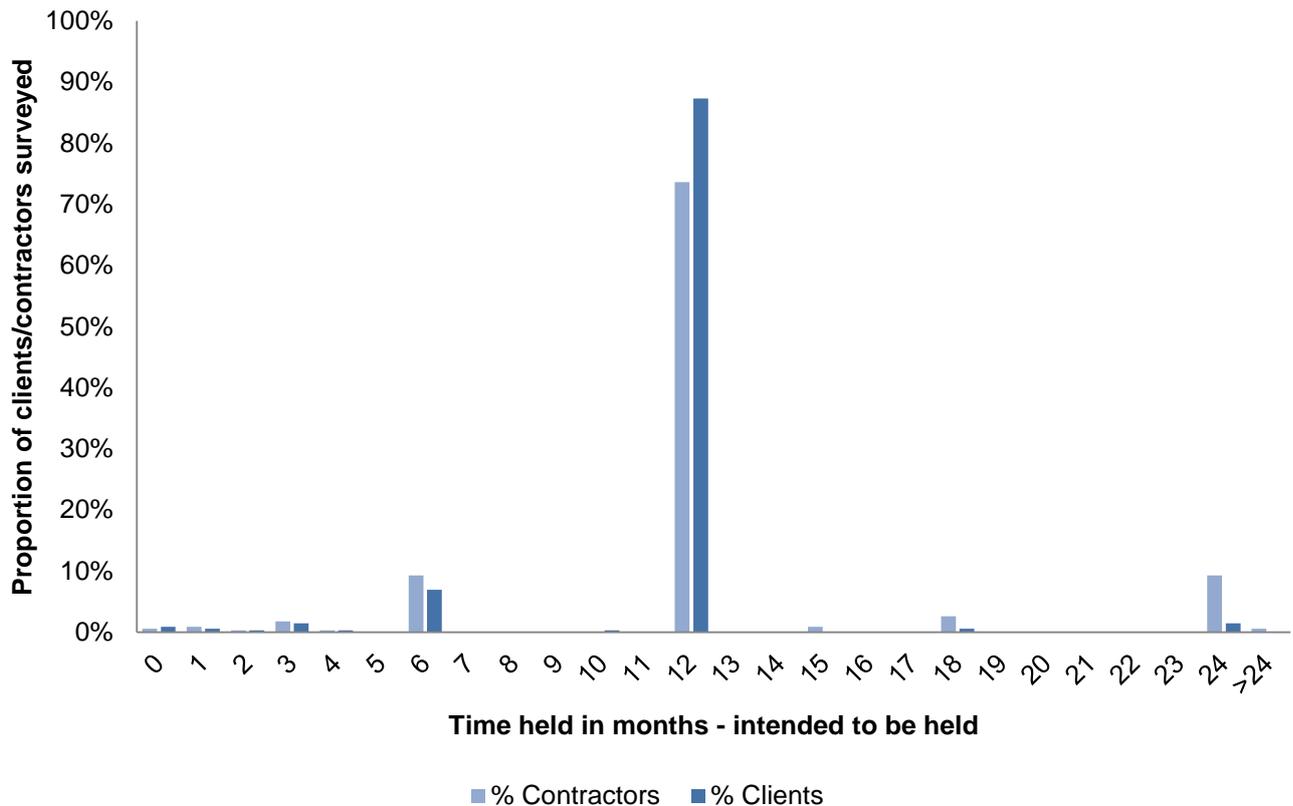


Source: BEIS analysis of Pye Tait survey data²⁶

43. Further, the majority of Pye Tait survey respondents (87% of clients and 74% of contractors) report that intended length of time over which retentions are to be held after completion of the contract (i.e. defects liability period) is 12 months. However, longer lengths of time are reported with 2% of clients and 13% of contractors surveyed report that retentions are intended to be held longer than this, the majority of which reported up to and including 24 months, although higher amounts of 30 and 36 months were reported by contractors in isolated cases. This is shown in Figure 6.

²⁶ Sample size: Minimum 'retention held from contractors' 339, 'retentions held by clients' 333, 'retentions held by contractors' 113

Figure 6: Proportion of construction contractors and clients surveyed reporting each 'typical' length of time that retention is intended to be held after completion of the contract (i.e. defects liability period)



Source: BEIS analysis of Pye Tait survey data²⁷

- 44. There is therefore some evidence of typical retentions being held for longer, or at higher rates than the norm. It is not known from the data gathered, however, whether construction customers are holding these higher retention percentages or holding retentions for longer because it is beneficial to their cash flow and they have the market power to set these terms, or whether the higher retention percentages and longer defects liability periods are a fair reflection of higher project risk.
- 45. Pye Tait (2017) research suggests that retentions are used by construction clients as a form of insurance policy to mitigate risk and higher levels of retentions or longer defects liability periods could, therefore, reflect the fact that they perceive the project to be of higher risk. **See Box 3** for detail.
- 46. It may, therefore, be the case that the higher levels of retention percentages used or longer defects liability periods are a fair reflection of higher project risk, and risk to the client that the work they commission is not completed without defects. Project risk will vary between contract contracts, and the 'right' level of insurance in the form of retention will also depend on the preference of construction customers (i.e. how risk averse they are).

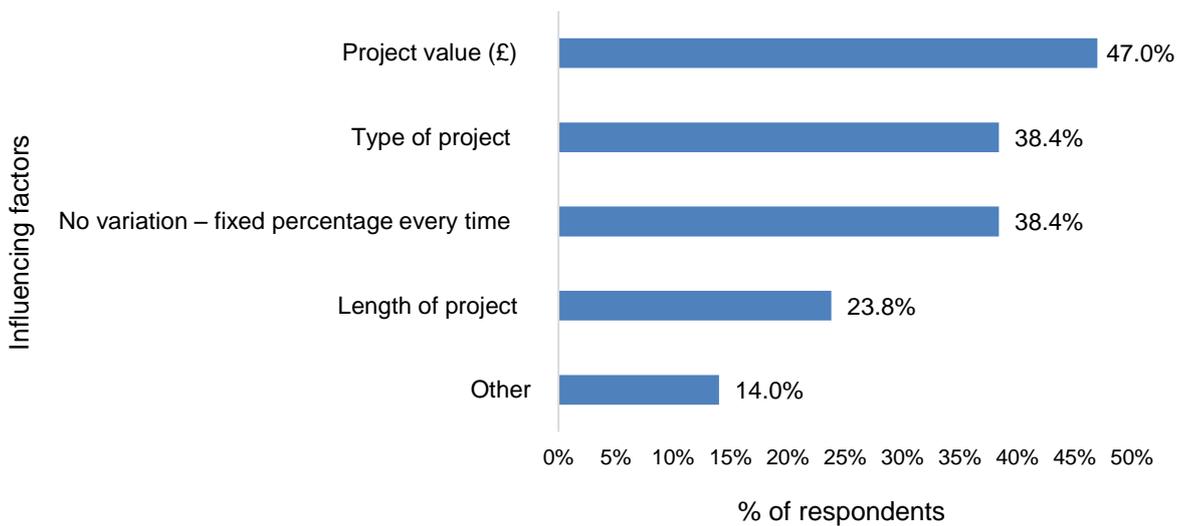
Box 3: Factors influencing the amount of retention typically held (Pye Tait, 2017)

Data gathered by Pye Tait's client survey indicates that factors such as project value, project type and length of project can influence the retention percentage held by a proportion of clients (Figure 7)²⁸.

²⁷ Sample size: 345 contractors, 346 clients

²⁸ This was asked to those clients with experience of holding retentions in the last three years. Respondents could select more than one response.

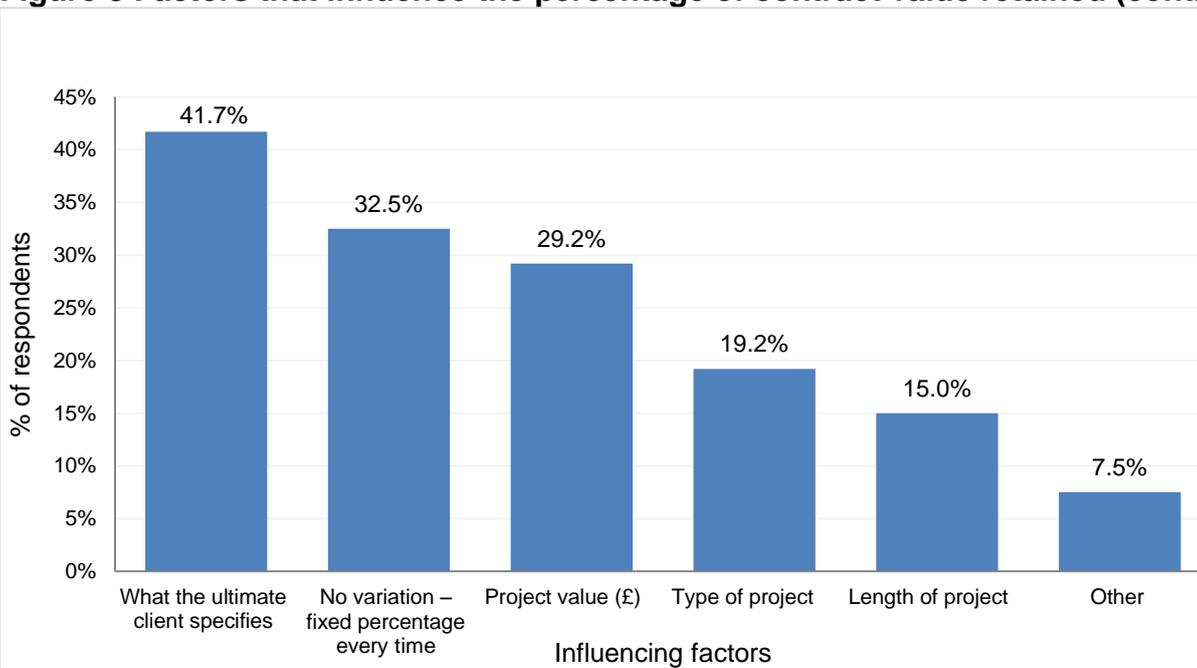
Figure 7: Factors that influence the percentage of contract value retained (client views)²⁹



354 respondents³⁰

Data gathered by Pye Tait’s contractor survey also indicates that factors such as project value, project type and length of project can influence the retention percentage held by a proportion of contractors (Figure 8)³¹.

Figure 8 Factors that influence the percentage of contract value retained (contractor views)



Base 120 respondents³²

Late payment and non-payment:

47. As outlined above, there are misaligned incentives between those holding retentions and those with retentions held against them – on the one hand, there is benefit in holding on to retention monies for as long as possible; while on the other there is a benefit to the other party of prompt payment. Market

²⁹ Pye Tait. (2017). ‘Retentions in the Construction Industry’

³⁰ Respondents were able to select more than one response

³¹ This was asked to those clients with experience of holding retentions in the last three years. Respondents could select more than one response.

³² Respondents could select more than one response

power of clients, main and large tier 2 clients can mean that they may be able to hold on to retention monies for longer than has been agreed in contract.

48. The Pye Tait study found qualitative evidence that suggests that some construction customers may be using their market power to delay payment or not pay back retentions in full, in some instances.

For example, “Qualitative feedback cites the following main reasons for not paying retentions back:

- *sub-contractors ask for their retention monies but do not pursue the claim, and eventually write it off;*
- *“deals are brokered” whereby not all the money is released, in order that the relationship is maintained to move on to the next contract; and*
- *it is alleged (among some tier 2 and 3 contractors) that main contractors or clients hold on to the money for as long as possible for their own benefit and/or to ensure maximum protection against defects.”³³*

Qualitative evidence suggests that sub-contractors may be reluctant to ask for or pursue their retention from a tier 1 company from whom they will need to obtain more work in the future. In other cases they may compromise on the amount owed, in order to receive some of the money rather than wait for it all. The decision to compromise in this way is strongly associated with a desire to maintain a good working relationship with their client (i.e. the main contractor), and avoid the risk of compromising opportunities for future work.”³⁴

Information failures

49. Evidence from the Pye Tait research reinforces what has been heard anecdotally - there are sometimes information barriers in the supply chain that prevent subcontractors accessing the retention money they are due, leading to late-payment and non-payment of retention monies.

50. Qualitative evidence gathered by the Pye Tait research indicates that sub-contractors can be unaware when the project has reached practical completion (which would trigger the release of the first half of the retention). For instance, a groundwork contractor may have left the site over year before the project reached practical completion. The situation can become even less clear with completion of defects liability period which typically occurs 12 months after practical completion.

51. This suggests that the knowledge of the 2011 changes to the Construction Act may not, as yet, be universal across the sector. In particular, those changes mean that it is no longer possible to make payment conditional on the performance of obligations under another contract. Each contract should now be more “self-contained” in terms of payment requirements.

Box 4: Evidence of information failures (Pye Tait, 2017)

“...10% of tier 2 and 3 contractors surveyed report that they have not received retention monies because retention monies were not released by the client so the main contractor declined to pay the subcontractor.³⁵ This is unjustified as 2011 amendments to the ‘Construction Act’³⁶ prevent any contract term which makes payment conditional on the performance of obligations under a superior contract. A number of tier 2 and 3 contractors participating in focus groups illustrated lack of understanding on the implications of the 2011 amendments for payment of retentions.”

³³ Pye Tait. (2017). ‘Retentions in the Construction Industry’

³⁴ Pye Tait. (2017). ‘Retentions in the Construction Industry’

³⁵ This was asked to those sub-contractors with experience of not receiving retention money back in the last three years. It relates to the last three years, and could have occurred in one or more instances during that time

³⁶ The Housing Grants, Construction and Regeneration Act 1996, also known as the ‘Construction Act’

“...it should be noted that a number of tier 3 respondents believe that there is nothing in statute or contract to compel the main contractor or client to inform their contractor that practical completion has actually been achieved, which should trigger the release of half the retention. This was the legislative position prior to the amends to the Construction Act in 2011 but this is no longer the case. This suggests that not all contractors further down the supply chain are fully aware of, and have a clear understanding of, the changes. A number of tier 2 and 3 contractors participating in focus groups also say there is nothing in statute which compels clients and main contractors to advise when the certificate of making good defects has been provided. This is an incorrect perception, as there are provisions within the 2011 Construction Act amendments to address this.”

Dispute Resolution

52. Holders of retentions can just omit to release them.
53. While collectively the amount held in retention is significant, it is typically held in small amounts against specific projects. As discussed above, retention is typically 5% of contract value, with half of this released upon practical completion meaning that 2.5% of contract value is typically held in the defects liability period.
54. Qualitative evidence collected by Pye Tait indicates that legal costs can be prohibitively high for contractors to think it worthwhile to take legal action to obtain outstanding retention monies:

“legal costs can often be too prohibitive to make it worthwhile continuing to chase retention money. The fees for an adjudicator can be between £200 and £400 per hour³⁷, however adjudicators for complex cases may charge more. The fee is agreed with the parties involved³⁸.”

Qualitative evidence from interviews further suggests a highly complex system for claiming back retained money. The contracts can be very ambiguous and the legalities of adjudicators add to the confusion. Depending on the amount to be claimed, and given the relatively high cost of the adjudicator fees, contractors say it may not be worth making the attempt. Therefore there are only a very small number of court cases that relate directly to retentions.”

55. Pye Tait also gathered survey evidence on contractors' experience of taking legal action to obtain outstanding retention monies. This found that in the last three years, approximately 14% of contractor respondents³⁹ that answered the survey question 'Over the past three years, approximately how many times have you gone to court/adjudication to obtain outstanding retention monies?' had gone to court/adjudication in one or more instance. Those small number of contractors surveyed who have taken legal action were asked to provide their estimated costs for this, which equated to an average cost per contractor of £16,300⁴⁰ with a relatively high standard deviation of £23,000. However, very wide variation in the average amount of money held in retention per contract and high variation in average legal costs, and small sample size mean that it is challenging to draw a clear conclusion from the quantitative data on whether legal costs are high relative to the amounts held in retentions.
56. We intend to use the parallel post implementation review of the “Construction Act” to assess the effectiveness of adjudication in handling small disputes, of which disputes about retentions form a small part.

Insolvency

³⁷ <http://constructionblog.practicallaw.com/the-reasonableness-of-the-adjudicators-fee/>

³⁸ <http://www.cedr.com/solve/constructadjud/>

³⁹ This was asked to those contractors with experience of having retentions held in the last three years

⁴⁰ This average is based on 34 respondents who have gone to court in the past three years due to outstanding retention monies, and that provided information on their cost of legal action.

57. Insolvency data shows that there are a high number of insolvencies in the construction sector but that the insolvency rate is not particularly high compared to other sectors⁴¹. However, with retention payments a sub-contractor can typically have to wait for around 12 months after practical completion for the second half of the retention monies to be due (see Figure 6). This delay to payments creates a specific set of issues around insolvency risk:

- **Imperfect information about risk level of client:** sub-contractors may be able to credit check their customers in terms of their current financial standing. However, a sub-contractor can typically wait for 12 for months for a retention to become due for payment. There is very little that they can do to understand what the financial standing of their customer will be so far in the future.
- **Inefficient allocation of risk and principal-agent relationships:** there is very little the sub-contractor can do to manage the risk of the main contractor/client going into administration and therefore not paying their retention monies back. The main contractor will not consider the additional risk to the sub-contractor when considering their own financial risk. The longer a retention payment is withheld, the greater the risk of lost funds from insolvency to would be recipients of retention payments.

58. Evidence collected by Pye Tait indicates that 44% of contractors with experience of having retentions held in the last three years have experienced non-receipt of retention monies due to insolvency of another organisation in one or more instance over this period. However, the retention monies unpaid as a result of upstream insolvencies occurred on only around 1% of all their contracts, over the last three years. Whilst the evidence indicates that the proportion of contracts affected may be small, the total value lost could still be significant. Evidence on frequency and scale of non-payment due to upstream insolvency discussed in more detail under 'Option 0'.

Policy objectives

59. The policy objective is to reduce the incidence of unjustified⁴²:

- late payment of retentions; and
- non-payment of retentions; (for the purpose of this Impact Assessment money unpaid due to upstream insolvencies has been included within this)

This will have the impact of improving cash flow through construction supply chains.

60. The issue under consideration is whether intervention would reduce some of the issues associated with the practice of retentions.

61. The extent of reduction and time frame in which this will be achieved will be determined by the package of measures which are taken forward as a result of the consultation exercise. We intend to use the consultation to gather evidence to support a clear and measureable objective.

62. Government is committed to promote greater fairness and transparency under commercial contracts. The Small Business Commissioner (SBC) builds on a package of measures to tackle late payment and unfavourable payment practices in the private sector. The SBC will enable small businesses to resolve

⁴¹ ONS insolvency service data (for England, Scotland and Wales. Data not available for NI) shows that construction is the sector with the highest number of insolvencies per year (2010-2014). However, there is a high number of enterprises in the construction sector, and if you look at insolvencies per enterprise using ONS ABS (UK) data this, this shows that approximately 1.5% of construction enterprises became insolvent over the 5 year period 2010-2014. This is not particularly high compared to other production sectors (SIC groups A-F).. This indicates that although the number of insolvencies is high in the construction sector, the insolvency rate (i.e. insolvencies per enterprise) is not disproportionately high, given the number of enterprises.

⁴² i.e. unpaid retention that is due according to contract terms.

disputes and avoid future issues by encouraging a culture change in how businesses deal with each other, promoting fair treatment for all. The SBC will handle complaints about payment issues between small businesses (fewer than 50 staff) and their larger customers, and provide non-binding recommendations as to how investigated issues may be remedied, resolved or mitigated. The SBC will also provide general advice, information and signpost users, via their website, to the most appropriate service, which may include directing small businesses to exercise their statutory right to adjudication for disputes under construction contracts. It has always been the intention that the SBC would not duplicate services or processes such as the statutory right to adjudication for construction contracts that were already in existence.

63. Government is also committed to reducing costs and increasing productivity in the construction sector. This is the central theme of the Government Construction Strategy 2016 – 2020⁴³. Pye Tait survey evidence indicates that retentions can be a cause of increased prices in construction – 40% of clients say higher costs and 18% of contractors say higher tender prices when there are retentions. While these proposals are not intended to remove the need for retentions, they do address issues related to their misuse which will remove burdens from the supply chain and thereby reduce the cost. If contractors' confidence that retention payments would be repaid could be increased, there could be a reduction in construction costs.
64. During the passage of the Enterprise Bill (which created the role of the Small Business Commissioner) Ministers agreed with Parliament that the practice of cash retention in construction warranted specific attention given the particular issues which surround it, which have been briefly outlined above. This is because other measures to tackle payment (discussed later under Option 0 – Do nothing) are not specific to retentions and therefore do not directly address the issues the practice can raise.
65. The market failures identified above can all frustrate the achievement of these wider policy objectives. This consultation impact assessment therefore seeks to explore the potential costs and benefits of a range of interventions which each address, at least to some extent, those market failures.
66. As part of the consultation process we intend to consider what set of specific outputs and outcomes will provide the best measure of how successful any interventions have been in achieving policy objectives.

Options subject to consultation

67. These consultation proposals apply to retention payments under contracts for construction work as defined by Part 2 of the Housing Grants, Construction and Regeneration Act 1996. They would therefore not apply to domestic consumers. The proposals apply only to business-to-business transactions because commercial parties are generally knowledgeable of both the legal framework governing construction contracts and also the techniques, processes and materials used in construction. Further, a different dynamic exists in business to consumer contracts with more of the market power and access to relevant information resting with the construction company. The market failures do not therefore exist in quite the same way in contracts with domestic consumers.
68. The Pye Tait research reviewed a number of alternative practices to retentions. These include Project Bank Accounts, Retention Bonds, Performance Bonds, Parent Company Guarantees, Escrow Stakeholder Accounts and Deposit Schemes / Trust Funds. The last aside, Pye Tait indicate that these are likely to be inappropriate for wide scale roll out across the sector. This is for a variety of reasons which either relate to the fact that they fail to cover the complete set of risks dealt with by retention (eg a performance bond may cover the risk of insolvency but not be as effective at dealing with defects) or that they impose unreasonable barriers to entry to barriers to small firms (the cost to procure a bond is higher for smaller contractors).

⁴³ <https://www.gov.uk/government/publications/government-construction-strategy-2016-2020>

69. This consultation impact assessment therefore covers the following options:-

- **Option 0:** Do nothing
- **Option 1:** Improve the exchange of information about retention payments - to address information failures and support more effective dispute resolution
- **Option 2:** Require that retentions are held separately in a retention deposit scheme – to address issues of market power generally and imperfect information and ineffective allocation of the risk of insolvency specifically.

These are discussed in more detail below.

70. A fourth option, a more effective dispute resolution process (and therefore a more effective sanction against late or non-payment) is being considered as part of the parallel post implementation review of the effectiveness of the 2011 amendments to the Construction Act. An objective of those amendments was to reduce the cost of adjudication and increase its effectiveness. While any cost reduction would clearly be of benefit to the specific issues of retention (in effect by creating a more effective sanction against the non-payment of a retention), it is important to consider the question in the context of all disputes under construction contracts not only those relating to the 5% of the contract sum typically held in retention. We will nonetheless ensure that any changes introduced as a result of the Post Implementation Review are developed with consideration of any specific issues driven by the practice of cash retention.

71. A fifth option, a cap on the proportion of contract value that can be held as retention and the length of time that retention can be held has also been considered. However, Pye Tait research indicates that there is not any evidence of a large proportion construction customers systematically setting retention terms which are longer, or at higher rates, than may be necessary to provide the required “insurance” for the contract in question, in order to boost their cash flow. Evidence suggests that a higher retention percentage is rare and is likely to be a reflection of a higher risk project that requires a higher level of “insurance”. We intend to test this hypothesis through consultation. Analysis also indicates that introducing a cap could reduce the amount of retention held on some contracts but could resultantly increase the retention held on others, if construction contractors wished to maintain their cash flow. There is a risk that introducing a cap could also risk introducing other unintended consequences such as all contracts moving towards using a retention percentage equal to the cap.

72. We intend to use the consultation to consider whether the options that have been analysed are appropriate and to test the Pye Tait analysis of the alternatives to retentions. This will then be used to develop an implementation plan, and be used to inform policy making and decision making on what the ‘preferred option’ should be in the Final Impact Assessment.

73. Given that the appropriate appraisal period is not yet identifiable at this consultation stage, a ten-year appraisal period has been used for the analysis in this Impact Assessment.

Proportionality of approach

74. This consultation stage Impact Assessment largely draws on evidence from the research project “Retentions in the Construction Industry”, conducted by Pye Tait (2017) on behalf of the Department for Business, Energy and Industrial Strategy, in order to develop the evidence base on the use of retentions in the construction sector. This has provided a source of evidence to inform understanding of the existence of market failures, and where the rationale for intervention lies, as well as evidence to inform understanding of the scale of some of the costs and benefits of the options considered. However, there are still a number of evidence gaps and further research questions that have been identified.

75. This consultation impact assessment has developed the analysis as far as possible, given the evidence currently available. Full quantification or monetisation of the majority of impacts identified will not be possible until we have filled the key evidence gaps that have been identified. The key research questions that remain unanswered have now been identified and we plan on addressing them through consultation, subject to stakeholder engagement and cooperation. These evidence gaps and research questions are discussed in more detail throughout the impact assessment and in the accompanying consultation document.

Analysis of policy options

Option 0: 'Do Nothing'

1. The market failures at hand are: imperfect information, imbalance of market power; principal-agent relationship between clients and contractors, and contractors and sub-contractors; misaligned incentives; the effectiveness of dispute resolution processes in dealing with (a potentially large number of) comparatively low value disputes; and the ineffective allocation of the risk of insolvency between clients and contractors, and contractors and sub-contractors.
2. The economic activity within the construction sector involves numerous principal-agent relationships between clients and contractors, and contractors and sub-contractors, in which each has incentives to act according to their own self-interest.
3. These can become accentuated with the practice of cash retention. For instance, it can be the case that the money is held for prolonged periods after it is due for payment, in part because of a perceived lack of clarity about the date and amount of payment which is due, but also due to possible issues of market power. Further, there are concerns about the effectiveness of the existing dispute resolution procedures in dealing with low value disputes. In addition, a further concern is that it may be extremely difficult for the sub-contractor to manage his exposure to the risk of insolvency of his customer where payments are subject to such extended payment periods.
4. These specific failures reflect the findings identified by the Pye Tait research into the costs and benefits of retentions and are being further explored, along with proposals to address them, through this consultation and through the parallel post implementation review of the 2011 amendments to the Construction Act.
5. That said, retention is one of a number of payment issues in construction and there are a number of measures in place to improve payment performance more generally, including:
 - *The Prompt Payment Code*
6. This is a voluntary measure which sets standards for payment practices. Given the unique characteristics of the construction sector, a construction specific version has been developed (the Construction Supply Chain Payment Charter) and is being promoted by Build UK (the leading trade association in the construction contracting sector) and the Construction Leadership Council. The Construction Supply Chain Payment Charter has an ambition for signatories to remove retentions by 2025 but does not set out how this will be achieved.
 - *The Government Construction Strategy 2016-2020*
7. This strategy sets out the Government's plan to develop its capability as a construction client. It has a number of themes, including collaborative procurement and embracing fair payment. It is particularly relevant to the question of retentions on two grounds. Firstly, it promotes the forms of collaborative procurement and partnership which the Pye Tait evidence identified tended to be accompanied by a reduction in the use of retentions. Secondly, it reinforces the Government's commitment to use Project Bank Accounts where appropriate.
 - *Project Bank Accounts*
8. Project Bank Accounts (PBS's) are a ring-fenced bank account from which payments are made directly and simultaneously by a client to members of the 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.

- *The Public Contracts Regulations 2015.*

9. These regulations, amongst other things, require public sector organisations to pay undisputed invoices within 30 days and ensure that this requirement is passed down the supply chain. This will apply to retention payments through the supply chain on public sector contracts once the due date has arisen.

- *The Reporting on Payment Practices and Performance Regulations 2017*

10. These (and related) Regulations introduced a duty on the UK's largest companies and limited liability partnerships to report on a half-yearly basis on their payment practices, policies and performance. The information must be published through an online service provided by the Government, and will be available to the public.

11. These measures represent a broad engagement with potential solutions to the broad issue of payment in construction, of which cash retention can be part. However, we do not believe it addresses some of the specific challenges with retentions and this is particularly the case in the short to medium term. This is for a number of reasons.

12. The Prompt Payment Code Construction Supply Chain Payment Charter⁴⁴ sets a 2025 deadline for the removal of retentions from the sector. While this is an important part of the suite of measures to improve payment practices in the construction industry generally, it is a voluntary initiative and can therefore only really work with the grain of industry practices. Even if a business was to sign up to the Charter, it would not be committed to do anything until the 2025 deadline. There are currently 37 signatories to the Construction Charter with a further 429 construction signatories to the overarching Prompt Payment Code.

13. The Government Construction Strategy 2016 - 2020⁴⁵, refreshed in March 2016, is driving culture change among government construction clients, and in the industry response. New models of procurement are being trialled on government construction projects and data is being gathered to measure and monitor their effectiveness. This also includes promoting more collaborative and integrated forms of working on public sector construction projects. Furthermore these models have been acknowledged by the Government's Crown Commercial Service. While it is the belief, borne out by the Pye Tait research, that such forms of procurement can remove the need for retentions, that outcome is not necessarily a direct consequence. It is also the case that public sector procurement accounts for only about 25%⁴⁶ of total construction output.

14. Project Bank Accounts are also promoted through the Government Construction Strategy. PBAs are a ring-fenced account which provides security and certainty of payment to the supply chains. Payments are made directly from the account to contractors, key sub-contractors and key suppliers. Research by Pye Tait indicates that while PBAs might offer some protection where there is an insolvency, they are unlikely to be a feasible alternative to retentions across the whole of the construction sector given the costs associated with setting them up and their subsequent administration.

15. The Public Contract Regulations 2015 are not construction specific. The commitment to 30 day payment terms, and to cascade this requirement through the supply chain, should be a helpful step in

⁴⁴ Construction Supply Chain Payment Charter
<http://www.promptpaymentcode.org.uk/cscpc.htm>

⁴⁵ Government Construction Strategy 2016 2020
<https://www.gov.uk/government/publications/government-construction-strategy-2016-2020>

⁴⁶ ONS, Construction Statistics Annual Tables (2016). Value of construction output by type of work. Calculated using 2015 data.

using public sector procurement to promote better payment practices across the board. However, as regards to cash retention specifically, they have limited impact. The requirement to pay within 30 days will only “bite” following the retention payment’s “due date”. That said, they will address some of the issue around late and non-payment of retentions, albeit on only 25%⁴⁷ of the industry’s workload.

16. The Reporting on Payment Practices and Performance Regulations 2017 are not construction specific. The purpose of this reporting is to increase transparency around large businesses’ payment practices and performance, helping suppliers, including small businesses, make better informed decisions about which businesses they trade with and encouraging businesses to improve their payment practices.
17. Individually and collectively, we do not therefore consider that these measures are sufficient on their own to address the key issues which arise from the practice of cash retention in construction, though we intend to test this position on consultation. Under consideration in this Impact Assessment is whether intervention would reduce some of the issues associated with the practice of retentions, and whether the benefits from any intervention would outweigh any costs.
18. The ‘Do Nothing’ option has been analysed as the counterfactual so there are no additional costs of this Option 0. However, the cost of maintaining the status quo would be to fail to address the weaknesses which research has identified can be associated with the practice of cash retention in construction, and continued late and non-payment of retention monies. There is a risk that this may threaten the viability of individual businesses, and particularly small specialist supply chain businesses, thereby undermining the long term health of the construction industry.

Unjustified late and non-receipt of retention money

76. Under the ‘do nothing’ option there will be an ongoing cost to the supply chain (transfer from the supply chain to those holding retentions) from unjustified late payment and non-payment of retention monies.
77. Evidence collected by Pye Tait indicates that delays in retention monies are commonplace and that not all retention monies are being paid back. This is discussed in more detail under ‘Rationale for Intervention’ above. However, it is not known from this what proportion of the late-payment and non-payment relates to justified late or non-payment relating to work not being completed to standard, and how much is unjustified.
78. Subject to stakeholder engagement with the consultation, we intend to gather views on:
 - The frequency with which retentions are unjustifiably withheld
 - The frequency with which payment of retention is unjustifiably delayed
 - The average length of unjustified delayed payment of retentions
79. This will help improve Government understanding of industry views on the incidence of unjustified late and non-payment of retentions. However, information gathered will reflect the opinions expressed by participants and it will be difficult to robustly measure unjustified late or non-payment or draw conclusions from this. As discussed in more detail in the Pye Tait research and under ‘Rationale for Intervention’, robust measurement of the incidence of unjustified late and non-payment is problematic because of the differences in opinion that can exist as to what constitutes ‘unjustified’ among clients, main and sub-contractors.

⁴⁷ ONS, Construction Statistics Annual Tables (2016). Value of construction output by type of work. Calculated using 2015 data.

80. Subject to industry engagement, we intend to use consultation to explore whether a robust methodology exists for measuring incidence of unjustified late and non-payment of retentions in the construction sector.
81. If possible, subject to the robustness of evidence gathered through consultation, we will aim to produce an illustrative monetary estimate for total unjustified non-payment per year, through multiplying the proportion of contracts where retention is unjustifiably not paid, by the average proportion of retention unjustifiably not paid per contract, by the estimated amount held in retentions across all construction contracts per year. Subject to industry engagement, we intend to use consultation to explore whether this is an appropriate methodology.
82. If possible, subject to the robustness of evidence gathered through consultation, we will aim to produce a monetary estimate for total unjustified late-payment per year, through multiplying the proportion of contracts where retention payment is unjustifiably delayed, by the estimated amount held in retentions across all construction contracts per year. Subject to industry engagement, we intend to use consultation to explore whether this is an appropriate methodology.
83. It should, however, be noted that any improvement in supply chain cash flow as a result of intervention would be matched by an equal reduction in the cash flow of main contractors and clients that hold retentions, and do currently not pay retentions back either in part or full when they should be due. Any intervention which corrected for unjustified late-payment and non-payment would, therefore, be a transfer and have zero net impact across all parties to construction contracts. It would, however, improve fair payment and have important distributional impacts. It could also strengthen the effectiveness of retentions as an effective deterrent against poor quality work, and reduce the incentives for contractors to increase the cost of their tender prices to offset the value of the retention.

Cost to the construction sector from non-payment due to upstream insolvencies

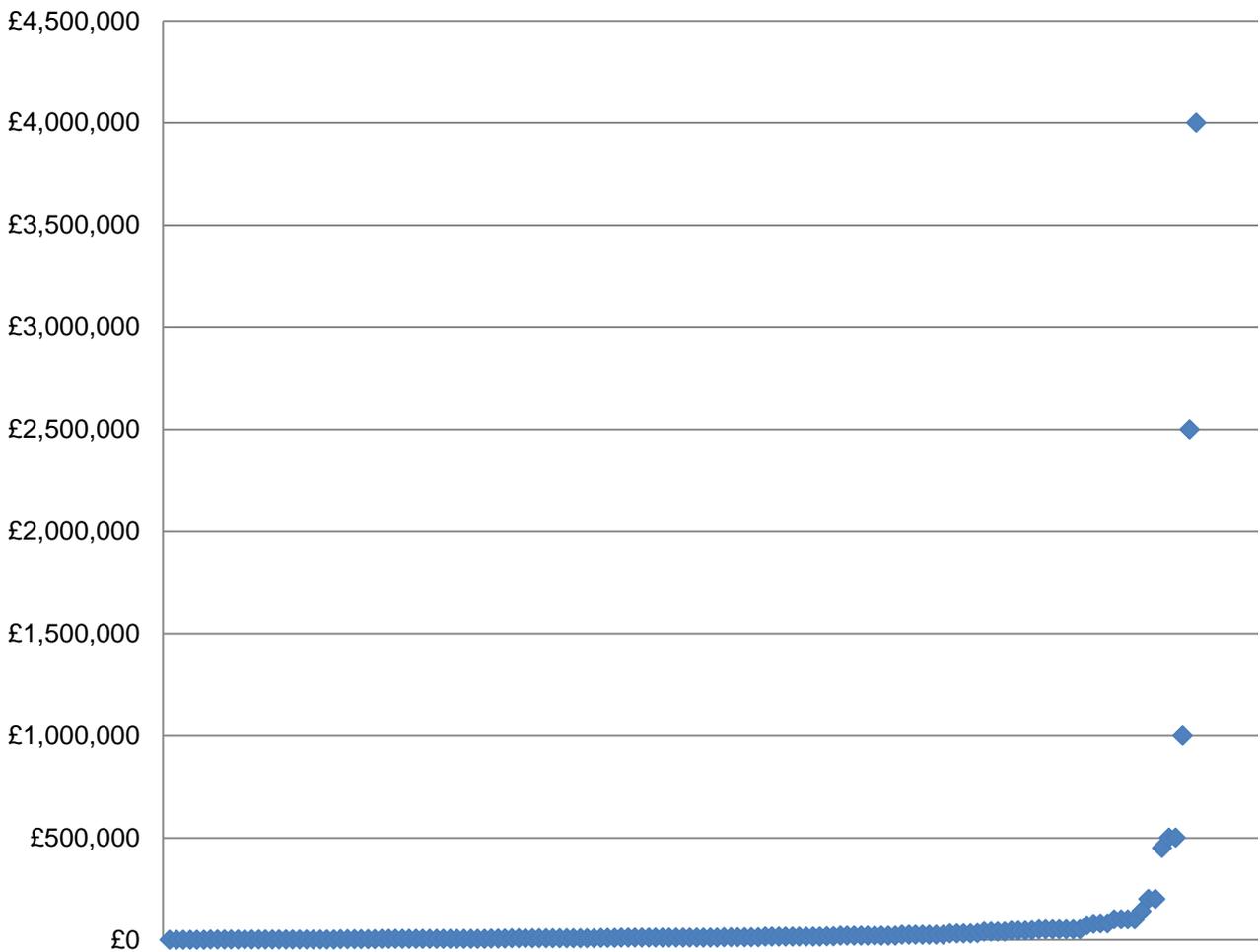
84. Under the 'do nothing' option there will be an ongoing cost to construction contractors from non-receipt of retention monies due to upstream insolvencies.
85. Pye Tait survey data indicates that 44% of contractors with experience of having a retention held from them in the last three years have experienced non-payment of retention monies owed to them due to insolvency of another organisation at least once over the last three years. There is wide variation between respondents but, on average, those contractors experienced upstream insolvencies 4.2 times each, resulting in non-payment due to insolvency of another organisation on around 1% of all of their contracts (i.e. including those without retentions held) over the past three years⁴⁸.
86. The mean average amount lost per contractor (i.e. across all their contracts) with experience of non-payment for this reason over the three years is approximately £79,900, with the average amount lost per instance of non-payment due to insolvency being approximately £27,300. However, there is wide variation in the losses reported and these mean values are skewed by a small number of respondents reporting very high values⁴⁹. Figure 9 illustrates the wide distribution of amounts lost reported per contractor.
87. This shows that that some contractors have experienced non-payment of very high values of retentions due to insolvency of other organisations over the last three, with values as high as £1 million, £2.5 million and £4 million each being reported by one contractor (i.e. across all their contracts). However,

⁴⁸ This 1% figure was calculated by comparing the total number of contracts where upstream insolvencies were experienced with the overall number of contracts of the past three years across all contractors with experience of having retentions held from them in the past three years.

⁴⁹ Verified by Pye Tait as correct survey responses, some companies have just reported experiencing a high value of non-payment due to insolvency.

the median values lost are far lower at £10,000 per contractor, and £4,000 lost per instance of insolvency. Given how skewed this data is the median is a better measure of the typical amount unpaid.

Figure 9: Scatter plot: Amount lost per contractor (i.e. across all their contracts) due to insolvency of another organisation over the last three years



Source: BEIS analysis of Pye Tait contractor survey data⁵⁰

88. This survey data on the median amount lost per contractor due to insolvency of another organisation can be used to produce a bottom-up estimate for the total amount of retention money lost per year in the construction sector due to upstream insolvencies.⁵¹ This is explained in the diagram below:

⁵⁰ Sample size: 151 contractor respondents

⁵¹ It has been assumed that this money has been lost due to insolvency of a contractor or client upstream to them in the supply chain.

229,060 construction contracting enterprises in England

- In 2014, there were 229,060 enterprises in the construction contracting sector in England (ONS, ABS)

Estimated 158,510 of these had retentions held from them in the last three years

- Pye Tait found that approximately 69% of all participants in their contractor survey had experience of having retentions held from them in the last three years.
- Multiplying the number of construction enterprises in England by 69% can, therefore, be used to estimate the total number of these with experience of having retentions held from them in last three years.
- This gives a figure of 158,510 construction contracting enterprises.

Estimated 69,744 of these have experienced non-payment of retention due to insolvency of another organisation in the last three years

- Pye Tait's contractor survey also found that 44% of these contractors, with experience of having retentions held in the last three years, have experienced non-payment of retention monies due to insolvency of another organisation.
- Multiplying 158,510 by 44% can, therefore, be used to estimate the total number of construction contractors who have experienced non-receipt of retention money due to insolvency of another organisation (in one or more instance) over the past three year.
- This gives a figure of 69,744 construction contracting enterprises.

Multiplying by the median amount lost, this gives an estimate of £686 million unpaid over three years due to upstream insolvency (in 2015 prices)

- As discussed above, the median amount lost per contractor (i.e. across all their contracts over the past three years) is £10,000 (£9,830 in 2015 prices).
- This can be multiplied by 69,744 to produce an estimate for the total amount of retention monies unpaid to construction contractors across the whole construction contracting sector in England due to upstream insolvency, over the past three years. This gives a figures of £697 million over three years in 2016 prices, (i.e. when the survey was conducted) and £686 million when deflated to 2015 prices using ONS GDP deflators

Divided by three this gives an estimate for the total amount unpaid due to upstream insolvency in one year of £229 million (in 2015 prices)

- Dividing £686 million by three gives an estimate for the amount of retention money lost by construction contractors due to upstream insolvencies in one year.
- This gives a values of £229 million per year in 2015 prices.
- This assumes that the amount typically lost per incidence does not change over time. It also assumes that the same number of construction contractors experience non-payment due to insolvency each year. This is unlikely to be the case but this is a best estimate given the snapshot of information given by the Pye Tait survey.

89. This estimate is based on the median value lost by contractors of £10,000 (in 2016 prices) because, as outlined above, the mean is skewed by a small number of particularly high reported values so the median is a better indicator of the typical amount lost.

90. Subject to stakeholder engagement, we intend to use the consultation to gather views on whether this is a suitable methodology for estimating the total amount lost by construction contractors due to

insolvency, and further evidence on the extent to which non-payment of retention monies due to upstream insolvencies is an issue for the construction sector.

Option 1: Clarification of impact of 2011 amendments on retentions

91. An amendment to the “Construction Act” made in 2011 means that it is no longer possible to make payment conditional on the performance of obligations under another contract. Each contract should now be more “self-contained” in terms of payment requirements, thereby improving clarity and transparency for the party receiving payment of when it will become due and its amount.
92. Evidence collected by Pye Tait shows that some businesses in the construction industry do not yet understand, or have no knowledge of, the potential impact of that amendment on retentions. Pye Tait report that, in some cases, the parties to a construction contract can still believe that the retention money is only due when all defects project wide have been corrected and the relevant certificate has been issued under the main contract. A number of tier 3 respondents to their qualitative research said that there was nothing in statute to compel the main contractor or the client to inform their supplier that the main contract has been satisfactorily completed.
93. The effect of this lack of knowledge or understanding is a continued lack of clarity about the timing and amount of a retention payment.
94. This option therefore suggests that the Government and the Construction Leadership Council (CLC) work with relevant industry representative bodies to improve industry understanding of the impact of the 2011 amendments on retention payments. This will be most effectively achieved as part of wider CLC and representative body work on prompt payment initiatives. This proposal would have the following benefits:
- **Improving prompt payment of retentions through overcoming information failures.** Bringing forward industry knowledge of the 2011 change should reduce the incidence of making payment of retentions conditional on the performance of obligations under another contract. This would only directly impact on the proportion of the construction industry and construction clients that are not already familiar with the revised Construction Act.
 - **Bringing forward reduced costs of adjudication** which will result from reducing the need, or the time taken, for the adjudicator to further consider two key questions: is payment due; and, notionally, how much is due. Again, this benefit would only accrue to those not already familiar with the revised Construction Act.
 - **Reducing the exposure of a party against which a retention is held of not receiving that payment due to upstream insolvency**, where a retention is currently held for longer due to a lack of clarity about the timing of the money’s release. This is because the longer a retention is held, the greater the risk that the party holding the retention will become insolvent.
95. However, this proposal will not tackle other underlying issues such as those associated with possible abuse of market power or insolvency.

Background

96. Under the “do nothing” scenario we would expect only slow change in the extent of understanding of what the 2011 amendments mean for retentions. Those changes are now over five years old and evidence gathered by Pye Tait suggests that it remains the case that many businesses do not

understand their relevance to retention payments.⁵² It is assumed that in time all businesses would eventually understand the changes. However, it is not possible to determine, given the limited evidence available, how long this might take in the absence of intervention.

97. A promotional effort would bring the benefits of the 2011 amendments more quickly to the fore. Increasing industry awareness of the changes will provide a greater certainty of entitlement to payment and may make people either more likely to pay, or more likely to seek redress through adjudication.
98. Through formal and informal consultation with industry we intend to seek to establish the value of wider, industry led, Government supported promotional campaign. In particular, subject to industry engagement, will aim to gather information on:
- What proportion of construction contracts are still making payment of retention conditional on performance under another contract.
 - What proportion of this is because of an information failure i.e. because parties to the construction contract are unaware that payment cannot be made conditional on performance under another contract.
 - Which contractors and construction clients (e.g. by industry sub-sector, size etc) are most likely to be unaware.
 - What is the likely to be the best approach for making sure that these contractors and clients are made aware of what the 2011 reforms to the 'Construction Act' mean for retentions.

Costs

One-off cost

99. There will be a one-off cost to industry representative bodies and Government of producing guidance on how the 2011 Construction Act reforms relate to retention payments, and then communicating this to the construction industry and clients.
100. We would hope to use existing industry knowledge and networks to minimise the cost of this. This will be the subject of informal consultation with industry bodies and relevant Government officials.
101. At this consultation stage it is not known what proportion of the construction sector are not familiar the 2011 Construction Act reforms and how they relate to payment of retentions. It is, therefore, not known at this stage what guidance and communication approach would be most suitable. Given this uncertainty it has not been possible to estimate the scale of this cost. Through consultation we will aim to gather evidence on the scale this issue and what parts of the construction sector it affects most. The intention will then be to use this information to understand what other previous information campaigns may comparable, and can then use this to produce estimates of this cost in the final impact assessment.

Industry familiarisation costs

102. This option would require construction contractors and repeat construction clients who use retentions, and are not already familiar with what the 2011 amendments mean for retentions, to familiarise themselves with the guidance. This represents a cost to industry as they will need to spend time familiarising themselves with the guidance.

⁵² In contrast the 2011 Construction Act reforms Impact Assessment assumed that all construction contractors would familiarise themselves with the reforms in the year that they were introduced.

103. Discussions with industry stakeholders to inform the 2011 'Construction Act' impact assessment indicated that it would take industry no more than 1hr per enterprise to familiarise themselves with the amendments as a whole. Using Office of National Statistics data, the average hourly rate for a construction manager in the UK is approximately £23 per hour (in 2015 prices)⁵³. The estimated familiarisation cost per construction enterprise for the 2011 revision to the Construction Act as a whole is therefore £23.
104. Given that prohibiting payment by reference to other contracts is one out of the seven key changes to the 'Construction Act' in the 2011 amendments (see Table 1 in the 2011 Impact Assessment), it has been assumed that it will take contractors one seventh of an hour to familiarise themselves with what the 2011 amendments mean for retentions under Option 1. This equates to approximately 9 minutes, at a cost of £3.29 per contractor. This is unlikely to be an accurate assumption, however, is a best estimate given that information is not available proportion of the familiarisation time from the 2011 'Construction Act' reforms that relates to retentions.
105. However, only a small proportion of this familiarisation cost would be additional under Option 1. This is because it is assumed that in time all businesses would eventually understand the changes under the 'do nothing' counterfactual. The impact of Option 1 would be to bring forward when construction contractors incur this familiarisation cost. The only additional cost will be due to differences in discounting – i.e because it is assumed that costs incurred further in the future are valued less than costs incurred in the present.
106. Analysis indicates that this additional cost would be very small. For example, if the £3.29 cost was incurred in 5 years' time it would have a discounted present value of £2.77. In present value terms there would be a small cost to construction businesses of £0.52 from incurring this cost 5 years earlier. However, this would be assuming that the average hourly rate for a construction contractor remained constant over time, and there was no wage inflation. Estimated additional familiarisation costs are, therefore, assumed to be negligible.

Ongoing costs

On-going cost to construction industry and clients

107. The 2011 reforms to the Construction Act requires contractors (or construction clients) to issue a payment notice to the sub-contractor setting out what will be paid and when, where a contractor was previously able to rely on a notice issued under his contract with the client. This represents a cost to the main contractor from having to issue the payment notice or withholding notice. The Impact Assessment accompanying the 2011 Amendment estimated that the average cost per payment or withholding notice was £25 in 2005 prices (approximately £30 in 2015 prices).⁵⁴
108. Option 1 would bring forward the date from which those businesses that are currently not aware of what the 2011 amendment to the Construction Act mean for retentions begin to issue these payment notices to sub-contractors, and start incurring the associated costs.
109. The scale of additional cost of Option 1 would depend on the difference between how long it would take relevant businesses to become aware of what the 2011 amendments mean for retentions under the 'do nothing' scenario, and how this compares to Option 1. In order to analyse the possible scale of

⁵³ £23.04 - data comes from the UK ONS Annual Survey of Hours and Earnings (ASHE) 2015 provisional (£19.17 per hour for 'Production managers and directors in construction', SOC code 1122), uprated by 20.2% to take into account of non-wage labour costs, as per general BIS practice.

⁵⁴ Figure came from responses to Improving payment practices in the construction industry, June 2007. The Impact assessment accompanying the 2011 amendment indicates that this £25 is the estimated cost in 2005 prices.

this cost more evidence is needed on what proportion of the construction sector are not already familiar with what the 2011 amendments mean for retentions, and are still making payment of retention monies contingent on performance under a superior contract.

110. If possible, subject to the robustness of evidence gathered through consultation, we intend to use the 'Construction Act' PIR consultation to gather more evidence on:

- The frequency with which payment of (each half of) the retention is still being made conditional on the performance of obligations under another contract (i.e. the number of contracts with pay-when-certified clauses);
- the proportion of construction clients and contractors that are not aware of the implication of the 2011 amendment for retentions and "conditional" payments;
- How quickly we can expect the parts of the constructions sector affected by this information failure to become familiar with the reforms, in the absence of intervention.

111. If possible, subject to the robustness of evidence gathered through consultation , we intend to estimate total additional costs of issuing payment notices under Option 1 through:

- Producing an annual cost estimate by multiplying the estimated number of contracts per year which still include pay-when-certified clauses for retentions, by the estimated average cost per payment or withholding notice.
- This cost will only be additional for the number of years that it is assumed to take, on average, for those who are not familiar with the reforms to become familiar with them in the absence of intervention.
- Total costs will be the estimated annual cost multiplied by the number of additional years that they will be incurring this annual cost for.

Cost to construction customers from improved clarity of when payment is due, and reduced adjudication costs

112. As discussed in more detail under 'Benefits', the intended impact of Option 1 would be to reduce late payment of retention monies through clarifying when retention money should be released, and making adjudication simpler. This would represent a transfer from those who hold retentions, to those with retentions held from them.

113. This would represent a cost to construction customers that hold retentions and are not already familiar with what the 2011 'Construction Act' means for retentions. This is because reducing late payment also reduces how long corresponding construction customers are able to hold on to retention monies for. Retention monies represent free trade credit for construction customers. If they are unable to hold on to retention monies for as long this will be damaging for their short term cash flow and they could potentially need to find credit from elsewhere in order to maintain their current level of expenditure. However, the impact of Option 1 is a transfer of retention monies to the rightful business under the 2011 reforms to the 'Construction Act'.

Benefits

Reduced late payment of retention monies through improved clarity and certainty of cash flow for construction contractors, and reduced adjudication costs

114. The 2011 reforms to the Construction Act means that contract terms cannot make payment conditional on the performance of an obligation under a superior contract. The intention of this is to provide greater clarity and certainty of cash flow for construction contractors, in particular small and micro firms in the supply chain.

115. Through making communication of the amount due under the specific contract clearer this also aims to make the adjudication process simpler and more transparent – i.e. you are removing the need for the adjudicator to determine whether a dispute properly exists under the contract in question relating to making payment conditional on performance under another contract.

- This should lead to a reduction in adjudication costs - the 2011 'Construction Act' reform impact assessment estimated that 50% of adjudication cost is spent determining the time and amount of the dispute when it is not clear.
- It is also likely to reduce the number of disputes, as there would be clearer common understanding amongst businesses of when the retention is due.

116. Option 1 would bring forward the date from which those businesses affected by the existing information failure become familiar with the 2011 amendments of the Construction Act, delivering the benefits outlined above, in terms of prompt payment and reduced adjudication costs.

117. The scale of additional benefit of Option 1 would depend on the difference between how long it would take relevant businesses to become aware of what the 2011 amendments mean for retentions under the 'do nothing' scenario, and how this compares to Option 1. In order to analyse the possible scale of this additional benefit more evidence is needed on what proportion of the construction sector are not familiar with what the 2011 amendments mean for retentions and are still making payment of retention monies contingent on performance under a superior contract.

118. If possible, subject to the robustness of evidence gathered through consultation, we intend to use the consultation to gather more evidence on:

- The frequency with which payment of (each half of) the retention is still being made conditional on the performance of obligations under another contract (i.e. the number of contracts with pay-when-certified clauses), and the impact of this on late payment.
- The proportion of construction clients and contractors that are not aware of the implication of the 2011 amendment for retentions and "conditional" payments;
- How quickly we can expect the parts of the constructions sector affected by this information failure to become familiar with the reforms, in the absence of intervention.
- The frequency with which disputes arise as a result of construction clients making payment conditional on performance under another contract.
- What proportion of adjudicator time is spent (per dispute relating to retentions), determining whether a dispute properly exists under the contract in question, as a result of the information failure.

119. Through wider consultation on the 2011 Reforms to the Construction Act we will also aim to determine whether the intended benefits from a simpler and more transparent adjudication process have been realised.

120. If possible, subject to the robustness of evidence that is gathered through consultation, we intend to calculate the scale of the **transfer of benefits to the supply chain from improved prompt payment** through:

- Estimating the total amount paid late by multiplying the proportion of contracts where retention is paid late due to information failure, by the estimated amount held in retentions across all construction contracts per year in England.
- Presenting this alongside information on the average payment delay resulting from construction customers making payment conditional on performance under another contract. The benefit from Option 1 will be in terms of the construction supply chain not having to wait this additional amount of time before they are paid their retention monies. Discounting can be used to value the delay in payment.
- There would be a transfer of benefit from those who hold retentions to the supply chain from this improved cash flow. The supply chain would have the option to use this elsewhere in their business, or may be able to reduce their borrowing from other sources as a result. There would be zero net impact on the construction industry as a whole; however, there would be important distributional impacts.
- The benefit transfer, in terms of improved cash flow, will only be additional for the number of years that it is assumed to take, on average, for those who are not familiar with the reforms to become familiar with them in the absence of intervention. Benefits should only be counted for those years.

121. If possible, subject to the robustness of evidence gathered through consultation, we intend to estimate **benefits to the supply chain from a reduction in the number of disputes, and a simpler and more transparent adjudication costs** through:

- Estimating the benefit from a reduction in the number of disputes by multiplying the estimated cost per adjudication by the number of adjudications arising purely as a result of clients making payment of retention conditional on performance under another contract.
- Estimating the benefit from making other adjudications simpler by:
 - Estimating what proportion of adjudicator time is spent (per dispute relating to retentions), determining whether a dispute properly exists under the contract in question, as a result of the information failure. Then multiplying this by the average cost per adjudication.
 - Multiplying this by the estimated number of adjudications (per year) relating to retentions, but not directly relating to clients making payment of retention conditional on performance under another.
- These benefits will only be additional for the number of years that it is assumed to take, on average, for those who are not familiar with the reforms to become familiar with them in the absence of intervention. Benefits should only be counted for those years. We intend to use consultation to explore whether this is an appropriate methodology.

Indirect benefit: Reduced contractor exposure to upstream insolvency

122. As discussed under 'Rationale for Intervention' the insolvency rate in construction sector is not particularly high compared to other sectors. However, with retention payments a contractor can typically have to wait for around 12 months after practical completion for the second half of the retention monies to be due. This delay to payments creates a specific set of issues around insolvency risk.

123. Late payment further increases contractor risk of not receiving their retention monies due to upstream insolvency. This is because the longer that a contractor has to wait for payment of their

retention monies, the greater the probability that the construction customer holding the retention will become insolvent before the retention is paid.

124. As outlined above, Option 1 should speed up the time taken for the rest of the construction sector to become familiar with the implications of the 2011 'Construction Act' reforms for retentions. This should provide greater clarity and certainty of cash flow for construction contractors, in particular small and micro firms in the supply chain, therefore, reducing late payment of retention monies (sooner than would have otherwise been the case).

125. A reduction in late payments would reduce supply chain exposure to not receiving their retention due to upstream insolvencies, to some limited extent. However, this option would offer no protection to those carrying out the work in the case of their customer going insolvent – their retention monies would not be ring-fenced.

126. It has not been possible to quantify this impact as evidence is not available to inform assumptions on the proportion of the construction sector are currently not familiar with what the 2011 amendments mean for retentions, and when they would become familiar in the absence of government intervention. It is also not known what proportion of non-receipt of retentions occurs due to upstream insolvency during the period of late payment. However, we would expect this impact to be small given that it would only affect a very specific set of contracts, for a limited time period. Subject to stakeholder engagement, we intend to use consultation with industry to gather further evidence on how frequently retention money is unpaid because the construction contractor went into administration after retention monies is formally due.

Risk – extended defects liability period

127. Option 1 would accelerate how long it would take for the rest of the construction sector to familiarise themselves with what the 2011 amendments to the Construction Act mean for retentions, providing clarity and transparency on when the retention payment is due.

128. However, limited qualitative evidence collected by Pye Tait suggests that some tier 1 contractors have responded to the part of the 2011 amendments which prohibits payment by reference to another contract, by lengthening their defects liability period. This has the implication of providing greater certainty on when payment is due but lengthening how long contractors and sub-contractors have to wait for it. This could be damaging for supply chain cash flow if they have to wait longer to receive their payment. This would represent a transfer of benefit from the supply chain (those who have retentions held from them) to those holding retentions.

129. Through consultation we intend to try and gather evidence on to what extent construction clients have responded to the 2011 amendments in this way, and to what extent this may be a risk.

Direct costs and benefits to business calculations (following OITO methodology);

130. At this consultation stage it has not been possible to quantify the costs and benefits from Option 1, and conduct direct costs and benefits to business calculations.

131. The direct cost and benefits to business under Option 1 will be:

- The cost of producing guidance, if this is borne or partially borne by representative industry bodies.

- Familiarisation costs (to construction contractors and businesses that are repeat construction clients) – we expect these to be negligible.
- Direct cost to construction clients and contractors from bringing forward the date from which they start issuing additional payment and/or withholding notices.
- There will be a direct benefit to construction contractors and clients from a reduction in adjudication costs.

Small and Micro Business Assessment

132. The main groups that would be affected by the proposed changes under Option 1 are:

- Construction contractor: those that hold retentions and those that have retentions held from them.
- Construction clients: those that hold retentions.
- There would also be a one off cost to Government and/or an industry body.

133. Option 1 would impact all businesses covered by the ‘Construction Act’ that are not already familiar with what the 2011 reforms mean for retentions, including small and micro businesses.

134. It would not bring any additional businesses into scope of the ‘Construction Act’. It would instead simply accelerate how quickly all businesses become familiar with what the ‘Construction Act’ means for the payment of retentions (payments cannot be made contingent on performance under another contract).

135. More than 99% of all construction contracting businesses in England can be classified as micro or small businesses.⁵⁵ It has not been possible to gather data on the number of construction clients that hold retentions in England and their size distribution. There are difficulties in estimating the number of construction clients as anyone or any business can be a construction client. There will be repeat construction clients but also a lot of one-off construction clients each year. Subject to stakeholder engagement, through informal consultation we intend to gather views on possible sources for this data.

136. Retentions are held down the supply chain (i.e. clients from main tier 1 contractors, tier 1 contractors from tier 2s, tier 2s from tier 3s etc), with companies generally getting smaller as you go down the supply chain. The purpose of this intervention is to reduce unjustified non-payment and late-payment of retention monies down the supply chain. We therefore envisage that it will largely benefit smaller construction contractors, at the cost of larger construction contractors and clients. i.e. it is likely to be a transfer of benefit towards small and micro businesses.

⁵⁵ BIS Business Population Estimates. (2015). <https://www.gov.uk/government/statistics/business-population-estimates-2015>

Option 2: Create a statutory “retention deposit scheme”

137. The cascade system of payment in the industry – client to main contractor, main contractor to sub-contractor and so on down the chain makes exposure of the different parts of the process to the insolvency of one participant particularly acute. The problem can be magnified by the practice of cash retention. This is because the retention money is held for extended periods. For instance, a demolition contractor preparing the site may finish their work 24 months before the project reaches practical completion and may have to wait a further 12 months after practical completion for the end of the defects liability and final payment of the retention money. Their exposure to the risk of losing the money to insolvency is therefore increased. In parallel their ability to manage that risk is greatly diminished as circumstances may well have changed over such a prolonged period. The factors contributing to the insolvency may well all relate to other contracts which the sub-contractor is not party to.

138. A way of reducing this ineffective allocation of risk would be for the retention money to be held in trust in a separate, ring-fenced account until it is either used to rectify defects or becomes due for payment.

139. Holding retention money in such a way would have the additional benefit of reducing the incentive for a client, main contractor, or large tier 2 contractor to hold on to the money for longer than the contractually agreed period. This is because there would be no benefit to them (for example, as a means of bolstering their working capital) other than as an insurance against the satisfactory completion of work.

140. Evidence collected by Pye Tait indicates that, amongst respondents to their survey with experience of retentions in the last three years⁵⁶, retentions have been held in trust in less than 0.1% of all their contracts⁵⁷ over the past 3 years. Taken together, the UCL (2013) research illustrating the extent of the sector’s reliance on trade credit⁵⁸, and Pye Tait data showing that over 60% of tier 1 contractors surveyed make use of the retention monies held (for example, as part of working capital or as part of general expenditure), indicates that businesses are very unlikely to put money into a deposit scheme on a voluntary basis. Informal consultations with operators of broadly similar schemes (i.e. the Tenancy Deposit Service) have indicated that, for a scheme to be fully effective, it must be statutory.

141. This consultation option therefore suggests that a statutory requirement for retention monies to be held in trust in a retention deposit scheme, operated by an independent party is introduced.

Scope of the Scheme

142. We suspect it likely that a retention deposit scheme will be prohibitively expensive for small businesses, or small value/ short term construction contracts. We therefore intend to use consultation to determine what an appropriate value threshold might be, above which the requirement to deposit retentions in an authorised scheme would apply and adjust any final impact assessment accordingly.

143. A different way of reducing the impact of a deposit scheme would be to limit the point in the supply chain at which the requirement might apply. For example, the Government in New South Wales places

⁵⁶ Either with experience of holding retentions, or experience of having retentions held from them.

⁵⁷ i.e. including those with and without retentions held

⁵⁸ Trade credit in the UK Construction Industry: An empirical analysis of construction contractor financial positioning and performance, UCL, July 2013

a similar trust fund requirement on big projects (those in excess of \$20 million Australian dollars by value) but only on tier 1 contractors.

144. However, the introduction of a similar threshold (value or point in the supply chain) in the UK would be likely to significantly reduce the benefits of such a retention deposit scheme. This is because evidence collected by Pye Tait (2017) indicates that incidences of late-payment and non-payment of retention in the UK construction sector are significantly higher for tier 2 and 3 contractors, than for tier 1 contractors⁵⁹. Through consultation we will aim to confirm this hypothesis and develop our understanding of whether this means that the introduction of such a “retention deposit scheme” with a threshold would not be a suitable option for intervention.

Features of a “retention deposit scheme”

145. Through consultation we intend to try and further develop Government understanding of how a retention deposit scheme would work in practice. We envisage that:

- The market will deliver private provision of deposit protection schemes/ trust accounts. (This is an assumption that needs to be tested, and there is a risk that this might not be the case).
- Providers of “retention deposit schemes” will be authorised by the Secretary of State.
- Scheme operators will be required to report on an annual basis on their performance.
- Businesses holding retentions under construction contracts (as defined by Part 2 of the Housing Grants, Construction and Regeneration 1996) will be required to deposit retentions in the scheme as they are withheld from stage payments.
- The scheme can only hold retention money (plus any related interest).
- That money will be held in trust.
- Where the contract makes no such provision, the Scheme for Construction Contracts will imply relevant terms requiring retention money to be held in a deposit scheme.
- Any disputes about the amount and timing of the release of retention payments will be dealt with by existing dispute resolution processes.

Operation of the scheme

146. Through consultation we intend to further develop Government understanding of how such a scheme would operate. We envisage that:

- Organisations withholding retention payments will be required to register with a scheme.
- Organisations will need to register specific contracts and the relevant information (such as start date, end date, payment schedule, retentions terms).
- Organisations will need to notify the scheme of the timing, amount and allocation of the retention money which is being deposited.
- Organisations will need to notify the scheme if any changes are made to the timings and payment due.
- Organisations will need to notify the scheme operator when a retention payment is due and its amount.

Account holder requirements

147. Through consultation we intend to further develop Government understanding of what the account holder requirements would be. We envisage that account holders would be required to:

⁵⁹ It is unknown, however, what proportion of this late and non-payment is for justified or unjustified reasons, within contract terms.

- Pay the “fee” for registering the contract
- Provide the information required for the contract to be registered (start date, end date, retention terms etc)
- Make retention payments into the trust account alongside stage payments under the relevant contract and provide an account of how they were calculated and who they are due to.
- Alert the scheme operator of key contractual payment milestones (practical completion / defects liability period etc for each sub-contract)
- Instruct the scheme operator to pay the retention money, a proportion of the retention money, or not to pay the retention money at all

Key assumptions in the cost-benefit analysis:

148. **The following analysis of familiarisation costs assumes that all retentions will need to be placed in a retention deposit scheme following the introduction of Option 2.** However, as discussed above, we suspect it likely that a retention deposit scheme will be prohibitively expensive and burdensome for small value, or short term construction contracts and an appropriate threshold would need to be introduced to mitigate these disproportionate burdens (in particular on small and micro businesses).

149. **Depending on how it is designed, a threshold could significantly reduce how many businesses the requirement to hold retention in trust applies.** This could significantly reduce a number of the costs and benefits associated with Option 2. If not all businesses are facing the same costs, this could also impact on their ability to pass through costs to their clients via increased tender prices and/ or fees, which could have implications for their competitiveness.

150. The analysis also assumes that all those that currently hold retentions will continue to want to hold retentions following the introduction of the deposit protection scheme. There may be some construction customers who decide that the increased cost of holding a retention means that it is no longer worthwhile as ‘insurance’ as the costs of holding a retention outweigh the benefits. This could result in a reduction in the proportion of contracts on which retentions are held. Again, this could reduce a number of the costs and benefits outlined below.

Costs

One off costs

Contract change costs

151. There would be a one off cost to various contract writing bodies and parties to construction contracts as they would need to alter their standard contract forms.

152. In order to be able to quantify this one off cost evidence needs to be gathered on how many contract forms there are that would need to be updated. Evidence is also needed on how long it would take to revise standard contract forms to take into account the changes proposed by this option and what the estimated cost of this would be. The estimated number of contracts that need to be updated can then be multiplied by the estimated cost per contract to produce an estimated total cost of updating standard contracts.

153. Evidence from the Impact Assessment accompanying the 2011 reforms to the ‘Construction Act’ can, however, be used to provide some incomplete indication of the scale of this cost. This used the example of the Joint Contracts Tribunal (JCT) to provide an indication of the scale of contract change costs associated with those more substantial reforms to construction legislation. It found that the JCT had some 50 contracts to attend to in 2011, and these would potentially need to be revised or updated.

It was estimated that it would cost, on average, £833 (approximately £880 in 2015 prices) to update each contract template leading to a total cost of around £42,000 (approximately £44,000 in 2015 prices). Evidence is not available in the 2011 Impact Assessment on the total number of standard contracts that were expected to require changing as a result of the reforms.

154. The 2011 reforms made a number of changes to construction contracts and relate to all business-to-business construction payments, whereas the changes under Option 2 only relate to retention payments which typically make up around 5% of the total contract value. It is, therefore, likely that the average cost per contract change under Option 2 will be much lower than the £880 (in 2015 prices), estimated for the 2011 reforms.

155. For the purpose of this Impact Assessment, given lack of other available evidence, £44,000 (**£0.04 million**) has been used as an initial estimate of what this one-off transition costs would be. However, we recognise that this is an approximate estimate as £880 is likely to be an overestimate of the cost per contract, and this is based purely on the number of contracts that the JCT had in 2011. Subject to levels of engagement, through consultation with industry and contract writing bodies we intend to gather better evidence on the average cost per contract, and the number of standard contracts that would need to be updated.

Familiarisation costs

156. This option requires parties to construction contracts withholding retentions to familiarise themselves with how a deposit scheme works as well as the requirements and protocols set out through guidance. In order to be able to estimate the time taken and costs associated with industry familiarising themselves with the new requirements, further evidence needs to be gathered on how long this would take, and how many organisations would be impacted.

157. Option 2 also requires insolvency practitioners and secured creditors who lend to construction contractors and repeat construction clients to familiarise themselves with the implications of the changes.

158. It has been assumed that familiarisation costs would be incurred by all groups in Year 0 of Option 2 being implemented.

Familiarisation costs for construction contractors

159. It is not known, at this stage, what form the guidance would take and how it would be communicated. It is, therefore, not possible to produce an appropriate estimate of how long it would take construction contractors to familiarise themselves with the guidance, and the associated familiarisation cost.⁶⁰

160. However, assumptions from the 2011 reforms to the 'Construction Act' Impact Assessment can be used to provide a rough indication of the scale of familiarisation costs to construction contractors. Discussions with industry stakeholders to inform the 2011 'Construction Act' IA indicated that it would take industry no more than 1 hour per enterprise to familiarise themselves with those reforms. To account for the fact that it may take some companies more or less time than the 1hr estimated, a range of 30 minutes in the best case, or 2hrs in the worst case was used. It is not clear at this stage whether it would take the construction industry more or less time to familiarise themselves with the guidance that would be needed under Option 2. Subject to industry engagement, through consultation we intend to gather evidence from industry on this.

⁶⁰ Published analysis of the New South Wales and New Zealand schemes that require retentions to be held in trust do not appear to provide any evidence on the scale of this cost that can be used to inform this analysis.

161. Using Office of National Statistics data, the average hourly cost in the UK for a construction manager is approximately £23 (in 2015 prices)⁶¹. If we assume that one person from each of the 229,060⁶² construction enterprises in England needs to familiarise themselves with the new requirements, and that this takes them 1 hour each, the cost to industry equates to approximately £5.3 million (in 2015 prices). Using the lower and upper bound estimates of 30 minutes and 2 hours from the 2011 Impact Assessment, this gives a range of £2.6 - £10.6 million.

162. However, this would assume that all construction contracting enterprises need to familiarise themselves with the changes. Evidence collected by Pye Tait indicates that only around 75% of construction contractors hold retentions or have retentions held against them in the last 3 years. If we, therefore, assume that 75% of construction enterprises will need to familiarise themselves with the new requirement, this indicates that the one-off cost to industry will be approximately **£3.9 million** (in 2015 prices). Using the lower and upper bound estimates of 30 minutes and 2 hours from the 2011 Impact Assessment, this gives a range of £2.0 - £7.9 million.

163. This estimated cost would be significantly lower if the assumptions identified above do not hold, and only a proportion of the construction sector that currently use retentions need to familiarise themselves with the guidance because of a threshold.

164. If the scheme was universal then all construction contractors that use retentions or have retentions held from them would face same costs and it is likely that this cost could be passed on to their clients through increased tender prices.

Familiarisation costs for repeat or serial clients

165. Repeat or serial commercial construction clients withholding retentions will also need to familiarise themselves with how a deposit scheme might work as well as the requirements and protocols set out through guidance.

166. Pye Tait data shows that approximately 85% of clients surveyed had experience of holding retentions over the last three years. However, no data is available at this stage on the total number of businesses that are serial construction clients. There are difficulties in estimating the number of construction clients as any business can be a construction client. There will be repeat construction clients but also a lot of one-off construction clients each year, projects may also span across years creating difficulties with how you count the number of construction clients per year. It has therefore not been possible to estimate how many clients would need to incur these familiarisation costs. Subject to stakeholder engagement, through consultation we intend to gather views on possible sources for this data.

167. If a robust source for this data can be identified, then evidence on the number of repeat construction clients can be used to estimate the total familiarisation costs to repeat construction clients using the same methodology as has been used for construction contractors above.

168. It is assumed that one manager, director or senior official for each repeat commercial construction client would need to familiarise themselves with the guidance, and that it would take them the same amount of time as a construction manager (approximately 1 hour). Using Office of National Statistics data, the average hourly cost in the UK for 'Managers, directors and senior officials' generally is

⁶¹ £23.04 - Data comes from the ONS Annual Survey of Hours and Earnings (ASHE) 2015 provisional (£19.17 per hour median wage for 'Production managers and directors in construction', SOC code 1122), uprated by 20.2% to take into account of non-wage labour costs, as per general BIS practice.

⁶² 2014 figure for England, ONS ABS

approximately £23 per hour in 2015 prices⁶³. The estimated familiarisation cost per repeat client is therefore £23.

Familiarisation costs for one-off and occasional construction clients

169. We do not believe there will significant additional costs for one-off and occasional construction clients.

This is because the process of construction will anyway be new to them so the costs of familiarisation will exist whether there has been a recent change or not. There will not be any additional costs to them from the introduction of Option 2.

Familiarisation costs for insolvency practitioners

170. As of 1st January 2016 there were 1,328 appointment-taking insolvency practitioners in the UK⁶⁴. It has been assumed that each of these would also need to familiarise themselves with the changes under Option 2.

171. The trade body R3 (the Association of Business Recovery Professionals) runs regular training sessions for Insolvency Practitioners and we envisage that that it is likely that these changes would be incorporated in to those programs. The costs of these programs vary according to the type of membership, venue and subject but a half day course typically costs around £180 and a full day course around £400.⁶⁵ As we are unaware at this stage of the degree of training that will be required we will use these two estimates as upper and lower boundaries, and the average as our best estimate.

172. It is assumed that (in Year 0) all 1,328 Insolvency practitioners will complete a training course to familiarise themselves with the new requirements. This gives a range for the one-off sector-wide cost of training of £0.24 million to £0.53 million, with a best estimate of **£0.39 million**⁶⁶.

173. In addition to the training course fee there would also be a cost to business in terms of forgone insolvency practitioner time. In 2013, the average hourly pay for an insolvency practitioner partner/director was approximately £366.⁶⁷ Inflated to 2015 prices and uprated to take into account other non-wage labour costs⁶⁸ this gives an average hourly cost of approximately £449.

174. Half day courses are run for approximately 3 hours, and full day courses are approximately 6 hours⁶⁹. IP cost per hour (£499) can be multiplied by the course length to give an estimate of the cost of IP time from having to attend a training course. This gives a range for the sector-wide cost of training time of £1.8 million to £2.5 million, with a best estimate of **£2.1 million**⁷⁰. This is likely to underestimate true cost per insolvency practitioner as this does not take into account travel time and costs⁷¹.

⁶³ £23.34 - Data comes from the ONS Annual Survey of Hours and Earnings (ASHE) 2015 provisional (£19.42 per hour median wage for 'Managers, directors and senior officials', SOC code 1), uprated by 20.2% to take into account of non-wage labour costs, as per general BIS practice.

⁶⁴ Source: insolvency service admin data. Statistic only available at UK level, and this is our best estimate of the number of IPs that will be impacted

www.gov.uk/government/uploads/system/uploads/attachment_data/file/511324/IP_Annual_Review_2015.pdf

⁶⁵ Insolvency Service. (2016) Consultation Stage corporate insolvency Impact Assessment .https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525529/Consultation_stage_corporate_insolvency_consultation_Impact_Assessment_-_Mar_2016.pdf

⁶⁶ An average of the upper and lower range estimates.

⁶⁷ <https://www.gov.uk/government/publications/insolvency-practitioner-fees-a-review>

⁶⁸ Uprated by 20.2% to take into account of non-wage labour costs, as per general BIS practice.

⁶⁹ <https://www.r3.org.uk/courses-and-events>

⁷⁰ An average of the upper and lower range estimates.

⁷¹ Given the high degree of uncertainty and likely variation of what these cost would be it has not been possible to quantify and monetise these in this analysis.

175. Total familiarisation cost to IPs from Option 2 can then be estimated by summing together the total training costs and the cost of IP time. The range of costs is summarised in Figure 10:

Figure 10: Insolvency practitioner one-off familiarisation costs

Course length	Cost per IP			Total cost across all IPs (£ millions)		
	Course fee	IP time cost	Total cost	Course fee	IP time cost	Total cost
Half day - 3 hours	£180	£1,346	£1,526	£0.24	£1.79	£2.03
Full day - 6 hours	£400	£1,861	£2,261	£0.53	£2.47	£3.00
Best estimate (average) - 4.5 hours	£290	£1,603	£1,893	£0.39	£2.13	£2.51

176. This methodology may overestimate total insolvency practitioner familiarisation cost as it may not be the case that all 1,328 IPs work on construction insolvency cases and need to familiarise themselves with the changes. Through consultation (e.g. with the trade body R3) we intend to further develop our understanding of what the costs to insolvency practitioners from Option 2 would be.

Insolvency practitioner: system cost changes

177. Insolvency practitioners may also need to introduce system changes for how they deal with construction insolvencies as a result of Option 2.⁷² This would also incur a cost to business in terms of insolvency practitioner time. Through consultation with relevant trade bodies (such as R3⁷³) we intend to gather more evidence of what the impacts of Option 2 are likely to be on insolvency practitioners.

Familiarisation costs for secured creditors

178. Lenders who provide secured finance to construction businesses and big construction clients may also need to familiarise themselves with the changes under Option 2. The changes will mean that retention money is ring-fenced in the event of insolvency and will no longer be available for distribution to creditors in line with the hierarchy of payment. After expenses incurred from the administration of the insolvency process secured creditors receive dividends ahead of other creditors. This means that secured creditors may see a reduction in their returns from insolvencies in the construction sector.

179. It is difficult to estimate with any certainty the number of businesses involved in secured lending to construction contractors and repeat construction clients in England. The 2015 Business Population statistics⁷⁴ estimates that around 465 employers in the UK were involved in monetary intermediation and this is our best estimate of the number of businesses impacted⁷⁵. However, this is probably an overestimate of the number impacted by Option 2 as it is likely that not all of these will lend to construction contractors and repeat construction clients.

180. Each of these businesses is likely to have a regulatory compliance manager who will be required to understand the changes in law. Using the Annual Survey of Hourly Earnings we estimate that the average labour cost for these employees to be approximately £25.⁷⁶

⁷² Source: discussions with Insolvency Service

⁷³ R3 is the Association of Business Recovery Professionals <https://www.r3.org.uk/>

⁷⁴ ONS Business Population Estimates. (2015). <https://www.gov.uk/government/statistics/business-population-estimates-2015>

⁷⁵ Data is not available for England only

⁷⁶ £25.24 - Data comes from the ONS Annual Survey of Hours and Earnings (ASHE) 2015 provisional (£21.00 per hour median wage for 'Corporate managers and directors', SOC code 11), uprated by 20.2% to take into account of non-wage labour costs, as per general BIS practice.

181. Given lack of other available information it has been assumed that it would take them around the same amount of time as insolvency practitioners to familiarise themselves with the changes and what this means for their business models. This is unlikely to be an accurate estimate, as they will be impacted in different ways by Option 2. We assume that it will take secured creditors between around 3 and 6 hours familiarise themselves with the implications of Option 2, with (the average) 4.5 hours as a best estimate. Subject to stakeholder engagement, we intend to test this assumption through consultation.

182. This equates to a total one-off familiarisation cost of between £0.04 million and £0.07 million, with a best estimate of **£0.05 million**.

Ongoing costs

183. Research conducted by Pye Tait identified two main costs associated with holding retentions in trust:

- the cost of administering the account; and,
- financing the money to be held in the account (which otherwise could be used by the client or contractor in their business).

184. These costs are borne by the party holding the retention – client, contractor, sub-contractor. We have also identified a number of additional costs which are outlined below.

185. Subject to stakeholder engagement, through consultation we intend to gather evidence on which costs could be passed through to the client and which would be met by contractors or sub-contractors.

Costs from setting up and administering a retention deposit account

186. We envisage that there will be a number of additional costs to those wanting to use retentions from having to set up and administer a retention deposit account:

- A one-off setup cost: administrative time and account setup fee
- An administrative burden per contract registered in the account
- An administrative fee charged per account
- An administrative burden and account fee if contract terms needed to be changed
- An administrative burden to release the retention monies from the retention deposit scheme

One-off account setup costs: administrative burden and account setup fee

187. There will be a one-off cost to those wishing to hold a retention from registering with a retention deposit scheme. It is expected that scheme registration would occur on an organisation rather than specific contract basis and that details such as company details, contact point etc would need to be provided. This would represent an administrative burden to those wishing to hold retentions, and is also likely to incur a registration fee to recompense scheme operator costs.

188. Given the high level of uncertainty at this consultation stage about how retention deposit accounts would be set up and run, it has not been possible to estimate these costs. Through consultation with industry and other relevant stakeholders we intend to gather more evidence on the costs which may be associated with registering for a trust account scheme. We also intend to explore further whether evidence may be available from similar schemes in other countries that could be used to inform

analysis in the Final Impact Assessment⁷⁷. Subject to the evidence gathered through consultation, total costs to business can then be estimated by multiplying the estimated cost per business by the estimated number of commercial construction clients⁷⁸ and contractors that will be required to hold their retention payments in trust.

189. If a threshold was introduced below which you did not need to hold retention in trust (see 'Key Assumptions' above), as is likely, then these costs would only apply to the proportion of the construction sector and/ or contracts within this threshold.

Ongoing administration fees and charges

190. In addition to these anticipated one-off costs we envisage that there will be on-going administrative burdens and fees associated with retention deposit accounts.

191. We envisage that deposit scheme operators will be required to register and also report on performance to Government. This will bring costs for which the scheme operator will need to seek recompense. We therefore envisage that there will also be a general annual registration fee which businesses holding retentions will need to pay.

192. We also envisage that there will also be an administration fee charged per contract to those holding retentions in a deposit account. The fee amount may be determined by value and the amount of transactions going through the account - it may be offset by any interest earned on retentions held by the scheme.

193. We also envisage that there will be an additional administration fee per contract if contract terms needed to be changed, to compensate the scheme operators for any resource required to make any required changes. This information would need to be provided for each contract.

194. We also envisage that there will be an additional administrative burden to those holding retentions from releasing the retention monies from the retention deposit scheme

195. Given the high level of uncertainty at this consultation stage over how a retention deposit scheme would work in practice, and what the associated costs would be it has not been possible to estimate how much these fees and charges would be. Evidence published on similar international schemes that have recently been introduced in New Zealand and New South Wales do not appear to provide an indication of the scale of these costs. The research conducted by Pye Tait was only able to gather very limited evidence on the costs associated with holding retentions in trust, and unable to produce any monetary estimates. We have been unable to identify similar schemes in the UK which could be used to inform estimates of these costs.⁷⁹

196. Through consultation with industry and other relevant stakeholder we intend to gather more evidence on how a retention deposit scheme would work in practice, and the costs which may be associated with administering such a retention deposit scheme, and the scale of such costs. We also intend to explore

⁷⁷ New Zealand and New South Wales have introduced similar schemes. However, their published regulatory impact assessments or statements do not appear to provide any estimates of these administrative fees which could be used to inform our analysis.

⁷⁸ As discussed previously, we do not currently have a figure for the number of commercial construction clients, and are not at present aware of a source that could provide this information. There are challenges identifying the total number of construction clients in a given year. Subject to stakeholder engagement, through consultation we intend to gather information on possible sources for this data.

⁷⁹ For example, this is in some ways comparable to the Deposit Protection Scheme for rented properties. However, there are many differences between the two schemes and this involves a completely different set of different processes and economic actors.

further whether evidence may be available from similar schemes in other countries that could be used to inform this analysis⁸⁰. Subject to the evidence gathered through consultation, we intend to estimate total costs to business by multiplying the estimated cost per business by the estimated number of construction clients⁸¹ and contractors that will be required to hold their retention payments in trust.

197. If a threshold was introduced below which you did not need to hold retention in trust (see 'Key Assumptions' above), as is likely, then these costs would only apply to the proportion of the construction sector and/ or contracts within this threshold.

Government administration costs

198. We envisage that deposit scheme operators will be required to register and also report on performance to Government. This will represent a cost to Government from having to administer the scheme.

199. Given the high level of uncertainty at this stage on what the process would be for registering and monitoring retention schemes it has not been possible to estimate what the associated costs would be.

200. Through consultation with relevant Government and industry stakeholders we will aim to gather more evidence on what the process should be for registering and monitoring Retention Deposit Schemes, and what the associated costs of this would be.

201. Total costs would partially depend on whether and where a threshold was introduced below which you did not need to hold retention in trust (see 'Key Assumptions' above).

Transfer generated by the absence of free trade credit

202. There will be a cost to those holding retentions from having to finance the money to be held in the account up front. This means that they will not be able to use this money which could have otherwise been available to their organisation.

203. As outlined under 'Retentions Overview', it is estimated that between £3.2 billion and £5.9 billion is held in retentions across the construction sector in England over the course of a year, with a central estimate of £4.5 billion (in 2015 prices). Under Option 2 clients and contractors would not be able to use this money elsewhere in their business. For the time that it is held in the retention deposit account neither the construction customer nor the contractor carrying out the work would be able to use and benefit from the retention money.

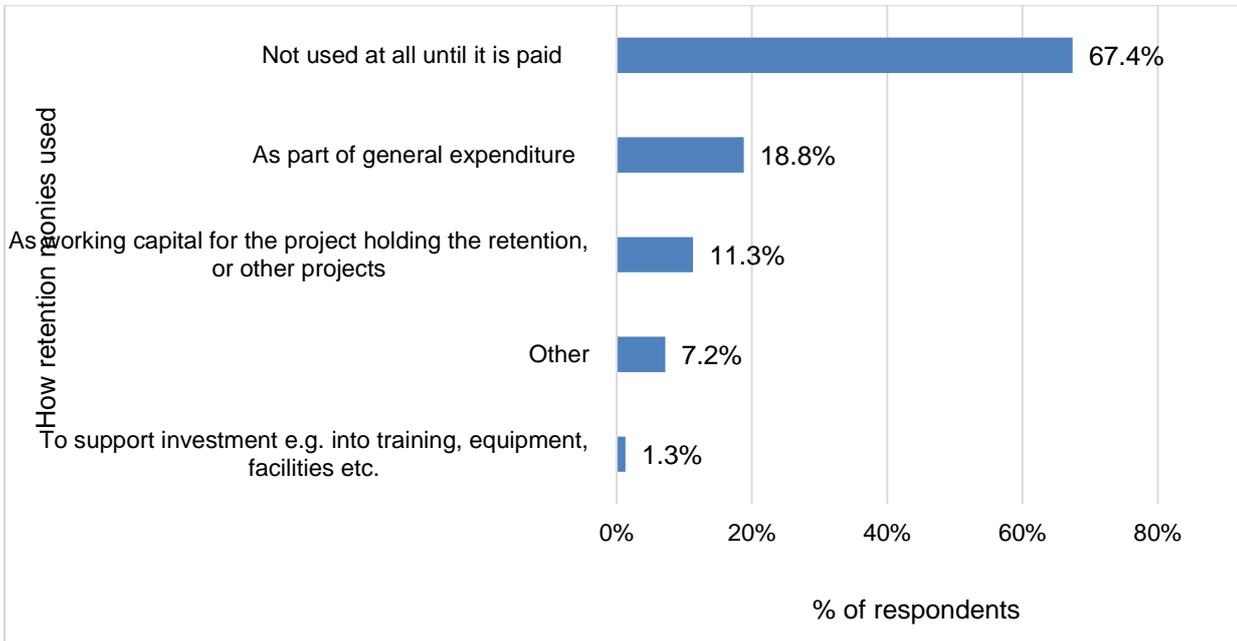
204. Evidence collected by Pye Tait provides an indication of how clients and contractors holding retentions make use of the money. This can be used to provide an indication of how much of an impact ring-fencing the retention monies so that it cannot be used by those holding retention would have, and how much money would need to be found from elsewhere to continue business as usual expenditure by those that make use of retention monies.

⁸⁰ New Zealand and New South Wales have introduced similar schemes. However, their published regulatory impact assessments or statements do not appear to provide any estimates of these administrative fees which could be used to inform our analysis.

⁸¹ As discussed previously, we do not currently have a figure for the number of commercial construction clients, and are not at present aware of a source that could provide this information. There are challenges identifying the total number of construction clients in a given year. Subject to stakeholder engagement, through consultation we intend to gather information on possible sources for this data.

205. Research conducted by Pye Tait found that approximately 67% of construction clients surveyed make no use of retention monies they hold. However, almost 19% use this as part of their general expenditure, 11% as working capital and 1.3% to support investment. This is shown in Figure 11.

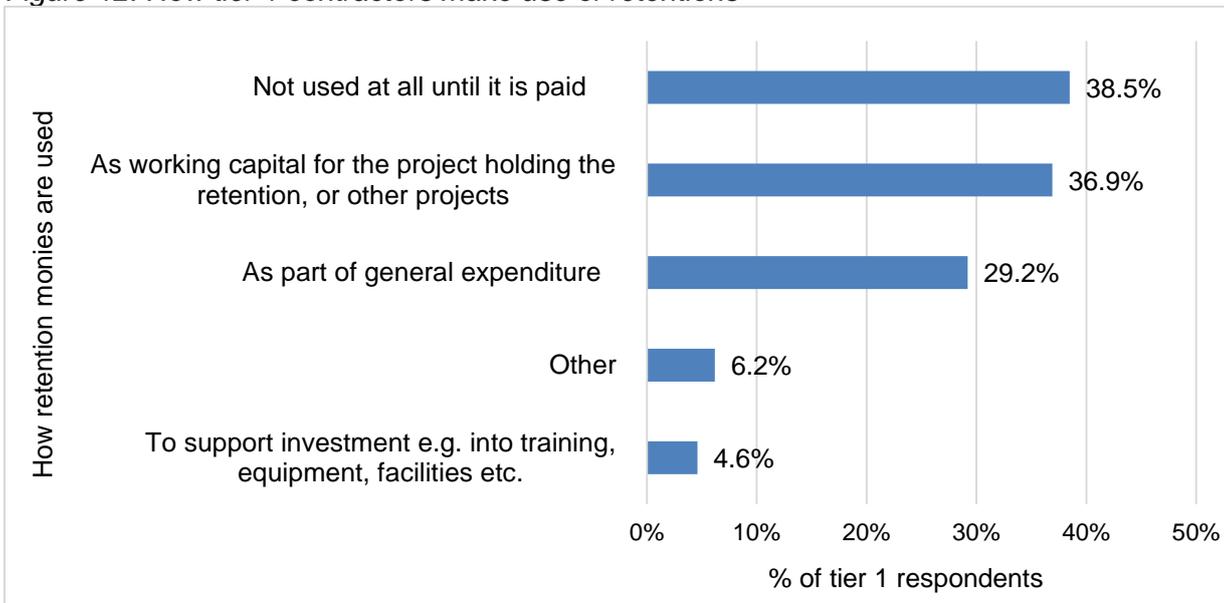
Figure 11: How clients make use of retentions – analysed by respondents⁸²



Base 323 respondents⁸³

206. The position changes significantly for Tier 1 contractors. Only around 39% of tier 1 contractors surveyed reported that they do not use retention monies that they hold at all until it is paid. Almost 37% reported using retentions as working capital, 29% as general expenditure, and almost 5% to support investment. This is shown in Figure 12.

Figure 12: How tier 1 contractors make use of retentions⁸⁴



65 respondents⁸⁵

⁸² Pye Tait. (2017). 'Retentions in the Construction Industry'

⁸³ Respondents could select more than one response

⁸⁴ Pye Tait. (2017). 'Retentions in the Construction Industry'

⁸⁵ Respondents could select more than one response

207. This indicates that the impact of Option 2 reducing the trade credit of those that hold retentions is likely to be more significant for contractors than main construction clients. Under Option 2 they will need to find money elsewhere to continue with their current levels of expenditure.
208. In order to estimate the possible impact of Option 2 on the amount of additional money that would need to be found by construction clients and industry from elsewhere in order to maintain current levels of expenditure it has been assumed (for simplicity, given lack of available evidence) that half of total retention monies held in the construction sector (£3.2 billion - £5.9 billion, with a central estimate of £4.5 billion, in 2015 prices) is held by the ultimate clients and half is held by construction contractors.
209. Half of the total sector wide retention value (approximately £1.6 billion - £3.0 billion, with a central estimate of £2.2 billion, in 2015 prices) is assumed to be held by construction clients. Pye Tait survey data found that approximately 33%⁸⁶ of clients⁸⁷ say they do make use of the retention monies they hold. It is therefore assumed, by proxy, that around 33% of all retention monies held by clients would be used by construction clients elsewhere in their business under the 'do nothing' scenario. Under Option 2 construction clients combined would need to find approximately an additional £0.5 billion - £1.0 billion, with a central estimate of £0.7 billion per year (in 2015 prices) in order to maintain their current level of expenditure.
210. Half of the total sector wide retention value (approximately £1.6 billion - £3.0 billion, with a central estimate of £2.2 billion, in 2015 prices) is assumed to be held by construction contractors. Pye Tait survey data found that approximately 61.5%⁸⁸ of contractors⁸⁹ say they do make use of the retention monies they hold. It is therefore assumed, by proxy that around 61.5% of all retention monies held by contractors would be used elsewhere in their business under the 'do nothing' scenario. Under Option 2 construction contractors combined would need to find approximately an additional £1.0 billion - £1.8 billion, with a central estimate of £1.4 billion per year (in 2015 prices) in order to maintain their current level of expenditure.
211. This equates to an estimated total across clients and contractors of approximately £1.5 billion – £2.8 billion per year, with a central estimate of £2.1 billion (in 2015 prices) that construction clients and contractors would need to fund from elsewhere, in order to maintain current levels of expenditure.
212. Retentions provide free trade credit to those holding them; therefore there is likely to be a cost of obtaining this finance from other sources. The cost to construction clients and contractors from obtaining this finance would however be a transfer of benefit to those providing the finance (e.g. banks). This would represent a net cost to the construction sector, and a net benefit to the wider economy. Those who were previously benefiting from using retentions for free finance, which is not their intended purpose, would now have this finance priced by the market. Evidence is not available at this stage on what the cost to construction clients and contractors from getting this finance from other sources would be. We intend to use the consultation to explore this further, subject to stakeholder engagement.
213. This analysis has assumed that all retentions across the construction sector will need to be held in trust. If a threshold was introduced, below which you did not need to hold retention in trust, (see 'Key Assumptions' above), as is likely, then these costs would only apply to the proportion of the construction sector and/ or contracts within this threshold. This could significantly reduce the level of this cost.

⁸⁶ 100% minus the 67.4% that say they make no use of retention monies they hold.

⁸⁷ Of those that hold retentions

⁸⁸ 100% minus the 38.5% that say they make no use of retention monies they hold.

⁸⁹ Of those that hold retentions

Transfer of money away from other creditors in the event of insolvency

214. Under the 'do nothing' scenario contractors owed their retention payment fall below secured creditors (such as banks) in the order of priority for getting the money that they are owed in the event of the business holding the retention going into insolvency. Option 2 is proposing that the retention money should be separately ring-fenced and that construction contractors owed this money should essentially be placed as higher priority than secured creditors to get the money that they are due in the event of insolvency.
215. While there is an ongoing benefit to construction contractors with retentions held against them from having their retention money protected in trust (see 'Benefits'), this represents an ongoing cost to other creditors, unsecured or otherwise as there would be less money potentially available to pay them what they are owed. The introduction of Option 2 would mean a direct transfer of risk and potential cost away from construction contractors with retentions held against them to other creditors. Other creditors can include secured creditors (e.g. banks) and other creditors (e.g. construction material suppliers if these are bought on credit, Government, employees).
216. The total amount lost by other creditors will be equal to the total amount of retention money protected in the event of insolvency, estimated at **£229 million per year** (2015 prices): see 'Option 0 – do nothing' for an explanation of how this estimate of how this has been reached.
217. Internal Insolvency Service analysis shows that approximately 90% of money released in the event of insolvency goes to other businesses, 10% goes to Government and employees⁹⁰. It has, therefore, been assumed that 90% of this cost (£206 million) would be incurred by businesses and 10% (£23 million) by Government and employees.
218. The 10 year PV to other business is estimated at approximately **-£1770 million**.
219. The 10 year PV to Government and employees is estimated at approximately **-£197 million**.
220. It is likely that Option 2 will mainly impact on secured creditors as these would have otherwise been first priority to receive what is due to them under the 'do nothing' scenario. By the time that a company goes into liquidation they will have already used up the majority of their cash resources, and it is likely that there will be little to pay out to unsecured creditors, once secured creditors have been paid (this explains why retention money is currently not being paid back in the event of insolvencies). The impact on other unsecured creditors is, therefore, expected to be smaller than on secured creditors. Option 2 will be mainly a transfer of risk and potential cost from construction contractors with retentions held against them to secured creditors.⁹¹

Benefits

Transfer of insolvency protection to those with retentions held

221. The insolvency rate⁹² in construction sector is not particularly high compared to other sectors⁹³. However, with retention payments contractor can typically have to wait for around 12 months after practical completion for the second half of the retention monies to be due.⁹⁴ This delay to payments creates a specific set of issues around insolvency risk.

⁹⁰ Source: discussions with Insolvency Service

⁹¹ Source: discussions with Insolvency Service

⁹² Approximate number of insolvencies per enterprise. See 'Rationale for Intervention' section for more detail.

⁹³ ONS Insolvency Statistics

⁹⁴ Pye Tait survey data indicates on 7.7% of contracts a retention is intended to be held for longer than 12 months.

222. In the event of upstream insolvencies construction contractors owed retention monies are not secured creditors and it is, therefore, likely that they will not receive the retention money that they are due (or only a small proportion of it).⁹⁵
223. Holding retentions on trust in a deposit scheme would protect contractors and sub-contractors against the risk of losing the retention monies that they are due in the event that their upstream clients become insolvent. It would be effectively transferring risk and potential losses from construction contractors due retention money to other creditors. This is discussed in more detail under 'Costs' above.
224. As discussed under 'Option 0 – do nothing', the total estimated amount of retention monies unpaid to construction contractors per year due to insolvency of another organisation is **£229 million per year** (in 2015 prices).
225. The total combined benefit to construction contractors from having their retention money protected and paid to them in the event of upstream insolvency would therefore be an estimated £229 million per year. This provides a 10 year PV of approximately **£1967 million**.
226. This analysis has assumed that all retentions across the construction sector will need to be held in trust. If a threshold was introduced, below which you did not need to hold retention in trust, (see 'Key Assumptions' above), as is likely, then these benefits would only apply to the proportion of the construction sector and/ or contracts within this threshold. This could significantly reduce the benefit of Option 2 in terms of insolvency protection.

Transfer of benefit: Impact on incentives around late payment

227. Holding the money in a separate, independently administered deposit scheme removes the ability of the party holding the retention to use it as an easy and extended source of trade credit. It also removes the incentive of the party holding the retention to seek to hold on to it for longer than the contractually agreed period to extend that credit. We envisage that it will, therefore, reduce some of the incentives to unjustifiably pay retention late. This represents a transfer of benefit from those holding retentions to those with retentions held.
228. Evidence gathered from Pye Tait's contractor survey indicates that 18% of contractors may be increasing their tender prices by an amount equal to or higher than the retention. In such cases it is perhaps questionable how effective retentions are as an incentive for contractors to complete work to a high standard, that defects will be remedied, and that projects will finish in their allocated time. If contractors think that they are more likely to be paid when due this could increase the effectiveness of retentions as an incentive to complete work to a high standard, and also reduce contractor incentives to increase project cost by an amount equal to the retention amount.
229. Subject to stakeholder engagement, we intend to use consultation to try and further understand industry views on how often the party holding the retention holds on to it for longer than the contractually agreed period so that they can continue to use it as trade credit. However, as outlined previously it will be challenging to robustly measure and draw clear conclusions on the extent to which this unjustified late or non-payment was occurring.

Other impacts

Possible impact on the proportion of construction customers holding retentions

⁹⁵ Source: discussions with Insolvency Service

230. As outlined above, there will be a number of additional costs to construction customers from holding a retention under Option 2. They would, therefore, need to decide whether the trade-off between the cost of holding a retention under the new scheme, and the benefit of the “insurance” it provides makes it worthwhile to still hold retentions.

231. As outlined above under “Scope of the Scheme” and “Key Assumptions” we suspect it is likely that a retention deposit scheme will be prohibitively expensive for small value, or short term construction contracts. We therefore intend to use the consultation to try and determine what an appropriate value threshold might be, above which the requirement to deposit retentions in an authorised scheme would apply and adjust any Final Impact Assessment accordingly. If there is not an appropriate value threshold then there would likely be a reduction in the number of (particularly smaller) contractors using retentions.

232. This will represent a benefit to construction contractors that would otherwise have had a retention held from them, in the form of improved cash flow. However, would mean that the construction customers are unable to benefit from using retentions as an “insurance” against defects.

Risks

233. The changes under Option 2 will mean that retention money is ring-fenced in the event of insolvency and can no longer be allocated to secured creditors. There is a risk that this may mean that secured creditors see lending to these companies as being higher risk, and that this increases their cost of borrowing. It is important to note, however, that this would be reflected by a possible reduction in the risk of those with retentions held against them. This could reduce the cost of borrowing for those with retentions held.

234. There would also be the possibility that not having the retention money available to the insolvency practitioner or the business itself would mean that they are less able to rescue a business under stress. This could have the effect of triggering more insolvencies. Having a cash buffer available is particularly important in the construction sector as profit margins tend to be low.

235. There is also a risk that private providers will not wish to deliver retention deposit schemes.

236. Subject to levels of engagement, we intend to use the consultation to explore these potential risks further with industry, secured creditors, insolvency practitioners and the Insolvency Service.

Alternative approaches

237. While the “retention deposit scheme”/ holding retentions in trust approach has benefits, it is also apparent that it is not without downsides – not least in terms of its possible administration costs and therefore applicability to smaller value contracts.

238. The Pye Tait research looked at a number of alternatives to retentions as well as a deposit scheme including:-

- Project bank accounts
- Retention bonds
- Performance bonds
- Parent company guarantees
- Escrow accounts

239. Their conclusion was that most of these would have suitability in certain circumstances to replace retentions, but they are not likely to be generally suitable for use across all construction contracts.

240. We intend to use the consultation to test this conclusion further and see if more suitable alternative mechanisms might be identified.

Small and Micro Business Assessment

241. The main groups that would be affected by the proposed changes under Option 2 are:

- Construction contractors - those that hold retentions and those that have retentions held from them.
- Construction clients – those that hold retentions
- Insolvency practitioners
- Secured creditors to companies that hold retentions

Construction contractors

242. Approximately 99.8% of all construction contracting businesses in England can be classified as micro or small businesses.⁹⁶

243. Retentions are held down the supply chain (i.e. clients from main tier 1 contractors, tier 1 contractors from tier 2s, tier 2s from tier 3s etc), with companies generally getting smaller as you go down the supply chain.

Construction clients

244. It has not been possible to gather data on the number of construction clients that hold retentions in England and their size distribution. There are difficulties in estimating the number of construction clients as anyone or any business can be a construction client. There will be repeat construction clients but also many one-off construction clients each year. Subject to stakeholder engagement, through consultation we intend to gather views on possible sources for this data.

Insolvency practitioners

245. There will be a small one-off familiarisation and possible system change costs affecting all insolvency practitioners as a result of Option 2. R3, the Association of Business Recovery Professionals which represents 97% of IPs, estimate that 46% of its members can be classified as micro and small businesses.⁹⁷ Through consultation with R3 we intend to further explore what the impacts of Option 2 would be on IPs, and whether any disproportionate costs to small and micro businesses might need to be mitigated.

Secured creditors

246. It is difficult to estimate with any certainty the number of businesses involved in secured lending to construction contractors and repeat construction clients in England. The 2015 Business Population

⁹⁶ BIS Business Population Estimates. (2015). <https://www.gov.uk/government/statistics/business-population-estimates-2015>

⁹⁷ http://www.legislation.gov.uk/ukia/2016/154/pdfs/ukia_20160154_en.pdf Note: these figures are for the UK not England only. Figures are not available for UK only

statistics⁹⁸ estimates that around 465 employers in the UK were involved in monetary intermediation and this is our best estimate of the number of businesses impacted⁹⁹. However, this is probably an overestimate of the number impacted by Option 2 as it is likely that not all of these will lend to construction contractors and repeat construction clients that hold retentions.

247. Figure 13, provides a breakdown of the number of UK employers involved in monetary intermediation by business size. This shows that 34% are micro and 30% are small enterprises.

Figure 13: Monetary intermediation business in the UK, by size¹⁰⁰

All employers	465
Micro (1 - 9 employees)	160
Small (10 - 49 employees)	140
Medium (50 - 249 employees)	100
Large (250 or more employees)	65

248. Subject to stakeholder engagement, through consultation we intend to gather more evidence on what creditors (secured and unsecured) typically lend to construction clients and contractors, and are therefore likely to face a cost under Option 2.

Distributional impacts analysis

249. The main impact of Option 2 will be to transfer the risk and potential cost of losing the money that they are owed due to insolvency from construction contractors with a retention held to secured creditors and other unsecured creditors of those holding retentions. Evidence shows that over 99% of construction contractors in England and 64% of all UK monetary intermediation businesses are small or micro firms. Subject to stakeholder engagement, through consultation we intend to gather more evidence on what creditors (secured and unsecured) typically lend to construction clients and contractors, and are therefore likely to face a cost under Option 2 (i.e. how many of these are likely to be small and micro businesses).

250. We also envisage that there will be a series of costs to the construction contractor and clients holding retentions from having to set up and administer a trust accounts, familiarise themselves with the changes, and not being able to use the retention money elsewhere in their business. As discussed in more detail under 'Scope of Scheme' we suspect it likely that a retention deposit scheme will be disproportionately and prohibitively expensive for small businesses, and / or for small value or short term construction contracts. A threshold is likely to be needed to ensure that small and micro businesses do not face disproportionately high costs. We intend use consultation to determine what an appropriate value threshold might be, above which the requirement to deposit retentions in an authorised scheme would apply, and adjust any final impact assessment accordingly. Exempting micro businesses using some kind of threshold is something that will be explored during the consultation period.

⁹⁸ BIS UK Business Population Estimates. (2015). <https://www.gov.uk/government/statistics/business-population-estimates-2015>.

⁹⁹ Data is not available for England only

¹⁰⁰ BIS UK Business Population Estimates. (2015). <https://www.gov.uk/government/statistics/business-population-estimates-2015>

251. We also envisage that Option 2 could reduce unjustified non-payment and late-payment of retention monies down the supply chain, due to changes in incentives faced by those holding the retention (i.e. because they can no longer use it as working capital). We therefore envisage that Option 2 could largely benefit smaller construction contractors, at the potential cost of larger construction contractors and clients. i.e. it is likely to be a transfer of benefit to small and micro businesses.

252. Familiarisation costs will apply to insolvency practitioners and secured creditors regardless of the type and size of business, so there is no adverse impact on small businesses.

Direct costs and benefits to business calculations (following OITO methodology);

253. The direct cost and benefits to business under Option 2 will be:

- Familiarisation costs (to construction contractors, repeat construction clients, insolvency practitioners, and secured creditors)
- Contract change costs for contract writing bodies and various parties to construction contracts.
- Transfer of risk and cost in the event of insolvency from the business that holds the retention from construction contractors to other business creditors. This represents a cost to other creditors (estimated 90% cost to business, 10% to Government), but a benefit to construction contractors to whom the retention money is due.
- Administration costs and account fees for those who currently hold retentions and continue to want to do so.
- Cost to those holding retentions as they will no longer be able to use retention money elsewhere in their business and may need to seek credit from elsewhere

254. The total net direct impact on business per year, given the costs and benefits that it has been possible to monetise is, therefore, estimated to be **£20.5 million**¹⁰¹.

Wider impacts

255. Competition Assessment: We do not envisage that the options considered would have adverse competitiveness impacts.

256. Small Firms Impact Test: see Small and Micro Business Assessment.

257. Justice: we envisage that the options considered will have no direct impact on Legal Aid (it is not available in respect of insolvency proceedings).

258. Sustainable Development: the Options considered will have no direct impact on sustainable development.

259. Greenhouse Gas and Environmental assessment: The options considered will have no direct impact on greenhouse gas assessments.

260. Health: The options considered will have no direct impact on health.

¹⁰¹ EANDCB, £2014 prices, 2015 PV

261. Equality Impact Assessment: The options considered will not have an adverse or disproportionate effect on any person as a consequence of race, ethnic origin, religion, gender or sexual orientation.

262. Human Rights: The options considered will have no direct impact on human rights.

263. Rural Proofing: The options considered will have no direct impact on Rural Proofing.

Summary and preferred option with description of implementation plan

264. As outlined above, we intend to use consultation to consider whether the options that have been analysed are appropriate, and to gather more evidence to inform the Final Impact Assessment. This will then be used to develop an implementation plan, and be used to inform policy making and decision making on what the 'preferred option' should be in the Final Impact Assessment.

Post Implementation Review (PIR) Plan

265. This will be developed for the Final Impact Assessment, once there is more clarity on the extent of reduction and time frame in which policy objectives will be achieved. This will be determined by the package of measures which are taken forward as a result of the consultation exercise. We will use the consultation to gather evidence to support a clear and measureable objective.