Australian Constructors Association

Credit where credit's due

Improving security of payment and liquidity in the construction industry

AUSTRALIAN CONSTRUCTORS ASSOCIATION

CREDIT WHERE CREDIT'S DUE
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About the Australian Constructors Association

Established in 1994, the Australian Constructors Association (ACA) is a trusted voice for the construction industry. We are the only representative body covering the three key sectors of the industry—vertical, horizontal and services. Collectively, our members construct and service over 90 per cent of the value of major infrastructure projects built in Australia.

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About this paper

This paper considers the issues that lead to the high rate of insolvencies in the construction industry and proposes practical ways to improve cash flow and security of payment throughout the whole industry supply network. If implemented, the construction industry would benefit from increased productivity, innovation and participation in the sector by small and medium sized enterprises.

Key points

Recent high profile business failures have highlighted the pressures faced by the construction industry.

918 construction firms entered administration between January and July 2022. The same period in 2021 saw only 589 construction administrations.

Construction firms represent 17 per cent of all businesses in the Australian economy, but account for 26 per cent of administrations.

These alarming figures are the direct result of a broken commercial model that amongst other things sees contractors exposed to a disproportionate share of the risk.

Poor commercial frameworks and a timing mismatch between expenditures and payments means that the construction industry effectively finances the construction of their client's projects.

These dysfunctional structures propagate risk throughout the industry, leading to high incidences of payment insecurity.

Project bank or trust accounts are blunt instruments that fail to address the root causes of the problem while imposing a great deal of administrative burden and cost on contractors.

Industry liquidity can be improved by:

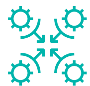
Advance payment provisions for site mobilisation costs and long lead, high value procurement items so contractors do not commence projects in a cash-negative position.

Payment terms that are sufficiently frequent and timely to support the contractor in meeting its payment responsibilities to the supply chain, business cashflow and to minimise the financing burden placed on the head contractor.

Removal of unnecessary preconditions from contracts to enable a valid payment claim.

Clear and timely variation processes that provide mechanisms to quickly resolve payment disputes.

Direct reimbursement of bid costs.



Simplification and harmonisation of financial requirements and reporting for contractors across jurisdictions.

National harmonisation of Security of Payment Acts (SOPA) regulations.

Effective and fair risk management frameworks such as the use of rise and fall mechanisms to address input cost escalation.

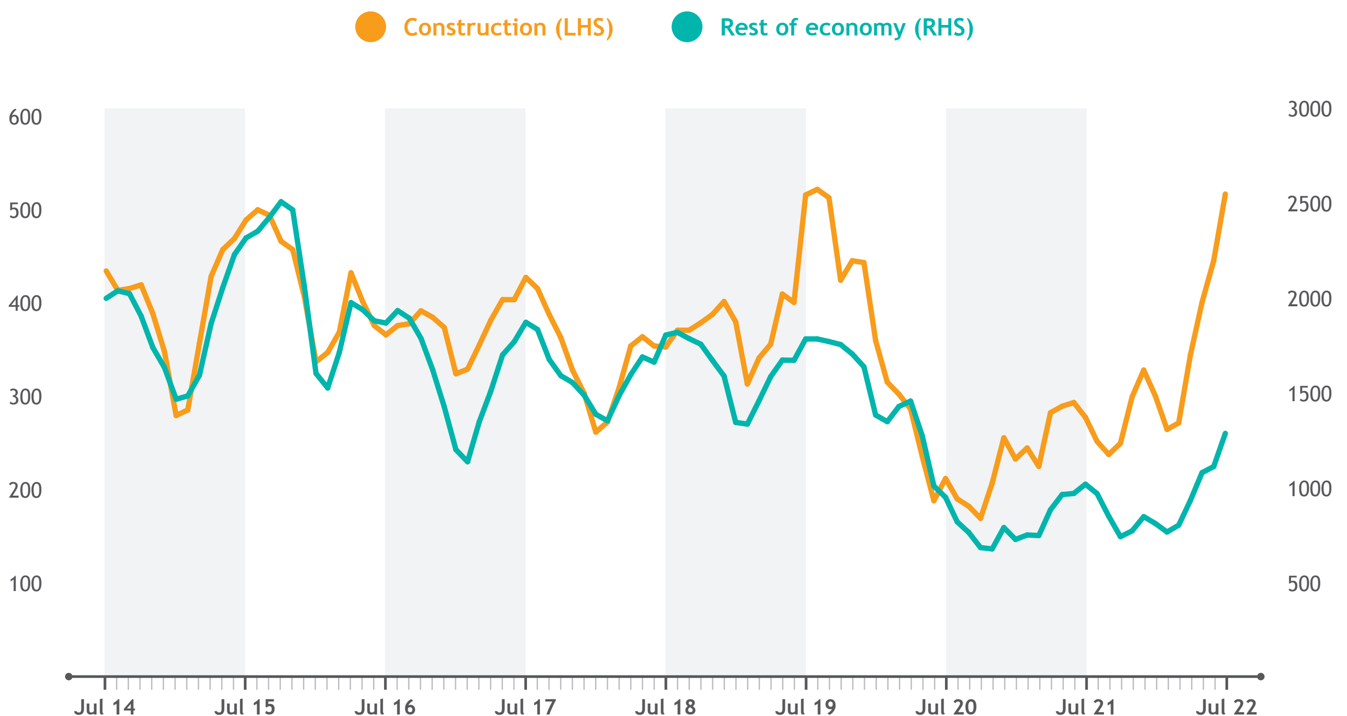
Introduction

A healthy construction industry is vitally important for the Australian economy. It is the country's third largest industry, employing 1 in 10 people, and contributing to 8 per cent of GDP.[1] Nearly 450,000 businesses operate in Australia's construction industry, accounting for 17 per cent of all firms in the economy.[2]

Insolvency has long been a feature of the construction industry. A company becomes insolvent when it cannot pay debts that are due. This can be from not having enough available assets to pay (balance sheet insolvency) or when a company has sufficient assets but has insufficient liquidity to pay debts as they arise (cash flow insolvency).

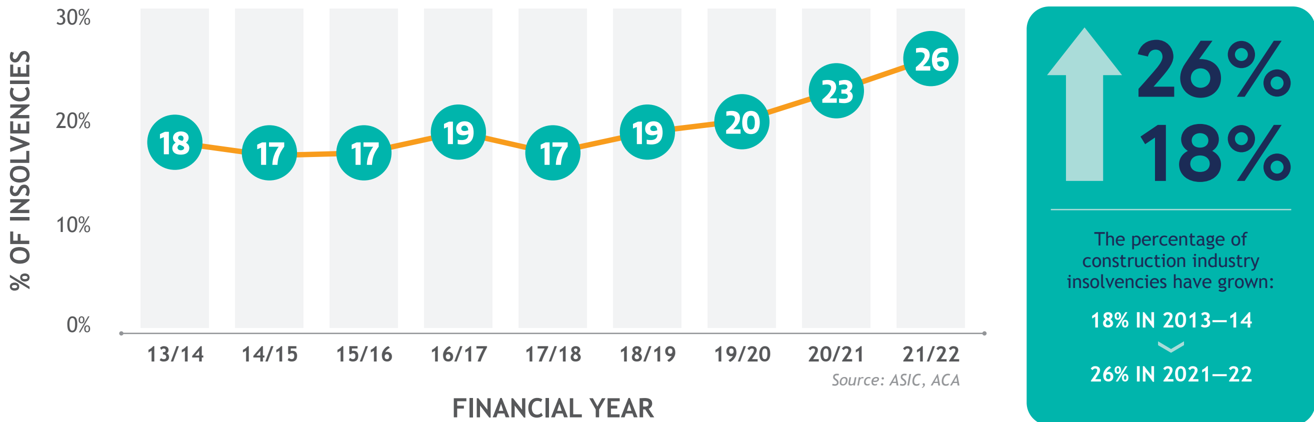
Recent reports of widespread difficulties among contractors have highlighted the pressures faced by construction firms, and the statistics reveal a worrying trend. While the number of companies entering administration have been rising across the economy over the last several months, the trend is particularly pronounced in the construction industry (Figure 1). As a result, construction firms now account for over one quarter of total administrations in Australia, a proportion that is noticeably higher than its 17 per cent share of firms (Figure 2).

FIGURE 1: ADMINISTRATIONS, AUSTRALIA



Source: ASIC, ACA
Note: rolling quarterly count

FIGURE 2: CONSTRUCTION SHARE OF TOTAL ADMINISTRATIONS, AUSTRALIA



Contractors and suppliers are not financial institutions but for too long they have been required to essentially bank roll projects on behalf of their clients, tying up cash that could otherwise be used to invest in new technologies, improve the capability of the workforce and reduce the impact of the industry on the environment.

The long-term nature of construction projects and clients' preferences for fixed-price contracting makes the industry particularly sensitive to inflation. If labour and material costs rise between bid and payment, it is left to the contractor to finance the shortfall. The pandemic put the weaknesses of this model into sharp relief.

This 'timing mismatch' between bid and payment is not a temporary artefact of the pandemic, but rather a structural feature of Australia's construction industry. It is just that the problem has been less evident until now because inflation has been structurally low for a decade or more, which provided contractors with some ability to predict and absorb escalation risk. Looking forward, however, few observers expect the benign inflationary environment of the last decade to return any time soon.

These risks are not confined to principal contractors. The dominant commercial and risk structures within the industry mean that subcontractors are also vulnerable to the risks borne by head contractors. The persistent and widespread focus on 'security of payments' within the industry demonstrates the systemic and difficult nature of these challenges.

This paper proposes several policy responses available to governments and private investors that would improve liquidity and address security of payment throughout the industry. It argues the increasingly popular response of 'project bank accounts' fails to address the root causes of these issues while imposing a costly burden upon contractors for little demonstrable return. The key points of weakness within the industry's current practices are next explored, before reviewing some practical solutions that governments and developers can readily implement to improve the functioning of the industry.

The vulnerabilities

Commercial frameworks

Selecting the most appropriate commercial delivery model for a project is of key importance when considering ways to improve liquidity in the construction industry.

In a competitive market, where bids are assessed on price alone, contractors are likely to compete against each other on their willingness to price and accept risks that cannot be properly assessed at tender. Even when weighting is given to other non-cost criteria, the lack of transparency around the assessment of tender submissions means that price and acceptance of risk remain dominant issues. Some of these risks are so big, they will lead to business failure if the risk is realised. To avoid this happening, many construction risks are mitigated by taking out insurance policies or by subcontracting work and associated risk down the supply chain.

With the ongoing impacts of the pandemic and the myriad of associated challenges, the high prevalence of disputes throughout the supply network is unsurprising. The dramatic increase in contract works and professional indemnity insurance premiums, which have become hard to arrange, are also of little surprise. Where project scope and design are well developed and risks quantifiable, it is entirely appropriate to allocate risks or create mechanisms which enable the risk of specific matters to be adequately placed. But in other situations a more transparent and collaborative approach to the management of risk must be adopted. Examples of such approaches were outlined in the Australian Constructors Association's July 2022 paper *Construction Cost Inflation: Ways to Address an Escalating Issue*.[3]

Whilst some State Governments in Australia are making changes and introducing relief mechanisms for specific costs that can be subject to extreme price volatility, this practise is not yet established across the industry. Until there is an effective and fair risk allocation framework consistently applied for specific items where risk mitigation is not possible for contractors (particularly on large, long duration lump sum projects), liquidity and security of payment will remain a concern for the industry.

Payment practices

Few other industries comparable to construction expect contractors to finance large amounts of work upfront on behalf of a third party. Civil aviation, for example, shares many of construction's commercial realities: long production times requiring large expenditures of working capital on plant, material, labour and sub-contracts. Unlike construction, however, it is widely accepted that aircraft manufacturers will offset these pre-delivery costs by requiring their customers to make significant early payments. This system is routinely facilitated by a special purpose tripartite credit facility between purchaser, manufacturer and lender.

Such sophisticated commercial arrangements are rarely employed in the construction industry. Instead, the principal contractor carries the liquidity pressures and the burden of risk associated with significant upfront payments. Construction projects have high working capital requirements for all involved in order to fund and manage the upfront cash outlays arising from high mobilisation costs, weekly paid labour, monthly paid staff, plant and equipment and early supply chain engagement.

These circumstances make it very difficult for contractors to maintain cash neutrality, let alone positive cash flow. Unfortunately, contracts continue to provide for a 'cash negative' payment regime—meaning the contractor is paid after work is done and materials ordered and fixed to site. Milestone payment regimes further exacerbate the issues with typical progressive payment models that do not account for mobilisation or long lead procurement upfront costs through an initial payment to a contractor.

The lag between expenditure by the contractor, including sub-contractors, and payment by the client can be substantial. Contractors can be required to repay substantial upfront costs, like site establishment over the duration of the project, or upfront procurement costs for long lead items. In some instances costs are incurred more than six months before the relevant items are supplied to a contractor. This results in contractors expending significant sums, sometimes millions of dollars, before receiving payment.

Few companies can finance such cash flow and it becomes a barrier to entry into the industry. Those that can need to find external lines of credit but such credit is getting harder to secure with increased insolvencies making construction one of the highest risk industries for investors and lenders. The lack of availability of finance may ultimately see many small to medium sized businesses leaving the industry which will negatively impact on the capability and capacity of industry to deliver the upcoming pipeline of work.

In addition to payment for the originally contracted scope of work, variations and claims often take months for clients or their contract administrators to process. Payment for additional work can be withheld in its entirety until a valuation is agreed even though the basis of entitlement is not in dispute. The result is head contractors are not paid for additional costs incurred for a substantial period. This can have significant impacts for the entire supply chain, particularly if the entitlement is disputed.

Other challenges with current payment practices include unnecessary and/or arbitrary documentation requirements for making a payment claim. Some contracts require contractors to provide documentation to support a payment entitlement that has no direct bearing on whether payment is owing. This places an administrative burden on contractors and can be used to delay payment if zealously enforced. Other contracts contain requirements such as release (from claim) documents that are required to be signed prior to a payment

being made. These can be used to require contractors to sign away entitlement to subsequently make legitimate claims under the contract. These can be particularly problematic when the contractor is in financial difficulty.

Finally, when a contractor is in financial distress it can lead to an increase in claims and adversarial behaviours as the contractor fights for survival. In these scenarios clients/suppliers seek to protect themselves against the prospect of contractor insolvency which can only serve to hasten the contractor's demise, particular in instances where the client seeks to access a bank security.

Bid costs

Contractors incur substantial bid and tendering costs in securing contracts. Typically, these can range from 0.6 per cent to 1.3 per cent of the estimated cost of the project or $600,000 to $1.3 million for a $100 million project. In many cases these costs are not reimbursed or only partially reimbursed by the client and contractors are expected to absorb the costs as part of doing business. Payment of bid costs can also be conditional on submission of a compliant bid thus influencing contractors to accept risk that they might otherwise exclude.

Costs incurred in bidding therefore form part of a contractor's overhead that is only recovered through successful delivery of projects. This can further drive acceptance of unquantifiable risk and lower profit margins in order to win projects to secure the overhead recovery which in turn can increase the prevalence of contractual claims.

Project security

Onerous requirements to provide security for contractor performance are another commercial impost on industry. These include retention of a component of amounts otherwise due for payment until the project is completed, bank guarantees and parent company guarantees. In addition, contractors are often required to provide duplicate security when seeking upfront payment for the purchase of key plant and equipment, and/or unfixed materials. In many instances, these security requirements are cascaded throughout the supply network to mitigate risk.

Once contractors secure materials and/or take ownership of key plant and equipment, there should be no need for clients to require security in the form of both bank guarantees and a legal right over an asset (either via an entry in the Personal Property Securities Register or through appropriate contract terms that transfer ownership of the relevant asset to the client upon corresponding payment for that asset). This duplication of security puts a strain on the contractor's ability to source additional lines of security to bid and deliver other projects, and is an unnecessary material cost to the project.

Banks and bond providers will only provide contractors with access to guarantees if they meet certain financial criteria which can significantly reduce the number of contractors able to bid certain projects. Banks also charge a fee for providing these guarantees which can be considerable on larger projects.

The wrong answer

Project bank or trust accounts have attracted increasing interest as a policy instrument for managing the liquidity issues facing construction firms in Australia.

Such models have been recommended by several reviews, including the Murray Review[4] and Collins Review.[5] The typical model is a deemed cascading statutory trust whereby the trust would arise on receipt of money by the trustee (being a party receiving payment for construction work carried out by a subcontractor/supplier).

There is little evidence that project bank/trust accounts achieve payment security but rather burden the construction process with considerable administrative overhead. Fundamentally, project bank/trust accounts do not address the root causes of poor payment practices and their costs outweigh any benefits.

Several assumptions are frequently made about statutory trusts which are unrealistic or inaccurate. For example, it has been suggested that:

- the additional accounting requirements will not necessarily require any more stringent bookkeeping that is now required for the proper running of a business
- a trust scheme might deter underbidding
- contractors using money from one project for a payment on another project is necessarily using money 'due' to another subcontractor
- all that is required is the opening of a new bank account for each project.[6]

Further, the Australian Constructors Association rejects the findings in a report prepared by Deloitte[7] for the Queensland Government which justified statutory project bank accounts for projects over $1 million. One of the key assumptions in reaching the conclusion was that sub-contractors included a price premium when tendering for projects to account for poor payment practices and that project costs would reduce by 2.5 per cent if a trust regime was in place. This assumption is incorrect.

The Australian Constructors Association's paper *Project and Statutory Trusts* notes that project bank accounts/trust accounts are a blunt instrument for a complex problem. They do not accurately target the problem they aim to resolve, and do not address the underlying causes of poor payment practices or industry insolvencies. Queensland was the first jurisdiction to introduce statutory project trust accounts. This legislated regime is overly complex and arguably fails to address the problem of subcontractor non-payment. The costs of project trust accounts include training, trust account oversight, compliance with audits, bank fees, legal costs and overhead costs associated with implementation of complex processes. In evaluating the impact of the Queensland model, the Building Industry Fairness Reforms Implementation and Evaluation Panel heard that the transition had been burdensome and would see contract prices increase by 2-3 per cent.[8]

Project trust accounts result in substantial administrative and financial burden to the head contractor for little to no benefit for sub-contractors. To provide better payment protection for sub-contractors, arguably the requirement for project trust accounts would need to apply to all levels in the supply chain irrespective of contract value. Otherwise, sub-contractors and suppliers at the end of the contracting chain become vulnerable and thereby erode any payment protection gained through the implementation of such a regime. To impose trust requirements on all tiers of the supply chain, however, would present a heavy administrative burden as well as creating fiduciary duties which carry considerable legal implications for businesses that are arguably least able to manage and facilitate compliance with such requirements. Additionally, as cash in project bank accounts is not viewed as operational cash, lenders may view a business as lacking liquidity when looking at the size of its future work, turnover and size of balance sheet and be reluctant to provide funding.

Retention trust structures are more meritorious; however, they can lead to a push for non-cash security which results in additional cost to those providing it and are not always available to a subcontractor. There is additional administrative burden and cost in retention trust accounts, although not as significant as project trust accounts.

The right answers

Prompt and fair payment is essential for the health of the industry. Contractors should not be required to bank roll projects for their clients. There are several policy responses available to governments and private investors to improve liquidity and address security of payment throughout the industry without resorting to the costly, burdensome and ineffective method of project bank accounts.

Advance payments

Airbus requires 20 per cent of the capital costs to be paid upfront before manufacture of a new plane. With a price tag of US$445 million, an A380 represents a similar investment to a mid-range construction project. In the cruise industry, the construction of new cruise liners is paid in instalments matched to agreed milestones; handover of each of the various packages results in priority advance payment. At the most basic level—utilities bills, airline bookings, or new mobile phones—all require deposits, up-front payments (first month), and mandatory direct debit subscriptions to ensure the provider does not carry the bulk of the risk. So why should the construction industry be any different?

Advance payment should be provided for site mobilisation costs and long lead, high value procurement items to avoid the contractor commencing in a cash negative position. It is common ground that a residential builder will receive a deposit up front when building or renovating a home. Yet, clients are reluctant to provide a mobilisation fee on commercial construction projects. The principle is the same: contractors require cash flow to run their businesses.

Advance payment arrangements can also enable early ordering and storage of materials, which in an environment of substantial input cost escalation, is important to lock in a price as early as possible as well as secure delivery in a heated market. Given this benefit, it is important that any payment for materials is not conditional on them being physically on site.

Recognising the problem with bank guarantees, alternatives to secure any advance payment made should be considered such as securing an interest to title of key plant and equipment or off site/unfixed materials. The contractor should be able to elect to provide either a bank guarantee or a security interest, not both.

Frequent payments

Payment terms should be sufficiently frequent and timely to support the contractor in meeting its payment responsibilities to the supply chain, business cashflow and to minimise the financing burden placed on the head contractor. This should not be seen as something that is just done at time of crises such as urgent recovery works following floods and bushfires or Covid stimulus works. It should be business as usual.

Monthly or fortnightly payment terms are preferential to milestone payments. Where milestone payments are in place, interim frequent payments should be considered. It is not uncommon for head contractors to have up to 60 days between payment claims, with 30-day processing times, resulting in waiting up to 3 months following expenditure before being compensated.

Simplified and streamlined requirements for payment claims

Unnecessary preconditions should be removed from contracts to enable a valid payment claim. The Murray Review recommended a prohibition on contract terms which preconditioned payment to notice requirements that are not reasonably possible, unreasonably onerous or serve no commercial purpose. This recommendation has merit.

Clear and timely processes for variations and dispute resolution

Variations and other claims are often not assessed and finalised by clients for months. This creates a difficult situation for a head contractor with a subcontractor variation claim. The head contractor risks bearing a variation expense that the client disputes being a valid claim. Clients should commit to timely processing of variation claims, and to making prompt payment of any undisputed portion of claims. Consideration could be given to contractual deeming provisions such as those contained in the NEC (New Engineering Contract, as created by the UK Institution of Civil Engineers) form of contract. This would mean variations are deemed approved if not responded to in a certain timeframe. Contracts should also permit on account payment for undisputed elements of variations and delay events as opposed to only when final agreement on quantum is reached.

Rapid resolution of payment disputes for the head contractor through a contractual mechanism and genuine commitment from clients to resolve variations and claims in an amicable way is desirable to avoid a need for statutory adjudication procedures and litigation.

Increased reimbursement of bid costs

Given that clients and particularly government clients pay for bid costs either directly through reimbursement of costs incurred or indirectly through contractor margin on projects, consideration should be given to increased use of direct reimbursement. As well as improving liquidity in the industry, this could encourage industry to do more upfront work to provide greater certainty in tenders, increase innovation and de-risk major projects. It could also enable a wider section of the market to bid for larger projects.

Consideration should also be given to procurement models that significantly reduce the cost of tendering. Having multiple contractors spending large sums of money on bids (even if these costs are reimbursed) is not overly productive and uses resources that could be diverted to other more meaningful activities, especially given current capacity constraints.

Reasonable financial requirements

Financial requirements for licensing or prequalification of contractors can be onerous, and some assets are not considered, for example funds in a joint venture account.

Some jurisdictions require detailed financial information on a regular basis for each project, in addition to providing that information at each stage of the procurement process for individual Request for Tenders, placing a further administrative burden on industry. Financial requirements for licensing in Queensland are particularly onerous, with some contractors creating Queensland-specific entities to meet the 'on paper' requirements, restricting cashflow elsewhere in the business.

Financial requirements for contractors should be simplified and harmonised across jurisdictions. This includes the provision of financial information with some government agencies requesting and assessing the same information from individual contractors at each tender stage and for projects in delivery. Financial information should not be required by a government more than twice a year across all projects (as the information remains substantially the same during this period). Ideally, this information should be provided once to a centralised body representing the government's procuring and delivery agencies.

Standardisation of regulations

Harmonising state-based Security of Payment Acts (SOPA) regulations at a national level should be a key priority of government. This was a recommendation of the Murray Review[9] and moving to implementing proposed recommendations is long overdue.

SOPA is the best mechanism for regulators to drive speed of payment and police payment disputes. Standardising SOPA would substantially remove the inefficiencies in claim to payment processes in the industry, with likely positive flow-on effects for payment behaviour generally, and therefore liquidity. Coupled with the new Payment Time Reporting Scheme (PTRS), a standardised SOPA would only strengthen the key piece of legislation supporting security of payment in Australia and should be a key priority of Federal Government in the near term.

Require reasonable security

Security undertakings requested from the contractor must be reasonable and proportionate. For example, contractors are often required to provide security for performance for the contract, as well as a parent company guarantee. Where a client has engaged a contractor on multiple projects, it should consider taking account of the portfolio of bank guarantees that it holds rather than requiring the provision of security on every individual project.

Consideration should also be given to innovative project security arrangements that bind more than just the main contractor and reduce the need for cascading securities. Recourse to security should be limited to ensure performance and not as a means to secure preferential settlements for disputed claims and variations.

Effective and fair risk allocation framework

An effective and fair risk management framework consistently applied for key inputs where risk mitigation is not possible for contractors (particularly on large, long duration lump sum projects) is essential to prevent contractors from bearing unquantifiable and unmanageable financial risk. A topical example is the use of rise and fall mechanisms to transparently deal with the risk of material/labour price escalation.

The time for action is now

Whilst they offer great terms, contractors and suppliers are a poor substitute for banks when it comes to financing construction projects.

By tying up industry capital, clients are missing out on the opportunity for increased innovation, reductions in carbon emissions, increases in productivity and reductions in the overall cost of construction. More importantly construction clients are significantly increasing instability in the industry on which they are relying.

Projects are no different to any other significant purchase and should be financed through institutions that are appropriately set up to do this.

For the sake of the economy, the environment and wider society we need to improve the financial health of the construction industry and we need to start now.

Endnotes

1: ABS Cat Nos. 6291.0.55.001, Table 4 and 5206.0, Table 6

2: ABS Cat No. 8165.0, Table 1

3: *https://www.constructors.com.au/wp-content/uploads/2022/07/Construction-cost-inflation_July-2022.pdf*

4: J Murray AM, ‘Review of Security of Payment Laws: Building Trust and Harmony’, December 2017

5: B Collins QC, ‘Final Report of the Inquiry into Construction Industry Insolvency in NSW’, January 2013

6: WA Law Reform Commission, ‘Financial Protection in the Building and Construction Industry’ March 1998

7: Deloitte, ‘Analysis of Security of Payment Reform for the Building and Construction Industry: Prepared for the Queensland Department of Housing and Public Works’, November 2016

8: Building Industry Fairness Reforms Implementation and Evaluation Panel, ‘Building Fairness: An Evaluation of Queensland’s Building Industry Fairness Reforms’, March 2019

9: J Murray AM ‘Review of Security of Payment Laws: Building Trust and Harmony’ December 2017

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