

PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT

Fifth Delegated Legislation Committee

DRAFT CONSTRUCTION CONTRACTS (ENGLAND)
EXCLUSION ORDER 2022

Wednesday 29 June 2022

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The Committee consisted of the following Members:

Chair: JAMES GRAY

Abbott, Ms Diane (*Hackney North and Stoke Newington*) (Lab)

† Aiken, Nickie (*Cities of London and Westminster*) (Con)

† Ali, Tahir (*Birmingham, Hall Green*) (Lab)

† Bacon, Gareth (*Orpington*) (Con)

† Buchan, Felicity (*Kensington*) (Con)

De Cordova, Marsha (*Battersea*) (Lab)

† Esterson, Bill (*Sefton Central*) (Lab)

† Hillier, Dame Meg (*Hackney South and Shoreditch*) (Lab/Co-op)

† Hunt, Jane (*Loughborough*) (Con)

† Johnson, Gareth (*Dartford*) (Con)

† Jones, Andrew (*Harrogate and Knaresborough*) (Con)

† Liddell-Grainger, Mr Ian (*Bridgwater and West Somerset*) (Con)

† McDonnell, John (*Hayes and Harlington*) (Lab)

† Millar, Robin (*Aberconwy*) (Con)

† Morden, Jessica (*Newport East*) (Lab)

† Rowley, Lee (*Parliamentary Under-Secretary of State for Business, Energy and Industrial Strategy*)

† Seely, Bob (*Isle of Wight*) (Con)

Guy Mathers, Ian Cruse, *Committee Clerks*

† **attended the Committee**

Fifth Delegated Legislation Committee

Wednesday 29 June 2022

[JAMES GRAY *in the Chair*]

Draft Construction Contracts (England) Exclusion Order 2022

9.25 am

The Parliamentary Under-Secretary of State for Business, Energy and Industrial Strategy (Lee Rowley): I beg to move,

That the Committee has considered the draft Construction Contracts (England) Exclusion Order 2022.

It is a pleasure to serve under your chairmanship, Mr Gray. The draft statutory instrument was laid before the House on 11 May for affirmative resolution. It is being made using powers under the Housing Grants, Construction and Regeneration Act 1996, which is typically referred to as the construction Act. The SI seeks to increase investment in water and sewerage infrastructure through a new procurement model. The specific order is limited to the model developed by Ofwat, which is known as direct procurement for customers.

The order has been drafted to provide a very narrow scope. It excludes only two types of construction contract from the provisions of part II of the construction Act. First, DPC head contracts, also known as competitively appointed provider contracts, are excluded from all requirements of part II of the 1996 Act. Secondly, DPC first-tier subcontracts are excluded from section 110(1A) of the Act. That will allow payments to DPC first-tier subcontractors to be conditional on obligations being performed in other contracts. All remaining construction contracts throughout the supply chain, in particular for small and medium-sized enterprises, will remain subject to all provisions of the Act. Application of the instrument is within England only, as construction is a devolved matter.

I will spend a few minutes setting out the rationale and context behind the draft statutory instrument. The design and construction of an asset can be procured by many different routes. Typically, the most common routes of procuring an asset are build-only, or design and build, where contractors will competitively tender for those types of contract.

DPC is a different type of contract from traditional procurement in the water sector, which would ordinarily be design and build, funded through five-year price reviews agreed between the water companies and Ofwat. Instead, DPC is based on a regulated water and sewerage provider—the water company in each individual area—competitively tendering for a third party to design, build, finance, operate and maintain a major infrastructure scheme. In DPC, the third party will likely be a special purpose vehicle, which will commonly include a construction company, a funder and a service provider. In turn, that SPV will enter into a series of subcontracts for the design, construction and maintenance of the asset.

In effect, that creates a new competitive model for water infrastructure financing, and then for delivery and operation, opening the market up to new participants. That can deliver significant additional value over and above the traditional approach, and we hope that it will do so. We hope that it will provide innovation, resilience and ultimately, in time, lower costs to customers.

On the legal context, part II of the construction Act creates a framework for fair and prompt payment through the construction supply chain, and a resolution procedure for disputes. Generally, the Act requires the legal framework for any transaction to be implemented through the construction contract. Where a construction contract omits to deal with an issue, or does so in a way that does not meet the requirements of the Act, the scheme for construction contracts, which has been around for a number of years, is implied. As a result of historical decisions, the construction Act has always prevented “pay when paid” clauses, which were often used previously as a way to delay payments to the supply chain. The Act also prevents any term in the contract that makes a payment conditional on the performance of an obligation elsewhere under another contract.

For many years, that legal framework has played an important role in improving the payment practices in the industry and is intended to cover a wide range of construction contracts. Notwithstanding that, the construction Act confers powers on the Secretary of State to disapply the provisions in limited circumstances. That has happened before: the construction contracts exclusion orders in both 1998 and 2011, due to the distinctive financing arrangements that the contracts underneath them were proposed, allowed that disapplication. For the same reason—a change to distinctive financing arrangements—we are seeking to use the exclusion again.

There is a risk that the proposed DPC contract arrangements could be challenged for non-compliance with the construction Act if changes are not made. DPC contracts fall within the definition of a construction contract, and must therefore include construction Act-compliant payment processes and adjudication arrangements. If they do not, the scheme for construction contracts is deemed to apply in any case. However, if that happened in future DPC contracts, it would adversely affect the structure and operation of those project contracts, and would threaten the viability of the procurement model. The whole point of DPC is to do something differently so that the infrastructure can be developed and delivered, and the construction Act elements and the scheme should not be applied as a result of that.

As part of the development of the statutory instrument, a targeted consultation was undertaken with the relevant construction industry and water stakeholders. Most held the view that DPC was important in unlocking significant private sector investment and helping water companies to deliver in the future. It was confirmed that the specific contracts would be disproportionately affected by the provisions of part II of the construction Act if changes were not made. In the absence of such an exclusion order, the tendering parties for the new procurement model have indicated their unwillingness to proceed, due to the risk of being challenged on non-compliance with the construction Act and the impact of any successful challenge.

Equally, any regulation must be targeted to ensure it is used only for intended contracts. The majority of respondents were in favour of exclusion, although some concerns were expressed regarding the impact of first-tier subcontractors and the potential risks to the supply chain. Stakeholders spoke about potential challenges down the supply chain business model, and the potential pinch point for first-tier subcontractors.

It is important to highlight, however, in relation to points about consultation, that the first-tier subcontractor or its parent company will often be part of the SPV itself, which will ensure that it has good knowledge of the funding structure, the contract terms and the risk allocation under this type of new procurement model. That means that the contractor is in a good position to assess and therefore price in contracts any associated risk—the general position associated with more traditional construction contracts. Stakeholders acknowledge that firms that bid for DPC contracts are likely to have previous experience of other funding models, and will have full knowledge of the terms, including the changed terms for payments and dispute resolution.

Although the Government understand stakeholder concerns, we believe that the benefits outweigh the risks, and we have introduced this statutory instrument to support future investment in the water and sewerage sector. Ultimately, it will be for individual water companies to determine how best to approach the matter and to sign appropriate contracts where they can.

DPC is a competitive delivery model focused on increasing investment and making it go faster to improve water and sewerage infrastructure. The Government believe that that model has an important role to play in attracting the investment needed to improve the operation, resilience and sustainability of that UK infrastructure. Two initial DPC projects are under active development in England, and a further 18 may come forward when they meet eligibility criteria. Ofwat expects DPC to be used in future for many major water infrastructure projects.

I emphasise that the exclusion order has been deliberately designed to be narrow in scope and to be used only for DPC contracts. The provisions will not, as far as we are aware, have any impact on SMEs throughout the wider supply chain. I commend the order to the Committee.

9.34 am

Bill Esterson (Sefton Central) (Lab): It is a pleasure, as always, to have you in the Chair, Mr Gray. I am grateful to the Minister for his in-depth explanation of the order, but I will perhaps tease out further one or two of the points that he made.

The Minister quite rightly made the point that the construction Act was designed to address, among other things, the very real concerns about poor payment practices, particularly through construction industry supply chains. It addressed the way in which pay when paid was used to undermine the interests of smaller firms and self-employed contractors. It explained the rationale, and the fact is that this has been used previously.

What the Minister has said, however, raises a number of questions, some of which were raised in the House of Lords. The Lords Minister's answers raised additional questions, which the Minister has not quite addressed this morning. First, he mentioned that the tier 1 provider

would often be part of the special purpose vehicle. Could he clarify how often that is likely to be the case? In circumstances where it will not be the case, what protections would there be through the supply chain? I can perhaps pre-empt his answer, because he did say that whoever the contractor is would be aware of the terms and the dispute resolution mechanism.

Cash flow was also raised in the House of Lords. Given what has been said by the Minister, the explanatory memorandum and in the House of Lords, I believe I am right in saying that payment is due to the tier 1 contractor when services are delivered. That gives rise to a question about the timeframes. If payment is made after one month, that should not adversely affect the cash flow and ability of the tier 1 contractor to pay SMEs, self-employed contractors and the workforce more widely. However, what are the implications if payment is made after six months or longer? I take the Minister's point about the SPV, but what protection is there for those contractors who are not part of it? That seems to be the key challenge to tease out, to make sure they do not end up with cash-flow problems.

We are all acutely aware of what can go wrong in the construction industry. In recent years, Carillion left £2 billion unpaid to its supply chain. I am not suggesting for one minute that this is another potential Carillion—it is on a very different scale and, as the Minister has set out, it is a regulated situation—but ultimately this comes down to cash flow. I am concerned about what happens if tier 1 contractors are not in a position to ensure their cash flow because of the way in which contracts are let and agreed, in spite of their awareness of the terms up front. We need to do everything we can to avoid problems through the supply chain for SMEs, self-employed contractors and the workforce. That is the key point.

On a related point, I want to tease out whether the concerns I have raised are the same as those raised in the consultation responses. I gently say to the Minister that it would be helpful if we could see the consultation responses before we debate statutory instruments, so that we can scrutinise the concerns that were raised with Ministers directly. It was helpful of him to draw our attention to what some of those concerns might be, but could he confirm whether I am correct in assuming that the people consulted raised the same concerns as me, or did they raise other concerns?

That covers the main points. In essence, I would like to hear from the Minister whether pay when delivered is in danger of getting close to pay when paid, and how that will be avoided and policed. Ultimately, if there is a situation where cash flow is problematic, how does he envisage ensuring that that does not create problems through the supply chain for SMEs, self-employed contractors and the workforce?

9.39 am

Lee Rowley: Many thanks to the hon. Member for Sefton Central for his constructive questions and comments. I will try to take them in turn, although I will take the third one first. I was not in the specific consultation meetings, but as I understand it consultation was undertaken over a number of months. I mentioned in my speech some of the things that the hon. Gentleman has pointed out. I will cover those in a moment, including the need to ensure that the model and the cash flows work and

[Lee Rowley]

that ultimately those companies further down the supply chain can still get the money they need for the services that they pay for.

The consultation covered a significant number of operators in both the water industry and the construction industry, ranging from Balfour Beatty to Build UK, the Civil Engineering Contractors Association, Costain, Deloitte and EY. There were roundtables with water companies covering Yorkshire Water, South West Water, Welsh Water and United Utilities. My previous comments were a fair reflection of the aggregate opinion, which is that they are content to progress and recognise that this has the potential to be an important new tool. They want to make sure that the contracts are organised in a way that minimises issues, but also recognise that there is risk and that that has to be priced in through the commercial transactions undertaken either when people or organisations join the SPV or contract into it.

Bill Esterson: The Minister mentioned the consultees and named some fairly large businesses. Were SMEs and those further down the supply chain part of the consultation? What were their responses?

Lee Rowley: A number of industry bodies were consulted, including Build UK and the Construction Leadership Council, which try to take a holistic look at the views of the industry as a whole. In my other role, as construction Minister, I work with them very closely and know that they try to ensure that they prioritise the views of all across the industry, not simply those who may speak with a louder voice, for whatever reason.

Let me turn to the other two points, which are important and I am happy to address them. We hope that the special purpose vehicle will be a tool that can be used to bring forward significant infrastructure improvements in the future, but the ultimate decision about how it would be set up in the one, two, three or n number of cases where this happens will be down to the organisations that want to go into those SPVs. The hon. Gentleman asked how likely the first-tier contractor is to be part of the SPV or its entity, but I cannot give him a number, a percentage or an expectation, because ultimately that will be down to the market to determine. However, experts and officials have indicated that, given historical precedent and what companies that play in this space are likely to do, they would expect those companies building this infrastructure, such as pipes or sewage improvements, to take an early interest in the discussions and the transactions. It is not unusual for such companies to be in similar financial structures early on in the SPV process, but that will ultimately be down to them.

That leads on to the second question, which is how do we make sure that there is not a problem of payment further down the supply chain. There are two broad answers to that. First, for those who are not first-tier suppliers, the same requirements apply around payment as they do today. The contracting that would be undertaken for tier 2 suppliers would be undertaken on the basis of the construction Act, and that Act and the scheme of construction contracts contain clear clauses about payment upon delivery, not payment when other organisations or entities choose. That is not changing.

What is changing is, in effect, the box before that. The SPV and the first-tier operator will need, either through being a group of one or through the SPV contracting to a tier 1 operator, to price in risk appropriately and organise themselves appropriately. They will also need agreement with their funders to ensure that they have cash available at the point at which they will need the working capital to pay tier 2 suppliers or whoever they are contracting, to ensure that the output is delivered.

That is fully transparent at this stage, and that is exactly what the DPC is designed to do—to allow private companies to go out and seek investment to cover the build element, including tier 2 suppliers, and then recognise that they will start to get a revenue stream at the point when the infrastructure is delivered. That is entirely the point of it. The revenue coming from the water companies will not start until delivery. That means that if this works, and we have confidence that it will, the risk to the public purse is minimised because companies pay on results, not on proposal, and because a set of companies and individual actors will be entering into a contract to ensure that they price the risk of delivery appropriately and deliver it to get a long-term revenue source from the Government.¹ I hope that those answers resolve the points raised by the hon. Gentleman. I am grateful for his contribution.

To conclude, I reiterate that the creation of any exclusion under the construction Act is the exception.

Dame Meg Hillier (Hackney South and Shoreditch) (Lab/Co-op): Before the Minister finishes, I note that it falls to Ofwat to monitor this legislation. Obviously, the very long-term timescales of some of the projects will be such that they may outlast our time as Members of this House. How is he going to make sure that Ofwat's monitoring feeds back into Government if there is a problem in the future? If there is a problem, that could be significant. On the other hand, if the model works well, it could be used for other infrastructure projects.

Lee Rowley: I am grateful for that question. I had a long discussion with Ofwat yesterday about the importance of its monitoring role. The first stage is to make sure that this works. Obviously, given that we have not yet changed the rules—this order has not gone through yet—we do not have a clearly working example in progress. I am very open about that. There will be a number of pathfinder projects, and they will have to be reviewed. Ofwat has been clear that it will review and, if necessary, suggest changes. It would be entirely appropriate for the relevant Committees and Ministers to remain close to that process over the months and years ahead. The fact that two parties are interested, as well a third in one of the other three nations, should give us clarity about what we hope will happen in the coming years—namely, that this will be a successful model that will balance the kinds of things that we have spoken about.

From the perspective of the Department for Business, Energy and Industrial Strategy, I accept that this will need to be monitored closely. I encourage all the relevant Committees in the House of Commons to do that. We want this to work. We want to learn from the challenges and make sure that it does not fall into the problems that have resulted from other types of financing structures, with which I am familiar from my time serving on the Public Accounts Committee, chaired by the hon. Member for Hackney South and Shoreditch. We hope that that will not be the case in the future.

1. [Official Report, 12 July 2022, Vol. 718, c. 1MC.]

Bill Esterson: The Minister has said that there has not yet been an example of this disapplication, so we are not in a position to judge it. There are, however, two earlier examples of where the construction Act has been disapplied. Are those examples relevant or are they different and, therefore, not relevant?

Lee Rowley: The reason the Act was disapplied in 1998 and 2011 was, in effect, the private finance initiative. PFI has a different structure whereby the Government are still involved in contracting out the cost. The order, however, relates to the arrangement between two private parties—the water companies and first-tier building contractors—though admittedly for a piece of infrastructure that will be important to the citizenry of the United Kingdom.¹ It will, however, be a different prospectus. I do not, therefore, think that we can draw conclusions from the previous disapplications. That is why we want to tread carefully, and why Ofwat is keen that we have some early pathfinders, so that we can learn and understand that the proposal works.

John McDonnell (Hayes and Harlington) (Lab): I do not want to delay the Committee, but the explanatory memorandum states:

“Public interest in the Exclusion Order is expected to be minimal. There are two projects under active development and a further 18 strategic water resource schemes are being progressed which may meet DPC eligibility criteria”.

We are, therefore, talking about projects being developed at a significant scale. Following on from the question asked by my hon. Friend the Member for Hackney South and Shoreditch about Ofwat and monitoring, do the Government intend to provide the House with regular reports on the schemes? If they are of a significant scale—they may be innovative, but they may also be an unknown quantity—we will want to monitor them more closely.

Secondly, on the consultation, the Minister skated over the issue of the SME response. It would be very useful if he could write to us specifically about the points raised by the SMEs, so that that can be built into further monitoring of the projects.

Lee Rowley: I am happy to write with more details on the consultation. Also, my colleague in the other place answered a parliamentary question yesterday and that contains more information, should Members be keen to understand it. As we have indicated, this is a staged

process. The purpose is to change the regulations to allow projects to come forward, and then we will need to learn from those projects. There will be much to learn on top of the consultation in the months and years ahead.

On reporting, Ofwat will take a very close view and provide updates. I will, therefore, let Ofwat provide the reporting structures in the way it deems appropriate. On the point about significant scale, the right hon. Member for Hayes and Harlington is absolutely right to say that the proposal applies to projects of over £100 million. This is not about a few million pounds or a few hundred thousand pounds in individual areas; it is about significant infrastructure changes that should greatly benefit communities over the coming decades.

John McDonnell: I will try to make this suggestion in as constructive a way as possible. The Minister's own involvement with the PAC will have demonstrated to him that Ofwat may not be the most effective means by which to monitor projects of this scale. It might well be that the Government will have a direct role to play alongside Ofwat in informing the House on how the new regulations are being implemented.

Lee Rowley: I am happy to consider that separately, and I will also correspond with the right hon. Gentleman on the other point that he has raised.

To conclude, I reiterate that the creation of any exclusion under the construction Act would be the exception, not the rule, and can be justified only in circumstances where the benefits clearly outweigh the costs. We think that that is the case with DPC, and that it has the potential to improve the pipeline of strategic water schemes that come forward, and to do so in a way that will both de-risk the taxpayer and ensure that independent companies and organisations with agency come together to deliver resources from which we will all benefit over the coming decades. I thank everyone for their contributions, and I commend the order to the Committee.

Question put and agreed to.

9.52 am

Committee rose.

1. [Official Report, 12 July 2022, Vol. 718, c. 2MC.]

