EXPLANATORY MEMORANDUM TO

THE REPORTING ON PAYMENT PRACTICES AND PERFORMANCE (AMENDMENT) (NO. 2) REGULATIONS 2024

2024 No. [XXXX]

1. Introduction

1.1 This Explanatory Memorandum has been prepared by the Department for Business and Trade and is laid before Parliament by Command of His Majesty.

2. Declaration

2.1 Kevin Hollinrake MP, the Minister for Enterprise, Markets and Small Business at the Department for Business and Trade, confirms that this Explanatory Memorandum meets the required standard.

2.2 Fergus Harradence, Deputy Director for Construction, at the Department for Business and Trade confirms that this Explanatory Memorandum meets the required standard.

3. Contact

3.1 Nicola Walters at the Department for Business and Trade, e-mail: nicola.walters@businessandtrade.gov.uk can be contacted with any queries regarding this Instrument.

Part One: Explanation, and context, of the Instrument

4. Overview of the Instrument

What does the legislation do?

4.1 These Regulations amend the Reporting on Payment Practices and Performance Regulations 2017 (the Principal Regulations) (S.I. 2017/395) and the Limited Liability Partnerships (Reporting on Payment Practices and Performance) Regulations 2017 (the LLP Regulations) (S.I. 2017/425), which impose a requirement on large companies ("qualifying companies") and qualifying limited liability partnerships (LLPs) to publish certain information twice per financial year about their practices, policies and performance in relation to paying suppliers. These current Regulations introduce requirements for qualifying companies and LLPs to publish certain information on practices, policies and performance with respect to retention clauses in any qualifying construction contracts with suppliers.

Where does the legislation extend to, and apply?

4.2 The extent of this Instrument (that is, the jurisdiction(s) which the Instrument forms part of the law of) is England and Wales, Scotland and Northern Ireland.

4.3 The territorial application of this Instrument (that is, where the Instrument produces a practical effect) is England and Wales, Scotland and Northern Ireland.

4.4 The UK Government is responsible for this policy in England and Wales, and in Scotland. The Northern Ireland Assembly passed a legislative consent motion in relation to section 3 of the 2015 Act (under which this Instrument is made) extending

to Northern Ireland, on 20 January 2015. The Northern Ireland Administration has been informed about this Instrument.

5. Policy Context

What is being done and why?

5.1 Late payment remains a significant issue for UK businesses, particularly small businesses. In 2022, Small and Medium-sized Enterprises (SMEs) were owed on average an estimated £22,000 in late payments[1]. This represents a significant cash flow challenge for small businesses - undermining opportunities to invest and innovate. Late payment causes problems for businesses that are not paid on time as it: adversely affects their liquidity; constrains their ability to invest; and can force businesses to exit the market.

5.2 The Principal Regulations and the LLP Regulations make it a requirement for large businesses that meet certain criteria to report their payment performance publicly through GOV.UK. The increased transparency has helped small businesses to make informed decisions before entering contracts with their larger suppliers, whilst the extra scrutiny has helped reduce payment times. It is estimated that around 10,000 companies and LLPs are required to report their payment data under these regulations[2].

5.3 The greater transparency is also intended to drive a culture change toward more prompt payment, as payment practices and performance are increasingly a reputational issue for company boards.

5.4 The wider UK construction sector, including contracting, products and materials supply and associated professional services is one of the largest sectors in the UK, with a turnover of £487bn in 2022, generating £182bn in value added, and employing 8% of the total UK workforce (3m people). However, it is characterised by high levels of fragmentation, with over 444,000 individual businesses, and projects having large and disaggregated supply chains. It is not unusual for 50 or more firms to be part of a supply chain on a major project.

5.5 Prompt and fair payment has long been an issue in the construction sector. Many have welcomed the Principal Regulations and the LLP Regulations and the positive impact they have had. Build UK, a representative organisation for the UK construction industry benchmarks construction businesses on their payment performance since 2018. Improvements show an average time to pay invoices was 45 days – now 32 days; invoices paid within agreed terms was 61% - now 82%; and invoices paid within 60 days was 82% - now 95%.

5.6 Cash retention is a long-established construction contractual practice, used through all the tiers of the supply chain, intended to provide security against defective work. It involves construction clients and businesses in the industry withholding payment of a proportion of the value of the contract over the duration of the project and for a period post-completion. It is customary that the first half of the retention is released back to the supplier at project completion, and that the other half is released following the expiry of a defects liability period for the project.

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[1] Smart Data Foundry (2022) – Payment Speed and Timeliness for UK Small & Micro Businesses – https://cms.smartdatafoundry.com/wp-content/uploads/2022/11/221103-late-and-slow-payments-part-one-Final59.pdf

[2] Reporting on Payment Practices and Performance Regulations: Final Stage Impact Assessment (2023) – https://assets.publishing.service.gov.uk/media/655db812544aea000dfb322b/payment-practices-reportingregulations-impact-assessment.pdf

5.7 In total, retentions typically account for 3-5% of the value of the contract, which is material in the context of an industry where profit margins are low. Retentions can be particularly problematic for small businesses in the supply chain, due to late, partial or non-payment of retentions, or these being permanently lost through upstream insolvency.

5.8 Specific construction payment and dispute resolution legislation is in place through Part 2 of the Housing Grants, Construction and Regeneration Act 1996 ("the 1996 Act"). Its purpose is to create a framework for fair and prompt payment through the construction supply chain, and a resolution procedure for disputes. Whilst the 1996 Act provides recourse in chasing unjustified non-return of retentions through dispute resolution, many sub-contractors are wary of the potential costs and risks of disputes. The principal considerations are costs compared to the size of claim, preservation of the commercial relationship and securing future work. Evidence from consultations[3] suggest that some companies consider that adjudication is not a cost-effective process, typically where the value of claim is less than approximately £30k. However, retention sums below this amount are important for SME sub-contractors, which regularly face cash flow pressures.

5.9 A formal consultation on the Payment Practices and Performance Regulations 2017 was conducted from 31 January 2023. Through the consultation there was strong support for extending the regulations beyond the sunset date which was 6 April 2024 and for amending and improving the requirements further. These amendments were brought forward by the Reporting on Payment Practices and Performance (Amendment) Regulations 2024 (S.I. 2024/444).

5.10 The consultation included two questions as to whether the scope should be extended to cover retentions and require qualitative and quantitative reporting on these. There was strong support (around two thirds of all respondents) for extending the scope of the Regulations to cover retentions.

5.11 This Instrument amends both the Principal Regulations and the LLP Regulations so that qualifying (large) businesses will also be required to report on standard terms for holding monies in retention in qualifying construction contracts. This includes a statement on whether the company's payment practices and policies include or not include retention clauses. Where a company makes a statement that retention clauses are included further information is required on:

- retention clauses are standard practice for all contracts, some or only in specific circumstances (and describe);
- there is a contract value under which no retention clause is included and that value;
- there is a standard rate (%) of retentions applied and that rate;
- there is a practice of using retention clauses no more onerous than held on them (and describe); and
- a description on the process for the release of retention.

5.12 The amendments will also require retention payment performance data for qualifying construction contracts in the reporting period:

[3] 2011 Changes to Part 2 of the Housing Grants, Construction and Regeneration Act 1996: Summary of Responses https://www.gov.uk/government/consultations/2011-changes-to-part-2-of-the-housing-grants-construction-and-regeneration-act-1996
Retention Payments in the Construction Industry: Summary of Responses https://www.gov.uk/government/consultations/retention-payments-in-the-construction-industry

- The % ratio of the amount of retention withheld from the business as against which the business holds on suppliers; and
- The % ratio of the amount of retention the business withheld from gross payments made to supplier's as against the gross amount paid to suppliers during the reporting period.

5.13 The open nature of the reporting is intended to encourage businesses to comply and to improve their payment practices, through public pressure and good payment behaviour by responsible companies leading the way, encouraging other businesses to seek to match the best. In addition to these 'behavioural change' mechanisms a clear sanction for noncompliance will remain in place, to deter any businesses from seeking advantage from not complying with the requirement. The Department will generally seek to encourage a business to comply with the reporting requirement before steps are taken to prosecute. The duty to report helps inform business decisions on whether or not to enter into contracts, as businesses are able to compare the payment performance of alternative customers. The duty also helps businesses negotiate fair terms and prices in contract negotiations.

What was the previous policy, how is this different?

5.14 Whilst the Principal Regulations and the LLP Regulations cover all payments made by firms under the provisions of construction contracts, they do not require firms to report on their specific practices in relation to cash retentions. This means that firms within the construction industry do not have information about either the retention practices of businesses they are considering contracting with, or their performance in relation to retentions, despite this being an important element of payment policies. Retentions can account for a significant proportion of profits from work on a particular project, as well as having an impact on the cashflow of smaller firms.

5.15 This measure increases transparency around firm retention policies and practices, as set out above. It will provide firms within the supply chain with details about the standard retention policies that are applied within contracts, including the percentage of retentions deducted, whether the retentions policy applied to subcontractors is more onerous than that applied to the higher tier contractor, and how retentions are released. It also provides key statistical information that will enable firms to assess the extent to which these policies are being applied in practice.

6. Legislative and Legal Context

How has the law changed?

6.1 The Principal Regulations implement section 3 of the Small Business, Enterprise and Employment Act 2015 (the "2015 Act"), using the regulation-making powers in that section for the first time, to create a new reporting requirement about certain larger companies' payment practices, policies and performance. The LLP Regulations extend the requirements in the Principal Regulations to large limited liability partnerships. The current Regulations amend the Principal Regulations using the powers under sections 3 and 161 of the 2015 Act and also use powers contained in sections 15 and 17 of the Limited Liability Partnerships Act 2000 to amend the LLP Regulations.

6.2 These Regulations introduce a requirement for qualifying companies to provide information on any qualifying construction contracts that they have with suppliers, in addition to the general information required for all qualifying contracts. The Regulations define "construction contract" by relying on the definition which is well

known in the construction industry set out in the 1996 Act and also define "qualifying construction contract", which is a construction contract which is also a "qualifying contract" within the meaning of the Principal Regulations, thus again building on familiar definitions. The detail of the information that must be provided by qualifying companies with regard to qualifying construction contracts is set out in a new Schedule which is introduced by this Instrument. The requirements for information focus on information on the use of retention clauses. This includes requirements for qualifying companies to publish information on standard terms for holding monies in retention in qualifying construction contracts, and retention payment performance statistics for qualifying construction contracts. More detail is set out as to the information required in paragraphs 5.10 to 5.15.

6.3 The LLP Regulations work by applying the Principal Regulations to limited liability partnerships. As such some minor amendments were needed to the LLP Regulations to ensure that these new requirements also apply to the relevant limited liability partnerships.

Why was this approach taken to change the law?

6.4 The Principal Regulations were made using powers in sections 3 and 161 of the 2015 Act. Therefore these requirements can only be introduced using these same powers. Similarly, the LLP Regulations were made using section 17(4) of the Limited Liability Partnerships Act 2000 and so again these same powers must be used to make amendments to these Regulations.

7. Consultation

Summary of consultation outcome and methodology

7.1 In 2022 the Government carried out a Statutory Review of the Reporting Regulations. The review concluded that the policy remains appropriate. On 31 January 2023, Government published a consultation on proposed amendments to the Reporting Regulations.

7.2 The consultation included the specific question as to whether the Regulations should be extended beyond their current expiry date of 6 April 2024. As part of this, other potential amendments and improvements to the Regulations were considered. This included whether the scope should be extended to cover retentions and require qualitative and quantitative reporting on these.

7.3 Around three quarters of respondents to the consultation (c90 of 120) favoured extending the scope of the Regulations to cover retentions. The Construction Leadership Council agreed in agreed in principle with publishing data on retentions and also noted that the suggested transparency would help drive positive behavioural change throughout industry – from clients through cascading requirements – to small businesses.

7.4 The Government response to the consultation was published on 22 November 2023. It confirmed the introduction of a requirement for qualifying businesses that are parties to construction contracts to report on their retention payment policy and key statistics in relation to retentions. The response indicated that work would continue with the industry, to explore what form of statistical reporting could be captured, taking account of the value of this information for businesses in the supply chain, as well as the cost and administrative challenges of obtaining and reporting on this information.

7.5 Further targeted industry dialogue took place with the Construction Leadership Council (CLC) and other stakeholder organisations. The information requirements as set out in this Instrument is considered to be the most useful for potential suppliers, in setting out what the overall policy of a firm is in relation to retentions. The statistical information requested has been selected after specific engagement with the industry, and seeks to strike a balance between providing useful information to firms in the supply chain with what it is practical for industry to collect based on their existing systems and internal processes.

7.6 The Reporting on Payment Practices and Performance (Amendment) Regulations 2024 (S.I. 2024/444) came into force on 5th April 2024. Those Regulations extended the Principal Regulations and the LLP Regulations beyond their current sunset date of 6 April 2024 to 6 April 2031 and require additional information to be reported by qualifying companies and LLPs. Due to the imminent sunset clause in the existing regulations and to avoid delay whilst further industry dialogue took place, this first SI did not include retention reporting requirements.

7.7 Engagement at official level has been undertaken on the proposed instrument with the Devolved Administrations.

8. Applicable Guidance

8.1 The Government is publishing updated guidance for large businesses in scope of the duty on how to comply. Copies will be placed in the House Libraries and sent to the scrutiny committees.

Part Two: Impact and the Better Regulation Framework

9. Impact Assessment

9.1 A full Impact Assessment has not been prepared for this instrument because it will only affect a limited number of businesses and the impact is estimated to be less than the Estimated Annual Net Direct Cost to Business (EANDC) of £10m. A full impact assessment was undertaken for the Reporting on Payment Practices and Performance (Amendment) Regulations 2024 (S.I. 2024/444), which is available on legislation.gov.uk.

Impact on businesses, charities and voluntary bodies

9.2 There is no significant, impact on business, charities or voluntary bodies because the reporting requirements will only apply to large firms and LLPs, and these requirements drawn on information that is readily available, or in the case of statistical reporting, already gathered by firms for the purposes of preparing accounts.

9.3 The legislation does not impact small or micro businesses.

9.4 There is no, or no significant, impact on the public sector because this legislation applies exclusively to firms within the scope of the Reporting Regulations.

10. Monitoring and review

What is the approach to monitoring and reviewing this legislation?

10.1 The approach to monitoring this legislation is via the required payment performance reporting published through GOV.UK, with notification of any issues in relation to the operation of this instrument.

10.2 A review provision is included in the Reporting on Payment Practices and Performance (Amendment) Regulations 2024 (S.I. 2024/444). This provides for a review 5 years after the Regulations are made. If the Regulations are not renewed following that review, they will expire on 6 April 2031.Therefore, the Instrument does not include a Statutory Review Clause.

Part Three: Statements and Matters of Particular Interest to Parliament

11. Matters of special interest to Parliament

11.1 None.

12. European Convention on Human Rights

12.1 The Minister for Enterprise, Markets and Small Business, Kevin Hollinrake MP, has made the following statement regarding Human Rights:

"In my view the provisions of the Reporting on Payment Practices and Performance (Amendment) (No. 2) Regulations 2024 are compatible with the Convention rights."

13. The Relevant European Union Acts

13.1 This instrument is not made under the European Union (Withdrawal) Act 2018, the European Union (Future Relationship) Act 2020 or the Retained EU Law (Revocation and Reform) Act 2023 ("relevant European Union Acts").