PAPER P32/09

CROSSRAIL LIMITED

EXECUTIVE COMMITTEE (PSG) MEETING

SUBJECT: **Project Bank Accounts**

MEETING: **5th August 2009**

1.0 Purpose

The purpose of this paper is to provide an introduction to PSG on the issues surrounding:

- fair payment practice, specifically the OGC fair payment initiative;
- the establishment of a project bank account.

In addition, the paper provides a brief summary of the industry initiatives currently in place and the business case rationale behind the establishment of a project bank account.

The paper is structured as follows:

- recommendation and suggested way forward;
- an overview of fair payment practice;
- an introduction to project bank accounts;
- industry endorsement;
- commercial considerations;
- supporting appendices.

2.0 Recommendation

It is recommended that PSG:

- approve the development of a "Fair payments Charter" along the lines of that recommended by OGC for adoption on CRL contracts;
- approve the development of a strategy for the adoption of a project bank account arrangement for use on CRL contracts based on best practice from other projects. The proposed arrangements would be subject to further approval before implementation; and
- approve the establishment of a working group to progress this strategy with representatives from CRL Finance, CRL Commercial, the Central Delivery Team and the Project Delivery Partner.

3.0 Fair Payment Practice

The Office of Government Commerce (OGC) produced a guide to “Fair payment practices” in June 2007 which makes the case for change in construction payment practices and follows on from a series of government initiatives in the 1990’s, most notably Sir Michael Latham’s recommendations in July 1994, which led to the Construction Act in 1996, and the Late Payment of Commercial Debts (Interest) Act of 1998.

The OGC have recently established a Fair Payments Community Group and will be taking action to achieve a greater take-up of best practice across Government Construction Clients. It is expected that the OGC Gateway Review process will be used to check that Clients are giving proper consideration to the use of Project Bank Accounts. Departments who are implementing the OGC Guidance include Defence Estates and the Ministry of Justice.

The OGC guide describes fair payment as being whether the contractual terms relating to the discharge of payment obligations and the payment process are fair and adhered to and it recommends principles and practices to be adopted in the public sector.

OGC highlight that poor payment practices in the construction industry give rise to substantial additional financing and transaction costs and they emphasise that certainty over how much and when payment is made builds up trust between supply team members and underpins collaborative working to achieve value for money projects for clients.

The stated aim of the improvements recommended by OGC is to provide greater certainty on payments to everyone in the supply chain and to optimise payments periods in order to minimise financing charges. Based on their analyses OGC contend that public sector clients could expect to save up to 2.5% on construction costs from the introduction of better payment practices.

OGC estimate that widespread adoption of these principles and fair payment practices set out in their guide would save the public sector some £200m rising to over £750m as the processes become embedded and confidence in the system increases. In the current economic climate it is also anticipated that the adoption of fair payment practices will help to reduce the risk of supplier failure due to cash flow problems.

OGC’s proposals, more details of which are given in Appendix 1, include:

- the adoption of a fair payment charter, which should be agreed and signed by the client and the main supply chain members working on a project or a framework of projects. An example of this charter is given in Appendix 2.
- targeting payment of the supply chain within 30 days.
- shorter payment periods, greater use of milestone payments and the inclusion of past performance on payment as a key pre-qualifying criterion for contractors.
- the introduction of project bank accounts where “practical and cost effective”.

4.0 Project Bank Accounts

OGC envisage that the client will set up a deposit account and will make payment of amounts due under the main contract directly into it. Before the client's money is paid into the account, the contractor must prepare a breakdown of the main supply chain payments included in its valuation.

Under the operating mandate for the account, the authorised signatories for the client and the contractor then release funds directly to the supply chain in the amounts contained within the contactor's breakdown. The account itself is governed by a trust deed under which the key subcontractors can claim money if the contractor becomes insolvent and helps to segregate project funds from any other funds.

Under OGC's proposals, contractors would be prevented from delaying payments due. However, contractors would still determine the amounts due to sub contractors and set off and counter charges would remain unaltered.

The project bank account would not provide additional comfort in the case of client insolvency since the amount paid by the client into the account would only be the amount due to the contractor already. OGC trust arrangements would be designed to protect sub contractors who are party to the trust deed.

The main benefits of a Project Bank Account are seen as being that it:

- ensures the lead contactor and the supply chain receive prompt payment of monies rightfully due through certified payments;
- allows the supply chain to receive payment from a single central account rather than through the lead contractor;
- encourages greater transparency and cost efficiencies and puts and end to poor payment practices.

5.0 Industry Endorsement

As highlighted by the Specialist Engineering Contractor Group (SEC), the National Audit Office Report on "Improving Public Services through better construction" (March 2005) has recommended the use of project bank accounts to ensure effective and fair payment mechanisms. The report can be found on the NAO website and SEC have publicly given their support to it's recommendations.

In its report, the NAO state that:

"Unfair payment practices such as unduly prolonged or inappropriate cash retention undermine the principle of integrated team working and the ability and motivation of specialist suppliers to invest in innovation and capacity.

Departments should have the appropriate visibility of the entire supply chain. Understanding how specialist contractors, and particularly small and medium sized enterprises, are engaged, evaluated and managed can contribute considerably to the achievement of value for money.

For example, Departments should ensure that they have in place effective and fair payment mechanisms, such as project accounts to provide certainty to suppliers payments dependent on delivery to time, cost and quality."

The NAO express the view that:

"The approach of using a single bank account for the entire construction ensures the timely payment of all parties and mitigates the risk of the main contractor unfairly withholding payments from suppliers further down the supply chain."

The NAO report quotes the case study of Defence Logistics Organisation Offices at Andover North in relation to project bank accounts:

"Defence Estates were concerned to ensure the timely payment of all parties working in the supply chain to manage risk that the prime contractor might unfairly withhold payment s from sub contractors. A project bank account was set up in trust for the whole supply chain and payments from it needed the authorisation of the client and the prime contractor. Defence Estates also had the ability to audit the account. The use of the single bank account helped to ensure the timely payment of all parties in the supply chain."

6.0 Commercial Considerations

The NEC Panel prepared a document in June 2008 entitled “OGC fair payment practices for use with NEC Contracts”. The NEC document includes a series of proposed Z clauses which address the establishment of a project bank account, the procedures for making payments from it and the establishment of a trust deed. The document also provides a series of guidance notes and flow charts relating to their application and the timescales to be adopted for assessment and payment under the project bank account arrangements.

Two banks, Barclays and the Royal Bank of Scotland” have now established project account facilities. The Barclays account was developed in association with international property and construction consultants “Rider Levett Bucknall”, is subject to fees but includes credit interest paid on account balances.

APPENDIX 1 – Fair Payment Practice, Supporting Notes

A1.1 Overview

The OGC guide recommends that public sector clients should adopt certain principles as the basis for reviewing their procurement strategy and procedures with regard to payment practices. These principles are embedded in what OGC call a "Fair Payment" charter, an example of which is given in Appendix 2.

- *Best "Fair Payment" practice process*
  Achievement of fair and efficient payment requires significant time commitments at the outset of a contract to agree and harmonise payment procedures and cycles in order to achieve the charter commitments of a maximum 30 day payment period.

- *Contractor relationships and selection*
  Evidence of good and current performance on "fair payment" should be a key pre-qualifying criterion for selection of lead contractors and through the "fair payment" charter or contractual arrangements to further tiers of the supply chain.

- *Simplification of interim measurement*
  OGC recommend the greater use of well defined milestone payments and payment schedules to simplify measurement and certification systems.

- *Retentions*
  Unfair withholding of retentions has an adverse impact on cash flow and is detrimental to relationships on site and clients are recommended to monitor implementation of the charter commitments.

- *Project Bank accounts*
  OGC see very good alignment between the establishment of a PBA and the "fair payment" principles and recommend progressive adoption where practicable and cost effective.

- *Peformance monitoring*
  Client's are recommended to monitor their own and their supply chain's compliance with the fair payment charter. OGC intend to conduct a review of the progress on implementation of the fair payment charter in Jan 2010.

- *Cost of implementation*
  OGC acknowledge that the start up and training costs of PBAs will vary in accordance with project size and complexity. OGC state that costs of initial implementation would be between £5-£10k, much of which would not be required in full on follow on contracts. OGC anticipate bank charges would be offset by interest generated while interim payments are on deposit for larger projects.

A1.2 Recommendations

The OGC make the following recommendations regarding the adoption of best "fair payment" principles and practices in the public sector:

- Formally adopt principles of "fair payment".
- Require "fair payment" charters to be signed.
- Introduce best practice payment processes targeted at achieving payments to the supply chain within 30 days.
- Consider more frequent interim measures, shorter guaranteed payment periods and advanced certification (not payment) in cases where contractors and suppliers can offer substantial discounts (cases of up to 10% have been quoted by OGC).
- Use evidence of good and current performance on "fair payment" as a key pre-qualification criterion for selection of lead contractors.
- Make greater use of milestone payments and payment schedules to simplify interim measurement process.
- Monitor charter commitments regarding fair contract terms and fair withholding of payment.
- Progressively specify the use of PBA where practicable and cost effective.
- Monitor compliance with the "fair payment" charter.

A1.3 Business Case for "Fair Payment"

OGC state that "fair payment" issues arise form commercial pressures, "custom and practice", lack of sophistication and in some cases manipulation and is not limited to contractor - sub contactor relationships, but throughout the supply chain.

- *Existing situation*

  Although the construction act prohibits "pay when paid" clauses, in practice many sub contractors carry out work before formal contracts are in place and many contractors wish to provide for contractual arrangements such that there is a reasonable expectation of being paid by the client before he pays his supply chain.

  In practice, wrongly presented applications, inefficient administration, usually greatly extends this period, with some contractors assuming retention of cash is a period to improve profitability. Payment periods of up to 90 days are common in the industy.

  Extended payment periods and delaying payment does not just incur short-term finance costs. Poor payers experience higher tenders, with surcharges being imposed by contractors and their supply chains that value "payment certainty" above all.

- *Options for improving payment process*

The two options considered by OGC for improving the payment process are the fair payment charter linked to improved "fair payment" processes and the project bank account to improve surety of cash flow for all parties.

- *Benefits*

OGC market research indicates tender savings of up to 5% could be achieved with the adoption of a project bank account, with an average saving of 2.5% quoted.

The figure of 2.5% was broken down into 0.5% against finance charges and 2% against surety of cash flow. Longer term savings were envisaged as overheads relating to debt chasing, supply chain insolvency etc could be reduced.

One of the key benefits was the perceived increase in transparency and trust that the measures proposed would promote.

- *Risks*

OGC identify a number of key client and contractor risks to be considered when implementing "fair payment" strategies.

- Failure to achieve payment periods;
- Contractors failure to open project bank accounts;
- Open book payments under lump sum contacts;
- Cost of implementation;
- Loss of contactor's cash flow benefits.

APPENDIX 2 – OGC Model "Fair Payment" Charter

Model 'Fair Payment' Charter[1]

Fair and transparent payment practices are an essential underpinning to achieving successful integrated working on construction projects. In working with each other in good faith and in a spirit of mutual trust and respect, we agree that by 1st January 2008[2] we will meet the 'Fair Payment' commitments set out below:

- Companies have the right to receive correct full payment as and when due. Deliberate late payment or unjustifiable withholding of payment is ethically not acceptable.
- 'Fair Payment' will apply equally between the client and lead contractor and throughout the supply chain[3].
- The process will be transparent in order that members of the supply chain have certainty of how much and when they will be paid.
- Companies will consider, where appropriate, operating relevant contracts on an open book basis.
- The correct payment will represent the work properly carried out, or products supplied, in accordance with the contract. Any client arrangements for retention will be replicated on the same contract terms throughout the supply chain. Any withholding of payment due to defects or non-delivery will be proportionate and demonstrably justified in line with arrangements made at the time of contract.
- To ensure effective and equitable cash flow for all those involved, all contracts will provide for regular payments and have payment periods not exceeding 30 days.
- In order to avoid payment delays, the client and all supply chain members will agree payment procedures at the outset of their contracts. Payment will be through electronic BACS transfer and will apply throughout the supply chain.
- Monitoring and auditing and problem resolution procedures will be agreed between the parties.

We the undersigned agree that this Charter is not intended to be a legally binding document and not used in construing any contractual commitment.

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[1] The Charter sets out the values and arrangements relating to payment practices consistent with integrated working. The Model Charter is flexible to allow for adaptation and can either be a standalone document or part of a wider partnership charter. In either case it is not intended to be legally binding.
[2] An introduction period is to allow time for clients and contractors to modify their business systems and procedures.
[3] The client would sign the Charter at the outset. Contractors and suppliers subsequently engaged would be expected to sign the Charter before appointment.

APPENDIX 3, Project Bank Accounts

A3.1 Overview

OGC envisage that there would be four key stages in establishing and managing a project bank account. These are broadly as follows and are explained in more detail in the schedule given in Appendix 4:

- Early familiarisation training for client staff and, post contract, for the selected contractor;
- During early planning and pre-procurement;
- During the procurement of the contracting team;
- Following appointment.

The OGC report also highlights important considerations in relation to the following:

- *The operation of the project bank account*
  The PBA is the medium, through which payments are made, but it is not a contractors' account, it is set up in trust for the whole supply chain.

- *Transaction security*
  To ensure security is maintained all notifications of payment and other instructions to the PBA can only be made by pre-registered contractor/client representatives.

- *Payment process*
  The process of preparing and certifying valuations or milestones is unaltered by the PBA arrangement. The client's role where joint signatures or joint authorisation of transactions are adopted, is merely to confirm payments transfers from the account.

- *Visibility and auditability*
  In order to secure the support and trust of all parties, the account needs to be transparent and open to scrutiny and audit.

- *Trust status*
  The PBA is in effect held in trust for the whole of the supply chain and prevents a receiver seizing the proceeds of the account. An example of a trust is given in the OGC guide.

- *The selection of suitable projects*
  In principle PBAs can be applied to any size of project whether one off schemes or part of an ongoing programme of work. However, in light of the costs involved they

are better suited to a programme of work or a larger project. PBA's can be applied to traditional lump sum and open book arrangements, although in view of the differing degrees of client visibility authorisation arrangements will be different.

- *Training the client's team*
  Training of client's staff on the operation of a PBA is a key to it's successful adoption. This training should cover roles and responsibilities, the rationale for its use, the benefits to the supply chain etc.

- *Selecting and appointing a bank*
  The selection of the correct PBA will be dependent on the type and value of project. For a programme of works a call-off arrangement with a selected bank needs to be established, after initial trials, in accordance with an agreed protocol.

- *Changes to the tender invitation and contract documentation*
  Standard tender documentation will need to be modified to accommodate a PBA. Changes will include mandating the use of the PBA, defining payment processes and the notice of payment provisions. Further amendments will need to cover the scale of bank charges, tenderer awareness training, amendments to the marking regime, post award training etc.

- *Arrangements for supply chain members outside the PBA*
  OGC recommend that the PBA is adopted on larger contracts initially, in view of the costs associated with their initial establishment. The OGC envisage that over time it will, however, be possible to include most levels of the supply chain, accepting that there will be projects, which are too small or for other reasons are not suited to the PBA arrangements.

- *Briefing tenderers*
  Tenderers must be appraised of the PBA arrangements during the tender process including the process for setting up the account, how it is to be operated, what charges will be levied and how interest will be dealt with.

- *Training successful contractors and their supply chain*
  OGC recognise that there is likely to be concern that PBAs are a means of attacking contractor margin and training (at all levels) is therefore considered an essential part of the adoption process to highlight the long term benefits that can be derived through lower tender prices, greater collaboration and cooperation.

- *Finalising payment arrangements*
  Although the operation of the PBA is standardised, the detail of payment arrangements may vary from client to client and project to project eg monthly payments versus milestones and the levels and degree of authorisation.

- *Activation of the account;*

Some clients may wish to open the PBA themselves while others may ask their appointed contractors to do so.

- *Operation of the account*
  Interim payments are agreed in the normal way, including the review and evaluation of the payments due to each member of the project supply chain by the contractor. The agreed interim payment is authorised by the client team and money is transferred directly into the PBA by the client's bill paying department. The client and main contractor then jointly authorise payment transactions by pre-registered contractor or client representatives.

APPENDIX 4 – OGC Typical Payment Process