

# Assessment of Progress to Improve Payment Security for Government Construction Subcontractors

## Executive Summary

Report 31: December 2016

### Introduction

The objective of this audit was to assess progress to improve the security of payments made to subcontractors by contractors on State government construction projects and compliance with the *Building and Construction Industry Training Fund and Levy Collection Act 1990*.

The audit focus was based on a request from Parliament's Estimates and Financial Operations Committee (EFOC) that the Auditor General assess the implementation of the Small Business Development Corporation's (SBDC) 2013 report<sup>1</sup> recommendations.

### Overview

The construction industry is a key driver of economic growth in WA. In 2015-16, construction accounted for 10% of WA's employment and \$31.3 billion of our gross state product<sup>2</sup>. It provides employment, housing and infrastructure.

In the past, construction companies employed large workforces. But, in the last 3 to 4 decades the industry has become more dependent on contractors managing projects and subcontracting work. Now, almost all larger projects use subcontractors to provide services.

A serious and ongoing issue within the industry is non-payment of subcontractors – a problem first recognised over 40 years ago<sup>3</sup>. The collapse of a WA government contractor in May 2016 and complaints of non-payment by subcontractors has brought attention back to the topic, despite a government investigation into the issue in 2013.

Subcontractors' complaints about non-payment for work done on WA government projects under the Building the Education Revolution program from October 2008 to October 2012<sup>4</sup> saw the WA government request the Small Business Commissioner to investigate the claims. The claims included that Building Management and Works (BMW – a unit in the Department of Finance) had not responded to their complaints.

The SBDC's 2013 report directed 13 recommendations at BMW, mostly to improve:

- processes for prequalifying and risk assessing tenders for government contracts prior to awarding of contracts
- administration of payments to contractors and obtaining statutory declarations from contractors that they have paid their subcontractors
- management of subcontractor complaints about non-payment.

It also included 4 recommendations aimed at construction contracts in both the private and public sector. This included a recommendation to improve dispute resolution legislation in the construction industry.

Appendix 1 provides further details of the recommendations. Government accepted all recommendations in June 2013 though it has not reported on their implementation.

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<sup>1</sup> Small Business Development Corporation Commissioner, Final Report: Construction Subcontractor Investigation (March 2013).

<sup>2</sup> WA Department of State Development, Western Australia Economic Profile, November 2016, p 1.

<sup>3</sup> CH Smith QC, Inquiry into the Building Industry in Western Australia, 1973 as cited in the Report on Operations and Effectiveness of the Construction Contracts Act 2004 (WA), Professor Philip Evans, August 2015, p.12.

<sup>4</sup> *ibid.* p. 1.

Although the SBDC recommendations were mainly intended for BMW, we also used them in this audit to assess practices used by the Department of Treasury (Treasury) and the Housing Authority (Housing), as they contract construction projects. Housing awarded the most construction contracts from the end of June 2013 to 1 July 2016 (1,153) followed by BMW (527) and Treasury (5).

Treasury's contracts are all large strategic projects valued over \$50 million. These are one-off projects for which Treasury appoints a head contractor specifically for the project. It does not appoint contractors to panels through a prequalification process that assesses their suitability to undertake future projects.

Non-payment of subcontractors can arise because of factors such as disputes over work quality, different interpretations of contract arrangements, poor accounting practices and contractor insolvency. To compound the problem, the rate of contractor insolvencies in the building and construction industry is high compared to other sectors of the economy<sup>5</sup>. The SBDC recommendations focus primarily on measures that protect subcontractors when contractors become insolvent.

As part of ongoing reforms, the State Government announced on 5 December 2016 that it would introduce a new code of conduct for WA's building and construction industry to prevent anti-competitive behaviour and improve workplace safety.

Another way the industry is supported, is through the *Building and Construction Industry Training Fund and Levy Collection Act 1990*. This Act establishes a fund to contribute to the training of workers for WA's construction industry. Funding is by way of a 0.2% levy on construction work over \$20,000 and on variations over \$25,000. In 2015-16, the fund received \$29.4 million in levies paid by the industry on construction projects. The Act requires a project owner to pay the levy. For most government projects, this will be the contractor. If a building permit is required for construction work, the levy must be paid before a permit can be issued.

## **Audit conclusion**

There has been substantial progress towards implementing the SBDC recommendations.

BMW has addressed all 13 of its SBDC recommendations. The Building Commission has addressed the recommendation that it review the *Construction Contracts Act 2004* (CCA) and the first of 2 proposed packages of change to the legislation have been passed by Parliament.

Treasury and Housing have improved many of their processes since the release of the SBDC report, though both require greater consistency and thoroughness in their pre-award assessments of financial capacity. Both agencies also need to improve the identification and documentation of strategies needed to mitigate the risk of contractors not completing the work.

All agencies generally have adequate procedures to ensure compliance with the *Building and Construction Industry Training Fund and Levy Collection Act 1990*. But, we saw scope for the Building and Construction Industry Training Fund (BCITF) to improve liaison with agencies to ensure easy identification of government projects in its system.

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<sup>5</sup> ASIC Australian insolvency statistic series 1A July 2013-December 2015.

## Key findings

### Processes are generally better

- The key processes that help ensure security of payments to contractors have improved, particularly within BMW. Treasury and Housing, which were not the focus of the SBDC review, have also reviewed and improved their processes though not to the same extent as BMW.
- BMW adequately assess the financial capability and business risk associated with the tenderers who contract for their construction projects and use weighted assessment criteria in their contract award process. However, Treasury and Housing do not have a standard tender assessment process for financial information and financial capacity assessments.
- Improvements are needed in how Housing and Treasury assess and document risk mitigation strategies when business risks associated with engaging a contractor were identified.

Housing could not show that it implemented strategies to mitigate the risk of appointing a contractor. Treasury has risk mitigation strategies for each contract, but there needs to be a clearer mapping of a specific strategy to the specific business risk of each contractor.

We acknowledge that for projects delivered through public-private partnerships, the private party bears significant financial risk and management responsibility. However, as a matter of good practice, there should be a clear trail between risks identified in early documents and strategies to address overall risks to the project.

- All 3 agencies have processes that help ensure security of payment to contractors, including requiring contractors to provide a statutory declaration that payments to subcontractors have been made. All 3 agencies undertake spot checks of payments and follow up concerns. Mostly, these processes were reasonable, though Treasury and Housing need to be more transparent about their processes.
- The Government has mandated the use of project bank accounts for all BMW projects valued between \$1.5 million and \$100 million, and introduced a Code of Conduct for contractors on State contracts worth more than \$10 million. The Code aims to stamp out inappropriate behaviour on construction sites and will apply from 1 January 2017.

### Dispute resolution processes are more robust

- Government has historically not accepted that it has a payment obligation to a subcontractor in the event of non-payment by a contractor. However, it has recognised the need to facilitate dispute resolution procedures. More recently, each agency has required contractors to keep them informed of payment disputes between a contractor and its subcontractors.
- All agencies have an adequate system and process in place to manage subcontractor claims of non-payment. BMW and Housing provide this information on their websites. The number of concerns raised at the agencies varies from 102 at BMW to 2 each at Treasury and Housing, although Treasury's information only includes complaints since March 2016. The complaints we reviewed were assessed within the prescribed time and against each agency's policy and closed.
- In November 2016, Parliament passed legislative changes that strengthened dispute resolution processes. These changes arose from the SBDC recommendation that the Building Commission review the CCA. A key finding of the review was that subcontractors were not given sufficient time to lodge payment dispute claims. The legislative changes increased the time to lodge from 28 elapsed days to 90 working days

and excluded the period between 24 December and 7 January from the calculation of working days.

- The Building Commission plans to push for a second set of legislative amendments in 2017 that will include continuing professional development for adjudicators of payment disputes, penalties for failure to comply with the CCA, and reducing overlap in the CCA.

### **Three recommendations were not assigned to a specific agency**

- Work had commenced on 14 of the 17 recommendations, but the progress varied across recommendations and agencies. We found 3 of the recommendations had not been assigned to a specific agency. However, the Building Commission is progressing one of the three unassigned recommendations, a review of the *Inquiry into Construction Industry Insolvency in NSW* (Collins report).
- The 2 unassigned recommendations relate to a study of commercial best practice for assessing risk and awarding contracts, and a role for BMW to positively lead standards and behaviours in the WA construction industry. However, given the range of reforms in the last few years, clear direction from government is required on whether it wishes to implement these recommendations.

### **Building and Construction Training Levy payment gap**

- There is a real risk that the levy payable by contractors on government projects is not paid or not paid in full. The BCITF relies on BMW, Housing and Treasury to provide information to it on government construction contracts but it has not established arrangements with all agencies to access this information directly. There is also a need to determine more closely the nature of Government contracts and if the contract as issued includes elements and services to which the BCITF levy would not apply. Testing of 41 BMW, Housing and Treasury construction contracts to the BCITF system showed a potential net underpayment for 13 contracts or variations, but these were not material.

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## **Recommendations**

By 30 June 2017:

- a. Housing, BMW and Treasury should ensure full information on strategies for protection of payments to subcontractors is made publicly available to inform contractors looking for work of government requirements
- b. Treasury and Housing should set clear standards for financial information, weighting of financial capacity, currency of business risk assessments and recording of risk strategies, to inform decisions on awarding contracts
- c. Treasury should develop a facility for subcontractors to submit complaints online, and improve its systems for subcontractor complaints about non-payment to track and manage complaints
- d. BCITF should formalise communication protocols with BMW, Treasury and Housing for sharing of information about government construction projects to monitor payment of the BCITF levy
- e. the Building Commission and the Department of Finance should liaise with their respective Ministers to determine whether the 2 unassigned SBDC recommendations are to be addressed.

## Agency responses

### Building Management and Works

The Department is pleased that the Office of the Auditor General has recognised efforts the Department has made since the release of the Small Business Commissioner's Construction Subcontractor Investigation report to improve security of payment in relation to its contracts. These efforts included significant business process re-engineering, the trial of project bank accounts, the introduction of new approaches such as the undertaking of spot checks of subcontract payments and the expansion of support provided to industry in terms of education and awareness.

The Department accepts the recommendations directed to it, namely that it implement measures to enhance the information on security of payment that is publicly available, and liaises with the Minister for Finance on unassigned report recommendations. The Department will implement these measures by 30 June 2017.

### Department of Treasury

Overall, Treasury supports the recommendations insofar as they are relevant to the agency, and will implement improvement measures accordingly.

In this regard, it is important to note that the recommendations of the Small Business Development Corporation (SBDC) that are the key focus of the performance audit were directed at building contracts managed by the Department of Finance's Building Management and Works (BMW) business. As acknowledged in the report, these contracts and their administration and management differ materially in many respects from the high value, complex building contracts managed by Treasury's Strategic Projects and Asset Sales (SP&AS) business. Therefore, the measures implemented by BMW and Treasury in managing subcontractor payment and related matters security are necessarily different in a number of respects.

Treasury's response to the individual recommendations has been included in Appendix 2.

### Housing Authority

Thank you for the audit undertaken which assessed the Housing Authority's progress on improving the security of payments made to subcontractors by contractors on government construction projects.

The Housing Authority accepts all the pertinent report recommendations and has started to address the matters raised by the audit.

### Building Commission

The Department of Commerce accepts in full the finding in the report and the recommendation. The Department of Commerce, Building Commission Division will, by 30 June 2017, liaise with the Department of Finance and the Minister for Commerce to determine if the two unassigned recommendations from the Small Business Development Corporation's 2013 report should be implemented, and if so, assign responsibility.

Further consideration of the recommendations in the 2013 *Inquiry into Construction Industry Insolvency in NSW* (the Collins report) will be undertaken as part of the development of the second package of reforms to the *Construction Contracts Act 2004*.

### Small Business Development Corporation

Thank you for the opportunity to comment on the Audit. I read it with interest and believe the findings presented will further contribute to reforms by government agencies playing

significant roles as major procurers of building and construction works for the State or as regulators of the construction industry.

I am of the view that this audit, along with the three significant initiatives have recently been implemented in Western Australia (i.e. the adoption of projects bank accounts, improvements to the principal security of payment legislation and the development of a code of conduct for state-procured construction projects) will lead to improved behaviour in the construction industry in the State.

### **Construction Training Fund**

The Construction Training Fund acknowledges the finding contained within the report. Previously, it has been difficult for the Fund to access information from other government agencies when they have awarded building and construction contracts for works where the BCITF levy would apply. The OAG audit has identified a control weakness in this practice and established there is a need for all government agencies to agree on a consistent and systematic process that will provide the Fund with all the relevant information it needs to undertake its statutory obligation.

Consequently, as a matter of urgency, the Fund will convene a meeting with all relevant government agencies to agree on a consistent method for exchanging information so the Fund can ensure the BCITF levy is paid on all building and construction contract works that are managed by government agencies.

The Fund would like to thank the OAG staff for their assistance and support during this audit.