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Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Sir/Madam

Insolvency in the Australian construction industry

Thank you for the opportunity to provide a submission to the Senate Estimates Committee regarding insolvency in the Australian construction industry.

The Air Conditioning and Mechanical Contractors' Association (AMCA) is the national peak trade association for member companies operating in the commercial and industrial air conditioning and mechanical services industry. Our members are highly skilled commercial operators with expertise in the design, manufacture and installation of air conditioning and specialised ventilation systems, as well as the ongoing service and maintenance of plant, equipment and infrastructure.

Submission summary

Insolvency in the construction industry is a worrying trend, with the AMCA witnessing the demise of several members over the past 24 months, including a foundational member of AMCA Victoria, and a well-established firm in Queensland.

The AMCA would like to highlight past reports into issues plaguing the Australian construction industry; in particular the Cole Royal Commission in 2004 and the Collins Inquiry into construction industry insolvency in 2013. Each of these reports presents a strong case for industry reform, and despite leading to some positive changes at both the state and federal level, many of the issues remain, while worthwhile reforms have been shelved or only partially implemented.

Representing the concerns of our membership, the AMCA submission will focus on issues confronting subcontractors in the commercial sector, and particularly the structural characteristics of the construction industry that serve to propagate onerous contract conditions for subcontractors, increased financial distress and risk of insolvency.

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Further Consultation

The AMCA would welcome the opportunity to consult further with the Senate Estimates Committee regarding any of the issues raised in this submission.

Yours Sincerely

Sumit Oberoi
Executive Director
AMCA Victoria

Responses to relevant Terms of Reference

c) Causes of construction industry insolvencies

Amendments to standard contracts

In a recent submission regarding Australian Standards' *AS11000: General Conditions of Contract*, the AMCA expressed its support for the broader use of standard contracts on Australian building and construction projects. These contracts are based on the underlying principle that construction project risks should be borne by the party best able to control those risks.

Unfortunately, it is common practice for these contracts to be amended on a project-by-project basis, fundamentally altering the risk allocation and increasing the risk of financial distress and insolvency to parties to the contract; in particular subcontractors.

Changes to the contract terms contained within AS2124 and AS 4000, as well as their companion subcontract, can prove difficult for subcontractors to resist due to structural power imbalances that exist in the tender market between head contractors and subcontractors.

Industry structure and power relationships

It is the AMCA's belief that the structure of the commercial building and construction sector, typically characterised by a top-down chain of contractual relationships, propagates an environment whereby risk is disproportionately allocated to subcontractors.

Factors leading to a structural power imbalance include:

- Vast differences in financial, legal and human resources, particularly as it relates to contractual negotiations;
- Access to legal advice to review contract conditions;
- Fierce competition between subcontractors, which leads to a "lose a soldier, send in another one" mentality among head contractors; and
- A reticence among subcontractors to push back against onerous contract conditions through fear of being excluded from future tenders.

These factors are amplified by fluctuations in the economic cycle, resulting in a tendency by some head contractors to insist upon particularly onerous contract conditions during times of financial pressure.

Cash flow and industry payment practices

Cash flow difficulties resulting from poor industry payment practices are a key driver of financial distress and the risk of insolvency. This is true of both onerous payment terms enforced by head contractors, as well as the invoicing and record keeping practices of subcontractors.

Issues with the payment practices of head contractors include:

- Some head contractors have been known to hold funds paid by the principle, despite having unpaid progress claims owing to subcontractors;
- The lack of legislation identifying the permitted uses of monies paid by the project principle to the head contractor increases risks for subcontractors waiting to be paid;
- Head contractors can employ tactics to strong-arm subcontractors into accepting long claim periods, ranging anywhere between 30 and 90 days;
- Delays in the payment of monies owed to subcontractors, regardless of the payment terms;
- The process for submitting variations is often onerous, leading to disputes, further delays in payment, and increased risk of cash flow trouble; and
- Clients have little or no accountability for the payment of subcontractors, and are often unaware of the contract conditions affecting subcontractors.

These issues are compounded by the fact that the pay cycle for onsite workers is typically weekly. This creates a mismatch in duration between accounts receivable and the payment of wages, and presents a substantial risk for subcontractors in managing cash flow. The issue is most precarious for smaller firms who are less likely to have bargaining power in contract negotiations, coupled with a relative lack of financial sophistication.

The payment of progress claims can be better facilitated by subcontractors by taking measures to improve the timeliness and accuracy of their invoicing practices.

Market cycles, workforce management and profit margins

The majority of construction work is performed by subcontractors, who are therefore the primary employers of workers onsite. Onerous contract provisions relating to payment terms, liquidated damages, latent conditions and others, not only adds to, but compounds the already substantial risk borne by subcontractor relating to workforce management and labor costs.

In particular, the cyclical nature of the building and construction industry can present significant challenges with respect to the management of the workforce. Consider the example whereby a subcontracting firm has a reasonably large project approaching completion. Without a new project of comparable size (or several smaller jobs), the firm faces the prospect of having an idle workers.

One option available to the firm is to reduce their workforce through redundancies. However this is a costly exercise with several negative implications, including:

- The wellbeing of those made redundant;
- Uncertainty for remaining staff;
- The attrition of skills and knowledge; and
- Costs for firms to rehire staff when new projects are won.

In response to these issues, mechanical contractors employ a range of strategies to avoid laying-off valued staff. For example, AMCA members in Victoria have devised a loose scheme whereby workers may be provisionally loaned to other firms to avoid redundancies. This option has proved to reasonably effective, but relies upon demand from other firms and is subject to cyclical fluctuations in the market. AMCA members also seek to avoid redundancies by having staff take annual leave entitlements during slow periods; however this is a limited and short term solution.

To avoid having to employ such strategies, subcontractors seek to keep staff employed by having a consistent pipeline of work. However this often means accepting jobs with onerous contract conditions and razor thin profit margins, perpetuating an environment of financial and personal stress, and clearly increasing the risk of insolvencies.

d) The incidence of 'phoenix companies' in the construction industry.

AMCA members have reported negative impacts resulting from phoenix company behavior, including the collapse and 'rebirth' of suppliers, as well as undercutting in the tender market.

An AMCA member in NSW reported recently that phoenix companies are frequently winning jobs by tendering at artificially low prices made possible by the competitive advantage they receive by not complying with tax, debt and other obligations. In such circumstances, reputable companies are simply not able to compete on price, and despite the unconscionable conduct of phoenix company operators, clients can be enticed to simply transfer the contract to the new company in order to take advantage of the lower costs on offer.

e) The impact of insolvency in the construction industry on productivity.

The spectre of insolvency can be a deterrent to firms considering investing time and resources into new and innovative building practices. New technologies, approaches and processes take time to embed within a business. Invariably, it also involves the acceptance of risk that the return on investment will not realized until some future time; potentially not at all. Subcontractors existing on tight profit margins can ill-afford the allocation of resources to such initiatives. Such disincentives explains why the construction industry has frequently ranked as the lowest of all industries in the annual Australian Innovation Systems Report, with only 30% of businesses being classified as innovative.

One tangible example is the slow and piecemeal adoption of building information modeling by Australia's building and construction industry, despite the significant opportunities for firms to deliver improvements in productivity, cost effectiveness, reductions in time and cost overruns, and limit the need for reworks and wastage.