

PROFITS, POLITICS & PROCUREMENT

Reimagining Scotland's Construction
industry - 2021 and beyond



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FOREWORD

The built environment is often referred to as the powerhouse of Britain's economy, accounting for between 6 and 10 per cent of the country's economic activity when ancillary industry, consultants, and advisers are included in its scope. Projects are planned over years and often decades. They can cost millions if not billions of pounds, raised through a mix of private and public sector investment. And yet, depending on the type of work, margins scrape in somewhere between 0.5 per cent and 1 per cent in the commercial and civil sectors, with the most profitable projects reaching a maximum of around 2 per cent.

As an industry, it is highly fragmented with many thousands of sole traders, self-employed contractors and a labour force working largely on a casual basis.

Where some sectors, car manufacturing for example, design product first and take that to market, construction has remained a highly customer desire-driven sector. Few buildings are identical and those purchasing them are often inexperienced in engineering, instead focusing on their functional needs of a building. In Scotland, a new school or hospital construction project is tendered by the local authority whose representatives may or may not have been involved in similar projects.

While the general public consider the country's schools, hospitals, transport networks and other public infrastructure to be a national concern, in fact decisions on and funding of this type of construction is local. Given that more than 50 per cent of large scale commercial and civil construction is publicly funded in Scotland, this matters. Funding is raised through council tax with the vast majority not allocated from central Scottish Government budgets.

Politics also come into this sector heavily, particularly in relation to financing and regulation. This presents a number of additional factors affecting which projects progress and the quality achievable within pricing constraints, which we will discuss in more detail later in this report.

Finally, the challenges faced by those working in construction are well known and well documented. Successive independent reviews commissioned by a number of governments over the past 20 years have all identified what 2016's Farmer Review dubbed construction's urgent need to 'modernise or die'.

While our research found almost universal agreement with this sentiment, what came across most strongly was the sense of

frustration at being unable to translate this objective into practice because of esoteric restrictions having little to do with construction itself.

The change in VAT payment rules will put huge financial strain on contractors of all sizes, the loss of tax relief on red diesel from next year will compound that, and IR35 adds yet another layer of administrative and financial burden into the mix.

That said, the Government's commitment to the UK going net zero by 2050 offered most in the industry hope that some of the challenges faced today might find resolution as a byproduct of all sectors having to push for dramatic reductions in their carbon footprints.

Construction covers a wide range of disciplines, from civil engineering, building bridges and tunnels and major infrastructure to house building, office blocks, retail parks, and everything in between. For the purposes of this report where we use the term construction, we refer to civil engineering and commercial building and refit, with residential house building a slightly different market with separate challenges and opportunities.



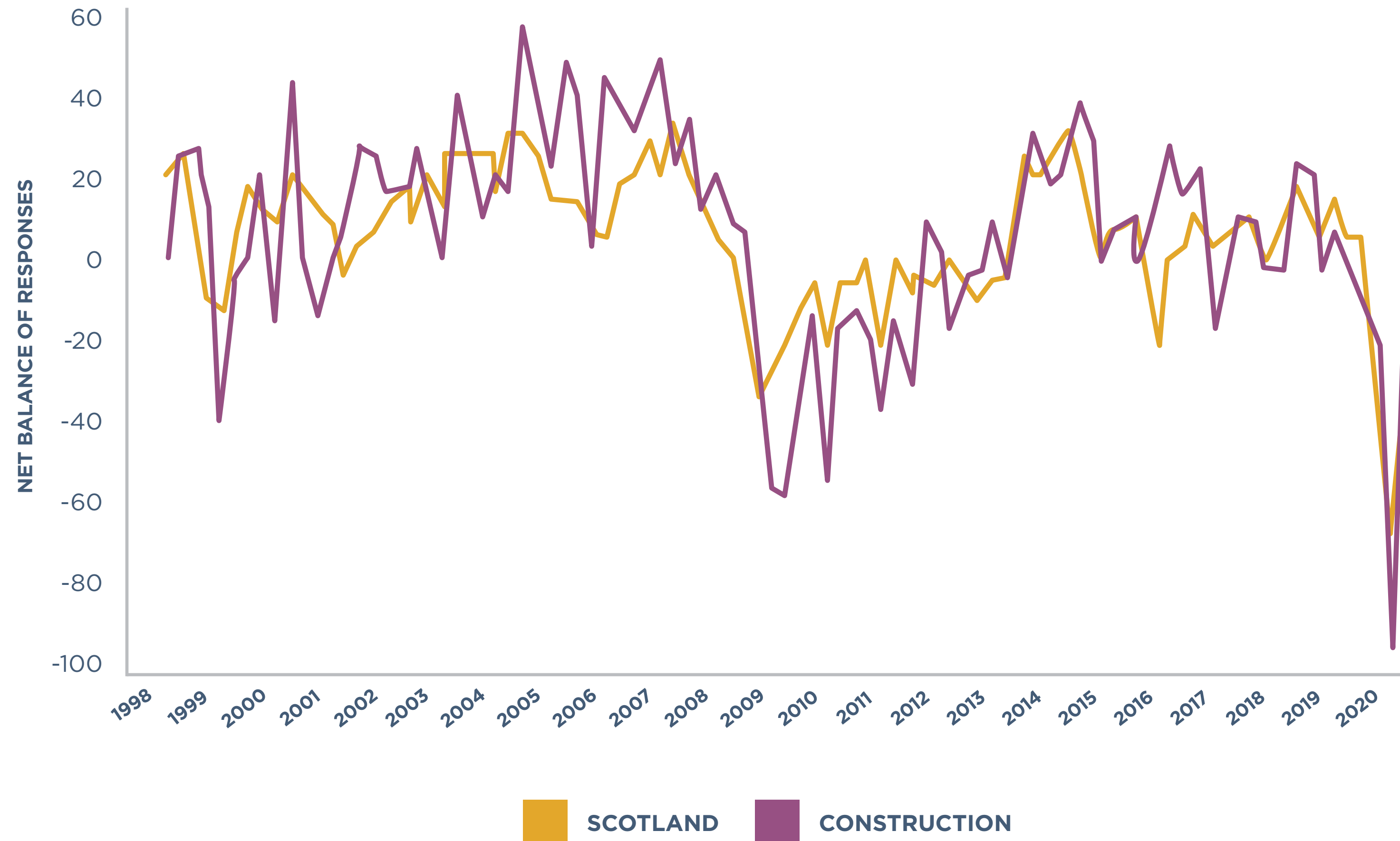
ANNE STRUCKMEIER
Partner

FIGURES

The experience of firms in the construction sector

- The net balance in the number of firms reporting an increase in their volume of business continued to be negative, meaning that similar to Scotland, the net balance was negative for the entirety of 2020.
- In the second quarter of 2020, the sector saw the weakest sentiment of our six sector groups. However, the construction sector has recovered to become the sector with the highest sentiment in the Scottish economy.

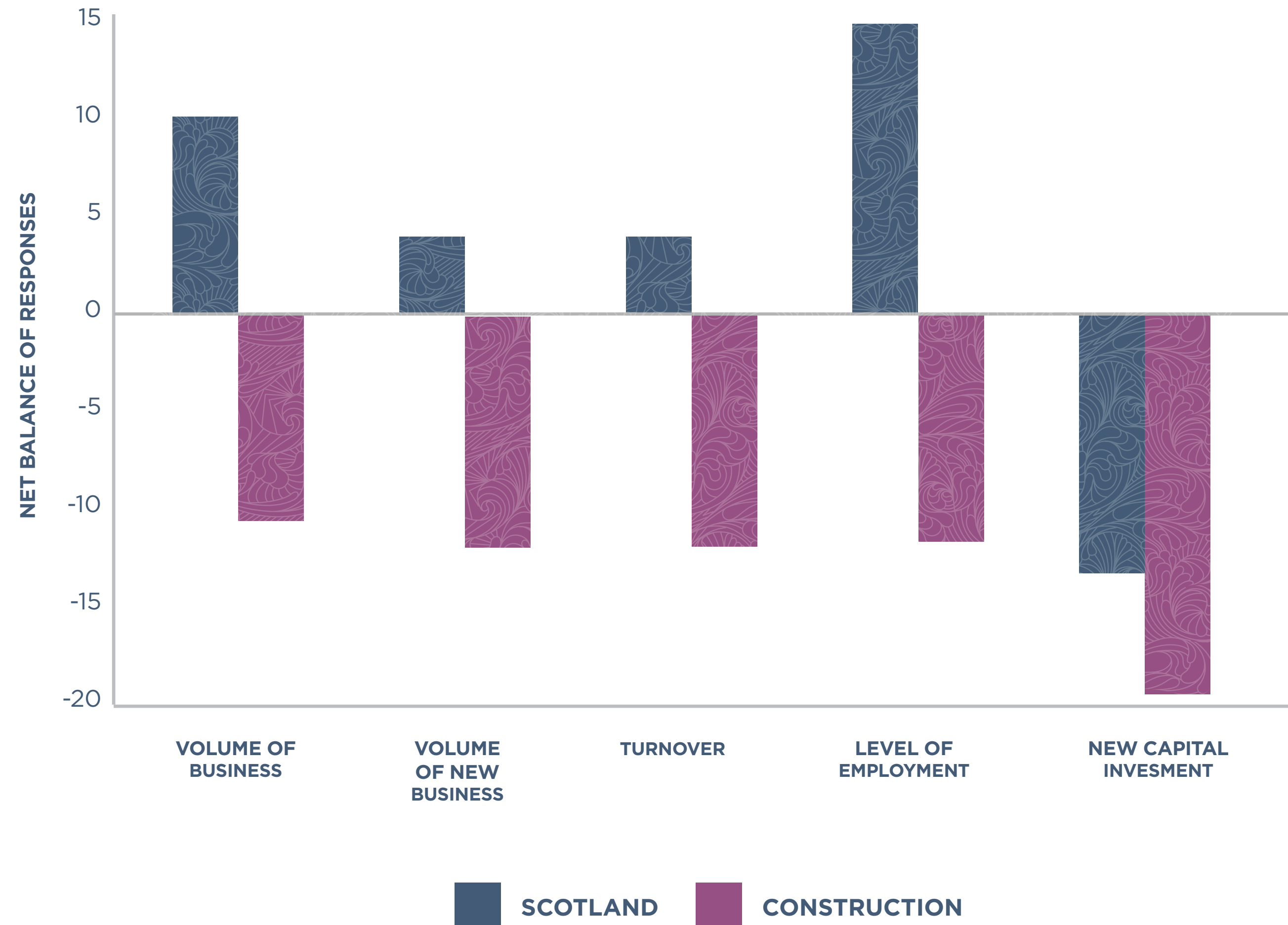
Chart:
Net balance (%) of firms experiencing an increase in their volume of business over the past 3 months, Q1 1998 - Q4 2020. Construction sector businesses and Scottish average.



FIGURES

- The sector reported a positive net balance for its expectations over the next 6 months across several indicators, including turnover and the level of employment.
- The sector, however, reported a negative net balance in their expectations of new capital investment, a higher negative net balance than the Scottish average.

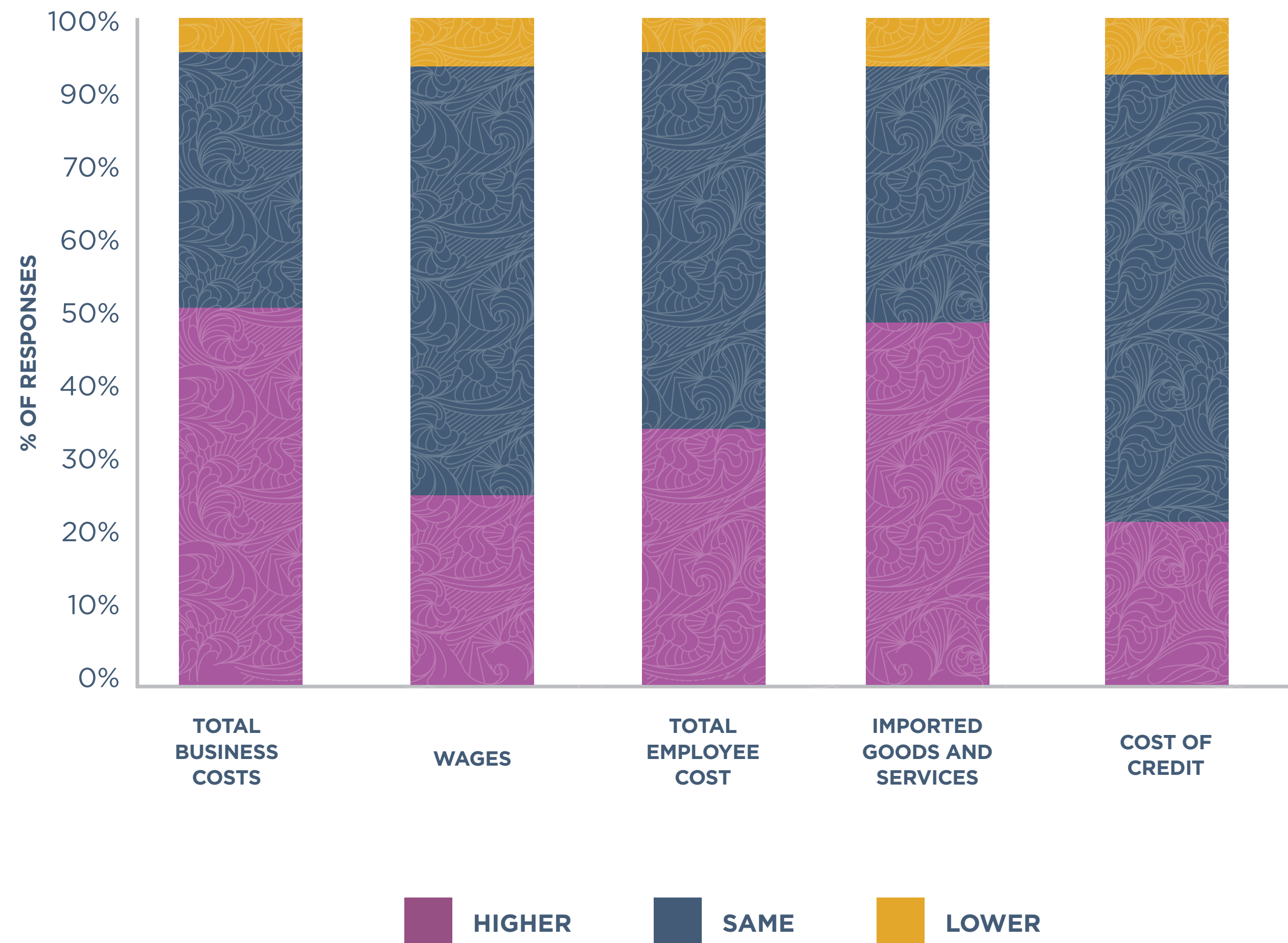
Chart:
Net balance (%) of firms expecting an increase in the given categories, Construction and Scottish average, Q4 2020.



FIGURES

- Most business reported that imported goods and services were the biggest cost driver for their business; with the majority also reporting higher overall business costs.

Chart:
% of responding business in the construction sector reporting higher, the same, and lower levels of cost drivers for their businesses compared to last 3 months, Q4 2020.



FIGURES

Over the coming months:

- Expected levels of capacity over the next six months in the construction sector was more positive than Scotland as whole.
- On average, firms expected to operate between 76-99% of normal capacity, with only 10% of businesses expected to operate at under 50% of normal capacity in the construction sector.

Chart:

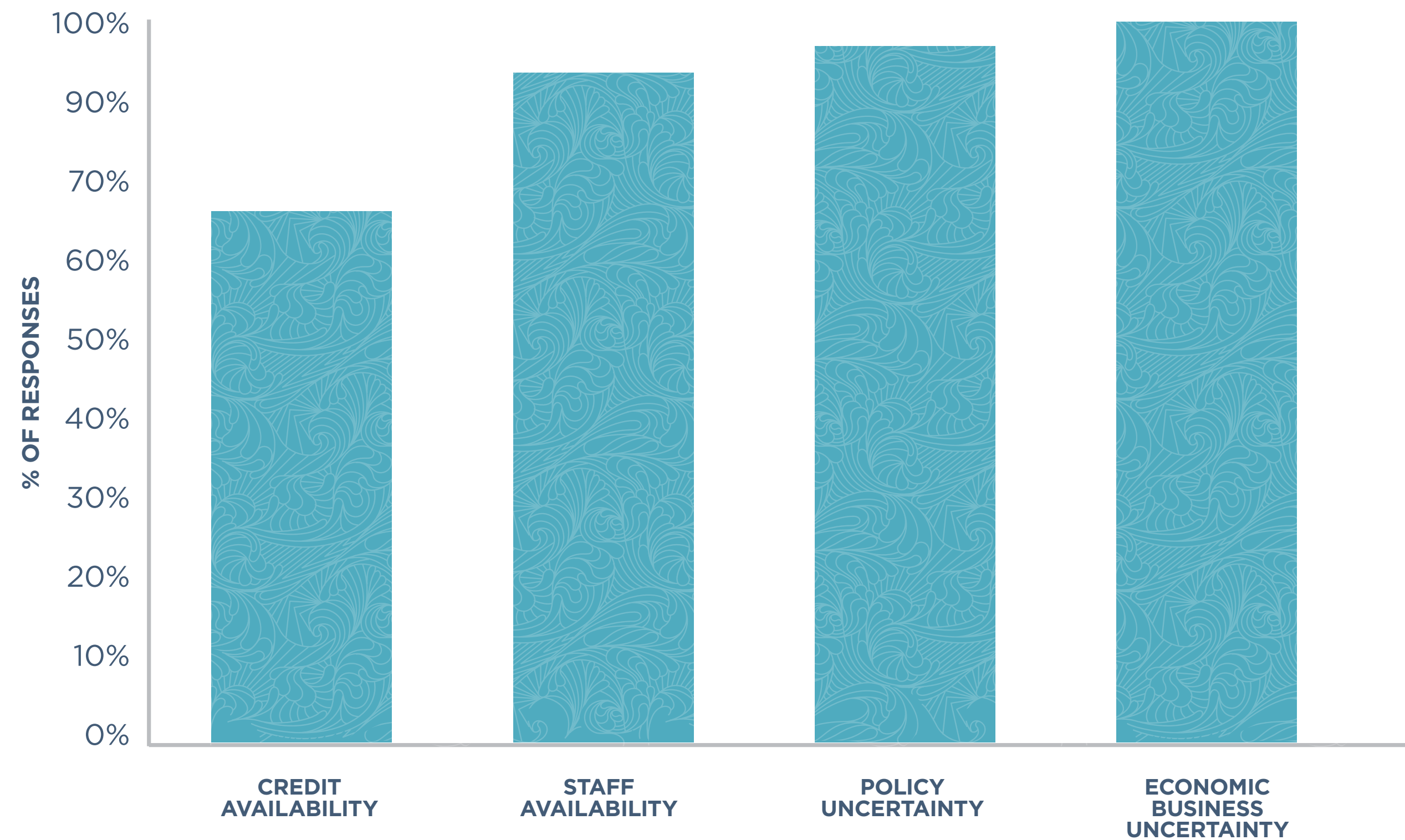
What level of capacity, compared to normal levels of operation over this period, do you expect your business will operate at over the next six months?



FIGURES

- Economic/Business uncertainty was the most important issue facing businesses over the coming 3 months, with 100% of businesses reporting it as 'Very important' or 'Important'. Policy uncertainty (98%) and staff availability (94%) were also important issues facing businesses.

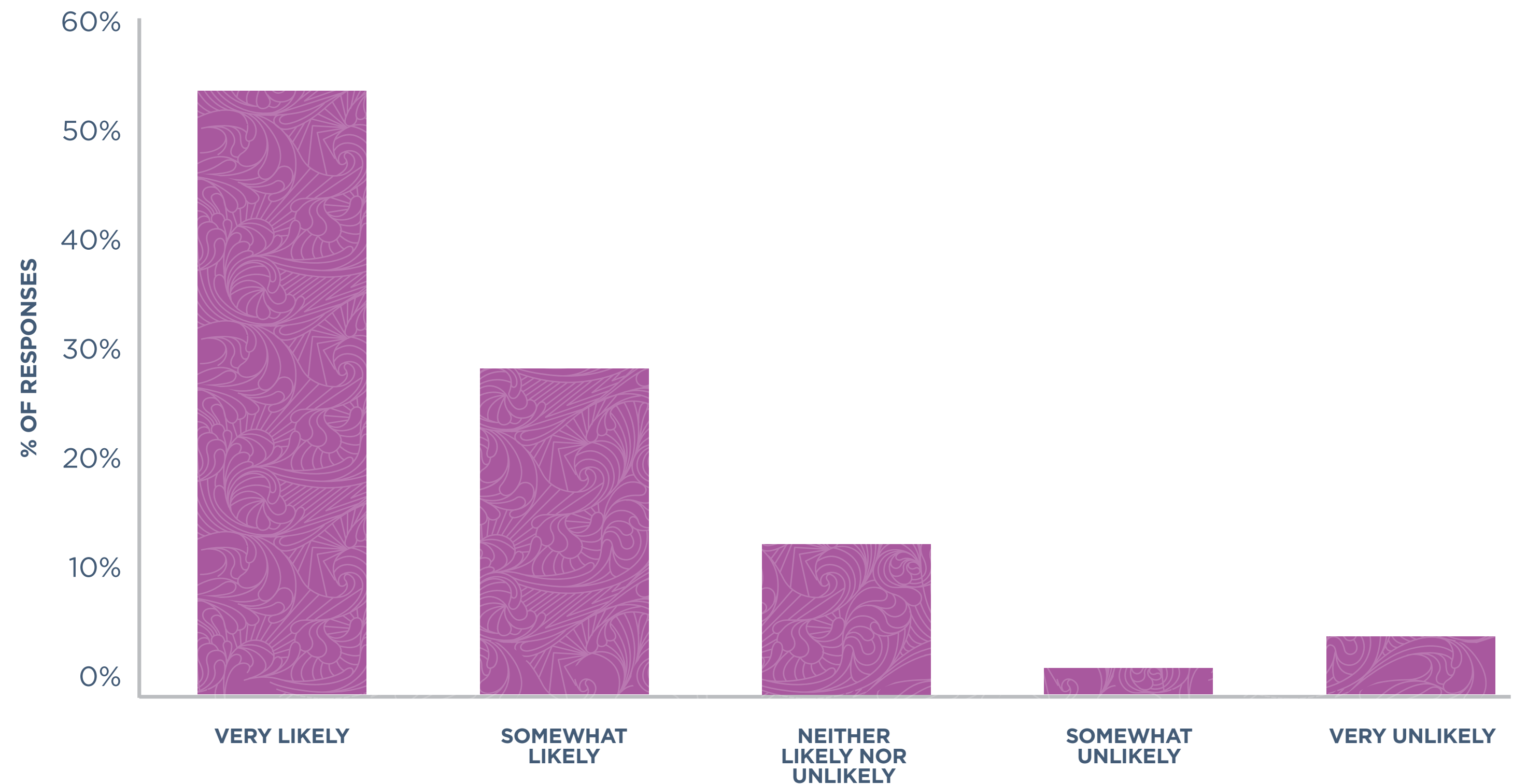
Chart:
In terms of your business how important are the following expected to be over the next 3 months? Includes only businesses within construction sector.



FIGURES

- Only 6% of businesses in the construction sector expressed that it was unlikely they would survive over the next 6 months, with 82% reporting that it was somewhat or very likely that they would survive. These figures are similar to Scotland as a whole.
- Whilst 74% of business also reported that their cashflow positions were secure or very secure, just over 1 in 5 businesses reported that their cashflow positions were insecure.

Chart:
What is the likelihood of your business surviving over the next six months? Includes only businesses within construction sector.



FIGURES

Government Support

- 42% of business said the level of government support has been sufficient or very sufficient, this was a slightly higher share of those who felt support was sufficient than Scotland as a whole (38.5%).
- 34% of businesses expressed that the level of government support for their business was somewhat or very insufficient for their survival, which was lower than the Scottish average (41%).

Chart:

To what extent is government support sufficient for the survival of your business? Includes only responses from businesses in construction sector.



PROFITS POLITICS & PROCUREMENT

Construction is one of the few remaining biblical trades: bricklaying and joinery are much the same today as they were 2,000 years ago. Compare that to the difference between a donkey and a Dacia and it's possible to begin to appreciate what Mark Farmer said in his review of the construction sector five years ago: that it must 'modernise or die'.

'Is there any other industry in the UK where almost nothing has changed since the 1950s?' asked one contributor.

Little has changed since Farmer's damning warning, largely because of politics. This year is Britain's first out of the European Union after a very messy Brexit, and in December, as the countdown to independence gathered pace, Westminster published a green paper aimed at transforming public procurement. This is significant for the construction sector, especially in Scotland where upwards of 50 per cent of new and retrofit construction projects are publicly funded.

The majority of contributors to this report highlighted the hope this paper offers, on more than one front. They noted too, one very big hurdle for Scottish construction in particular in relation to it however.

Scottish building regulations, public sector procurement and local government are within the jurisdiction of the Scottish Government at Holyrood, meaning any changes to these policy areas by the British Government need not apply north of the border should the Scottish Government overrule them.

This is vital for Scottish construction, which relies heavily on public money for work. Public sector projects are typically put out for tender with local authorities mandated under European standards to appoint the contractor who comes in with the lowest price, thereby saving taxpayer funds.

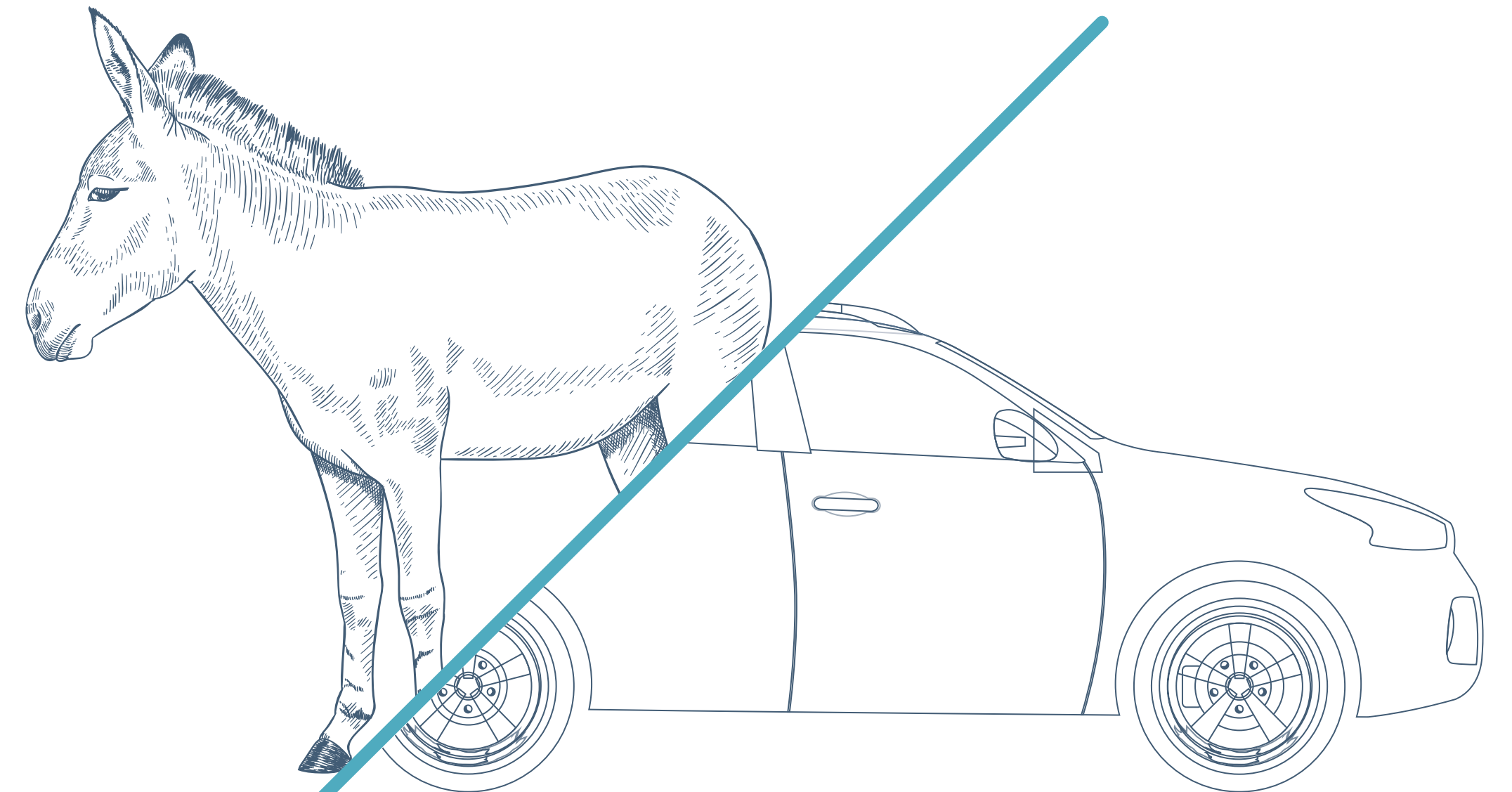
As one contributor put it, 'you'll always find someone who'll do the work for less just to secure the job'. But, he pointed out, this has bad outcomes in a number of areas: construction materials and labour costs are fixed, and bidding under what a project should cost will necessarily result in the appointment of sub-contractors likely to cut corners on quality to make up for the losses passed on by the parent contractor.

Spending inevitably goes over budget, with any later changes to specifications exploited as an opportunity to make up

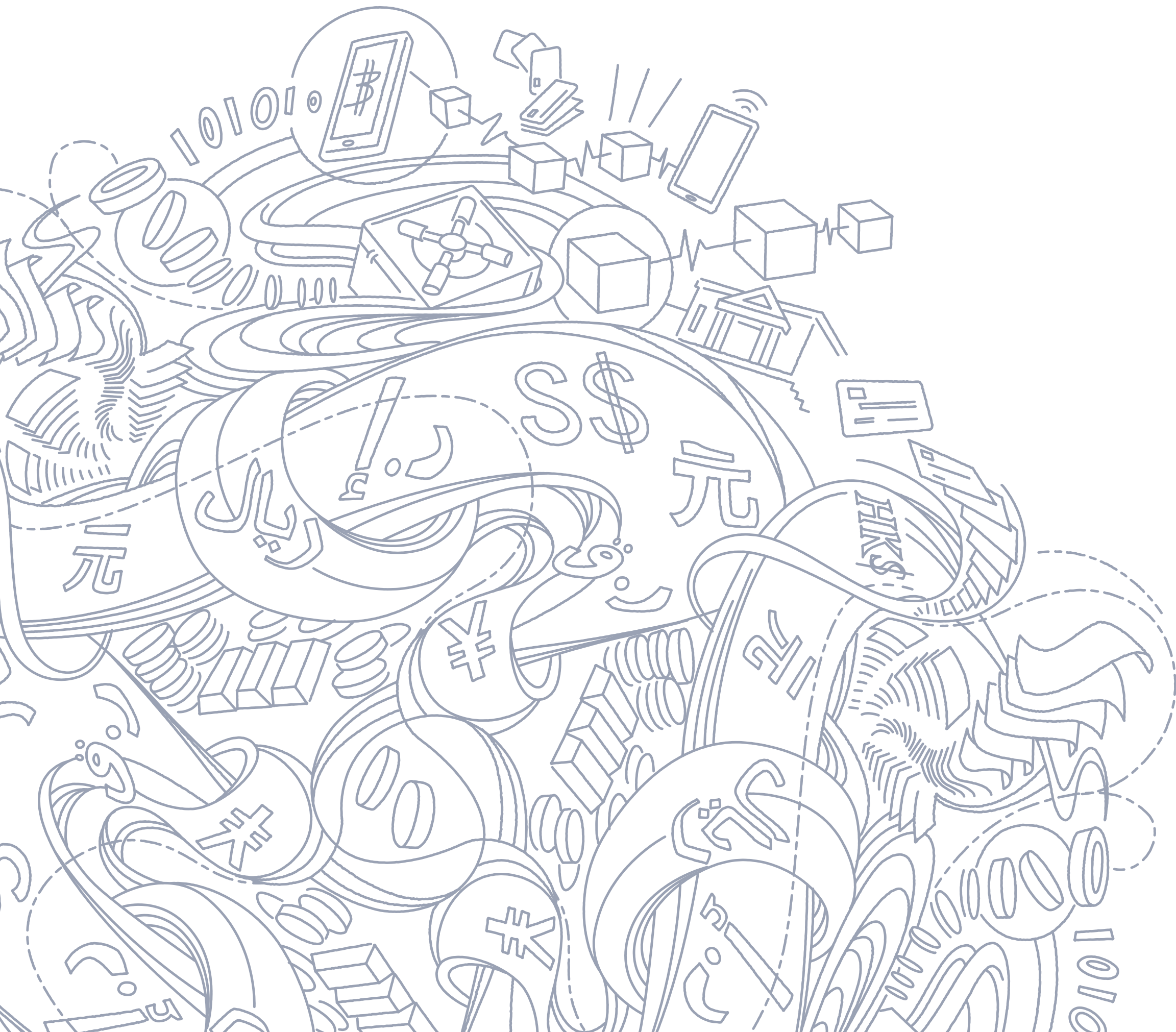


MODERNISE OR DIE.

Mark Farmer



PROFITS POLITICS & PROCUREMENT



for losses incurred. ‘That’s why you’ll see moving a electricity socket by a metre priced up at £1,000 when in reality that costs pennies,’ said one.

From the outset, this set-up puts enormous pressure on the profitability of projects which are vital to the wellbeing of the British public. Added to this equation is the fragmented nature of the construction industry, which is made up of thousands of smaller sub-contractors. One project can employ numerous sub-contractors, further eroding profitability all the way down the chain. The incentivisation of the procurement rules to undercut realistically priced contractors, regularly costs clients more than they budgeted for.

Such tight margins damage reinvestment into the sector and its processes, many of which could be dramatically improved through offsite standardised construction and better digitalisation. This would improve building safety and reduce cost, as well as enabling a much more diverse workforce to emerge.

‘The green paper as it is currently drafted is game changing,’ said one contributor, referring specifically to how public sector procurement choices should be

made. EU directives force governments to choose the cheapest contractor; the newly independent British Government is proposing to change the rules to allow choices to be made based on the fairest value. In practice, this removes the incentive for less scrupulous contractors to submit lowball bids to win projects which are then delivered over budget and at sub-standard quality.

Politics becomes very relevant here: the Scottish Government has been vocal about its desire to separate from the United Kingdom in favour of rejoining the EU. Putting aside its practical ability to achieve this, both politically and economically, the statement of intention means it is unlikely to deviate from European directive standards even if Westminster enacts its proposed procurement changes.

‘There is massive political uncertainty around Scottish independence and Europe,’ said one contributor. ‘This is very bad for Scotland - no company is going to choose to build their new headquarters here without understanding what laws they will have to adhere to in five years’ time.’

WHAT DOES MODERNISATION LOOK LIKE?

‘Every building, especially in civil engineering, is a prototype built in a muddy field.’

More than one contributor said this, or words to this effect.

‘Can you imagine a car manufacturer taking orders from customers with a vague idea of what they want their car to do and be and designing every car from scratch? It’s mad, but that’s what construction is like,’ said one.

All those we interviewed said it doesn’t have to be this way. Modern methods of construction have been trialled repeatedly in the UK, with an increasing recognition that offsite, standardised construction for residential homes can (and in some cases does already) deliver safer, cheaper to build and maintain and more carbon efficient homes.

This is much harder to achieve in the commercial and civil engineering sectors of construction where all those contributing to the report said clients had to drive this type of change.

‘Without clients asking for a standardised approach – one that by virtue of the fact it doesn’t yet exist because no-one has asked for it is going to be more expensive to start with – there is no

driver to change the way construction is delivered. It has to be led by local authorities but their priorities are not long-term enough to see the cost benefits asking for this would eventually offer.’

Another contributor said moving to factory-based platform construction where possible would also force more consistent safety standards across the industry.

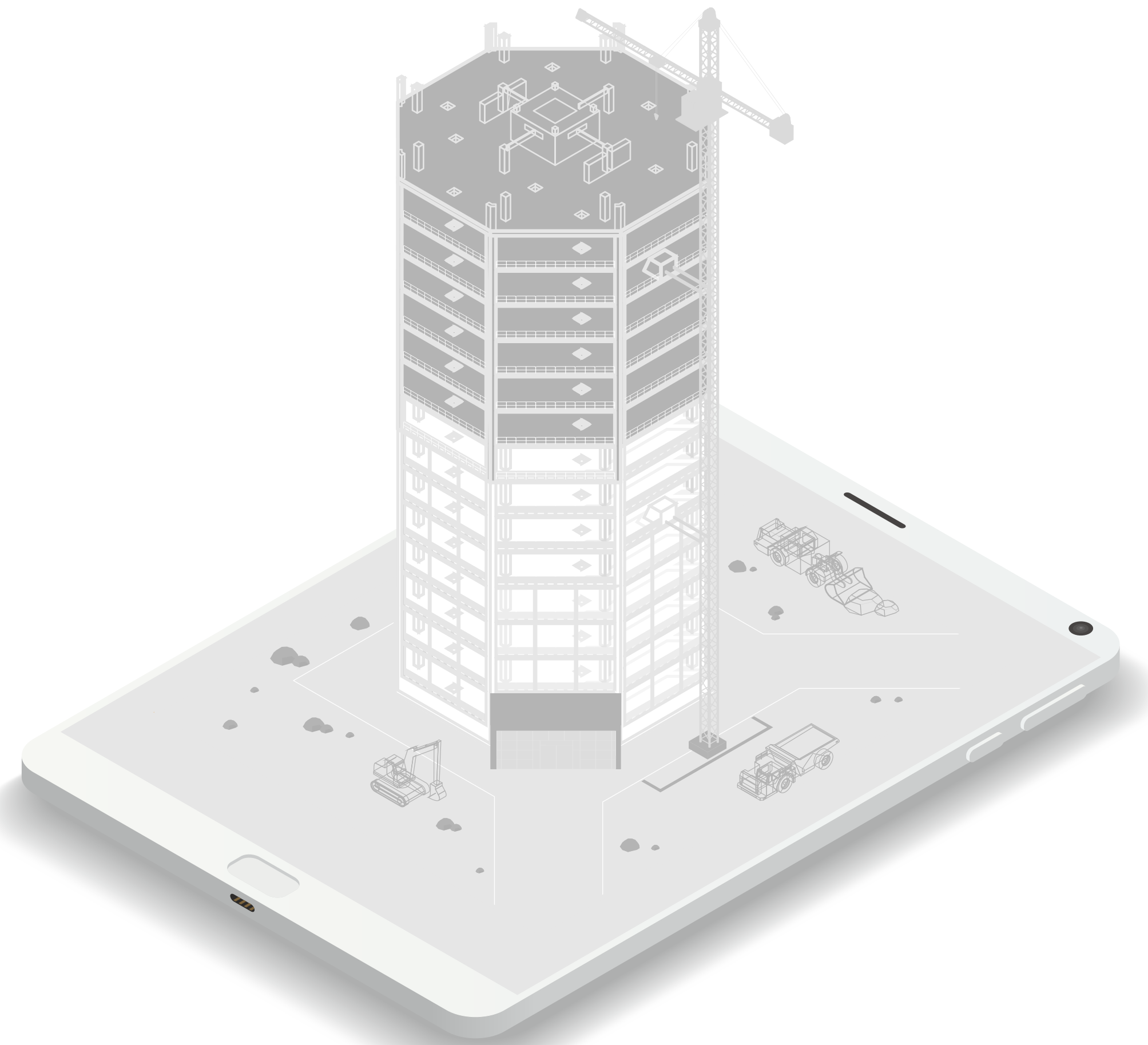
‘There’s always someone prepared to do something for nothing in this industry, it’s the sad reality. All that changes in a factory environment where you can’t gamble that way either on pricing or on safety.’

Even without factory-built buildings there are several ways the construction industry could modernise, improve safety standards and deliver more long-term cost and carbon-efficient buildings.

One contributor pointed to a very poor use of data in the sector, with Scottish data particularly thin on the ground. ‘Until we can see what is going on onsite, what public sector spending is on different kinds of construction projects and how actual spends differ from tender bids, it’s very difficult to know where and



WHAT DOES MODERNISATION LOOK LIKE?



how to improve processes – especially when everything is bespoke.’

The internet of things was also raised as an interesting area for the near future: ‘Technically it’s possible to create smart buildings that know when to replace fixtures or fittings or what requires maintenance and pre-empt that. Using existing technology you could design a building that knows when to replace or upgrade ceiling tiles, for example, and orders the necessary parts itself.’

Cost was cited as the number one barrier to being able to modernise.

‘The technology is already there in most cases, but it costs money to use and money to install and there has been very little appetite to upgrade for that reason,’ said one.

Passivhaus energy standard construction is the bar many investors and clients want, but few are will to pay the extra 13 to 17 per cent it costs to make a building comply with strict carbon output standards.

All agreed that skills was an area the sector could do with massive investment and improvement. ‘It’s very clear that if we are to modernise, we need to attract new skills into our sector.

‘The message that everyone in construction should be putting out to young people today is, if you care about climate change, if you’re good with data, operations and modelling, you should work in construction because that’s where you’ll make a difference,’ said one.

Those working in the sector are often cast as engineers in hard hats or heavy (male) labourers. But all those interviewed said the sector would benefit enormously from a more physically and gender diverse workforce, enabled through more digitalisation, both on and offsite.

‘When you consider the car industry factory lines, we have to ask ourselves if a similar approach is possible in construction,’ one noted.

While not directly related, the move to increase digitalisation and standardisation is also fundamental to the sector surviving a number of policy changes which are becoming much more onerous this year and next. These include scrapping tax rebates on red diesel from April 2022, which will hit contractors hard and strengthen the impetus towards electrification and thus, digital processes where possible.

NET ZERO: A GOLDEN OPPORTUNITY

Overwhelmingly, there was huge optimism that net zero targets enshrined in law under Theresa May's leadership have the potential to be the trigger needed to drive much of the change needed in the sector.

'There are just so many massive opportunities,' said one contributor. 'The infrastructure that will be needed to support the move to renewable energy provision, meeting the housing supply crisis, retrofitting homes and offices and every other kind of building to cut their carbon emissions, changing the way supply chains are managed, what materials are used and where they are sourced – all this is going to be a huge focus for the next decade and after.'

It's likely that net zero will encourage the use of local building materials much more – at the moment, Scotland and the rest of the UK rely heavily on European imports to supply contractors with bricks, marble, concrete and steel.

Not only does that play into the national agenda to combat climate change, it also neatly deals with some of the less savoury results of Brexit, including fractious trading relationships with Europe, increased costs of importing materials and

increasingly costly transportation.

Though all contributors noted the ongoing work in both Westminster and Holyrood, as well as in Europe and internationally, on how companies can and should disclose their carbon output, there was a general feeling that getting to a consensus on this will take considerable time.

In construction particularly, there are many aspects to carbon outputs: how is the workforce getting to and around sites? What is the embodied carbon in the materials used? Is machinery electric and running on renewable energy? How much and what source of energy is being used to build and then to run buildings?

Working out what to disclose was seen as a priority, with some suggestion that Scottish government could usefully regulate in this area.

One contributor highlighted the 'massive disconnect' between both Scottish and British government's net zero ambitions, particularly in the year of COP26 being hosted in Glasgow, and the public sector procurement process forcing down prices.

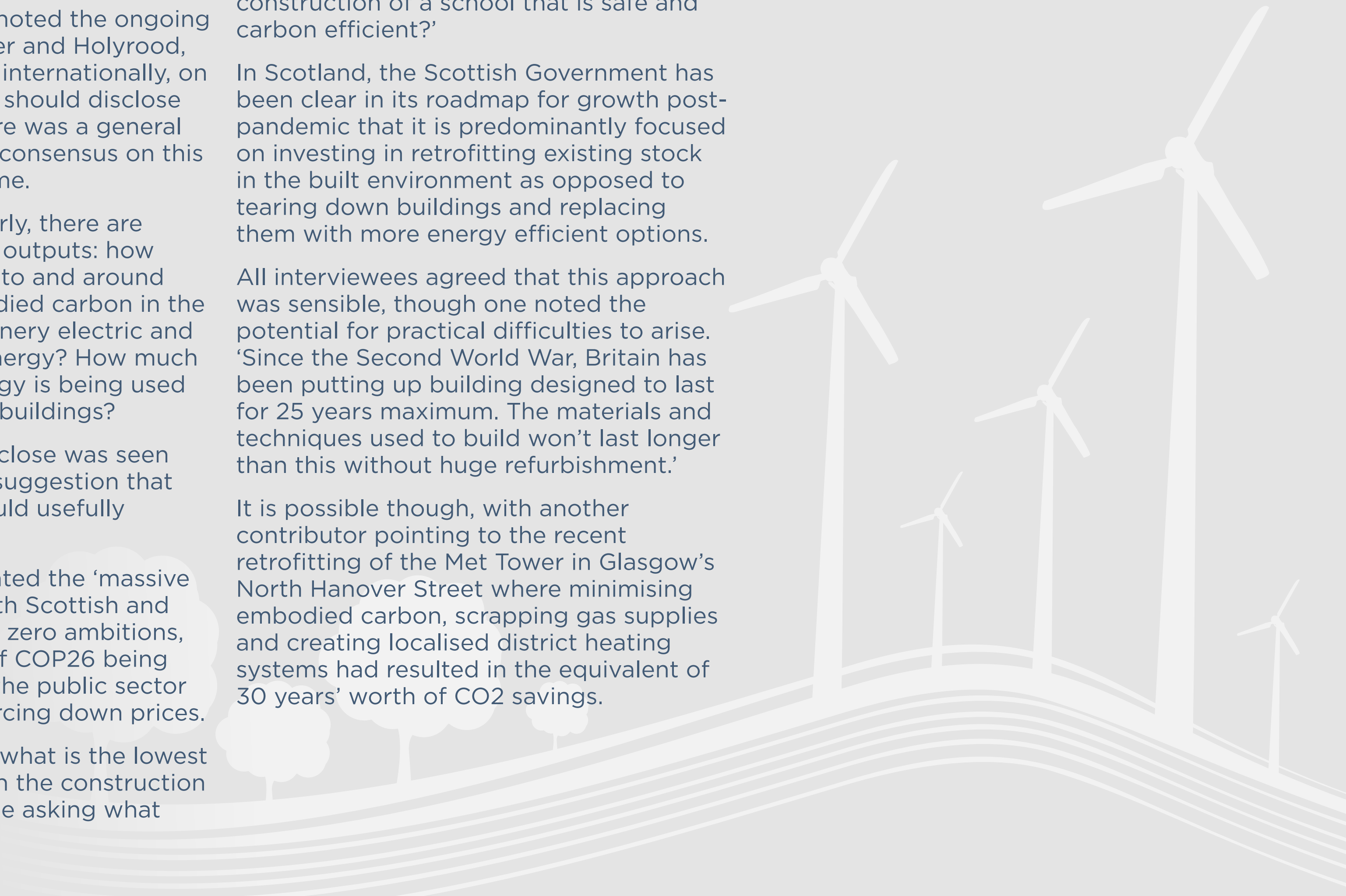
'We shouldn't be asking what is the lowest amount we can spend on the construction of a school. We should be asking what

is the right amount to spend on the construction of a school that is safe and carbon efficient?'

In Scotland, the Scottish Government has been clear in its roadmap for growth post-pandemic that it is predominantly focused on investing in retrofitting existing stock in the built environment as opposed to tearing down buildings and replacing them with more energy efficient options.

All interviewees agreed that this approach was sensible, though one noted the potential for practical difficulties to arise. 'Since the Second World War, Britain has been putting up building designed to last for 25 years maximum. The materials and techniques used to build won't last longer than this without huge refurbishment.'

It is possible though, with another contributor pointing to the recent retrofitting of the Met Tower in Glasgow's North Hanover Street where minimising embodied carbon, scrapping gas supplies and creating localised district heating systems had resulted in the equivalent of 30 years' worth of CO2 savings.



CONCLUSION

In the wake of the pandemic and in Scotland, the Scottish Government's decision to close construction sites completely during the first lockdown, one contributor said the impact of Covid on Scottish construction was 'little short of catastrophic'.

But, concessions were made on the Scottish Government's commitment to funding certain large construction projects in March's Scottish Budget.

'We needed certainty on pipeline,' said the same contributor. 'And virtually every project will go forward with funding which puts the construction and infrastructure sectors in a good position.'

Appetite from both private and public sector clients tendering new projects is heavily geared towards the net zero agenda, with another contributor saying they have already seen significant resilience on increased construction costs among private sector clients where carbon savings can be achieved.

Barriers to delivering a more modern construction sector remain high, especially in Scotland because of the political uncertainty surrounding Scottish independence and future relationship with Europe. But all felt that the ingredients

to modernise construction, deliver more cost and carbon efficient buildings and infrastructure and support a more diverse industry full of green jobs are there. The political will exists to drive the green agenda forward and the industry seems cautiously optimistic that this, together with the rising tide of awareness on environmental, social and governance considerations, has the potential to trigger the construction sector's own green industrial revolution.



PROBLEMS. POSSIBILITIES.
COMPLEXITY. CLARITY.
OBSTACLES. OPPORTUNITIES.
THE DIFFERENCE IS IMAGINATION.

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