

Construction market in the Kingdom of Saudi Arabia

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Introduction

While the booming construction market in the Kingdom of Saudi Arabia (“**KSA**”) offers many opportunities and rewards, there are inevitably accompanying risks and challenges.

In our experience, liquidity, unbalanced risk allocation and contract administration are key pressure points in the KSA construction market and, in this article, we provide a brief overview of these important factors.

Key issues

(i) Liquidity

Despite of the buoyant construction market in KSA, some participants in the construction sector are experiencing financial difficulties, particularly in the form of restricted cashflow.

While such liquidity issues are often most acutely experienced at a contractor and subcontractor level, employers (especially commercial developers) are not immune from suffering from financial difficulties.

We therefore recommend that contractors take proactive steps to satisfy themselves as to the financial arrangements that the employer has in place to ensure that it can pay for the works that are being performed (particularly as works are invariably paid for in arrears).

A further (and perhaps the predominant) cause of liquidity constraints in the market originates from the prevalence of ‘back-to-back’ contracting and specifically ‘pay when paid’ payment terms, which are legal and enforceable in KSA and this financial strain is typically magnified if payment terms are elongated.

Inevitably, this can place stress on the contractual chain, particularly as the main contractor is likely to build in a ‘buffer’ in respect of the timing of its own payment obligations to its supply chain (and this will, in turn, cascade down the supply chain).

Further exacerbation can be caused if the conditional payment regime is opaquely drafted and can therefore be abused.

For example, it is relatively straightforward for an unscrupulous main contractor to contend that it has not received any payment under the main contract (or payment for a particular subcontractor’s scope) and to therefore deny that its obligation to make payment to its supply chain has crystallised.

The main contractor’s position in this regard will be strengthened if its subcontracts prohibit subcontractors from liaising directly with the employer, thus meaning that a subcontractor is unlikely to be able to conclusively verify whether the employer has actually paid the main contractor. Even if a subcontractor is not contractually prevented from approaching the employer, it is unusual for employers to concern themselves with supply chain issues other than when it is in their interest to do so (i.e. if the employer wishes to make direct payments to subcontractors).

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An added risk to a subcontractor engaged on a ‘pay when paid’ basis is that the employer may not be making payments to the main contractor on account of a dispute that solely concerns the employer and the contractor, but has nothing to do with the subcontract works or services in question.

Notwithstanding the competitive contracting environment (and while we accept that such mitigants can be challenging to negotiate), we recommend that stakeholders who are subject to conditional payment regimes seek to qualify the absolute nature of this risk allocation by building in certain safeguards.

Such safeguards may include such things as: (i) requiring the main contractor to substantiate its position regarding receipt of payments from the employer under the main contract (as well as to demonstrate the actions that the main contractor has actually deployed to recover payment); and (ii) seeking thresholds regarding the activation of pay when paid regime.

A related liquidity issue that we are encountering with increasing frequency in the KSA construction market is that of payments made by the employer to the main contractor being diverted by the main contractor from the project in question and allocated by the main contractor for other purposes that are not connected with the project.

This situation typically manifests itself in subcontractors and suppliers not being paid their dues and creates fertile ground for disputes as a project that is starved of liquidity is highly likely to experience fractured relationships, significant delays as well as substandard works being performed.

As a partial solution to this situation, the employer can include a clearly drafted right of audit in the main construction contract that provides transparency regarding how payments from the employer have been distributed by the main contractor.

Additionally, the employer may also wish to reserve the right (but not the obligation and without creating any privity of contract) to make direct payments to subcontractor, if the employer reasonably considers that due amounts have not been paid by the main contractor to its subcontractors.

(ii) Risk allocation

Agreed risk allocation under a construction contract also directly interfaces with liquidity issues, particularly as the materialisation of a particular risk can have profound consequences in terms of cost as well as time.

While the dual principles that risk should be: (i) accepted by those who are best placed to manage the risk in question; and (ii) adequately priced are generally accepted in theory, this is not always the case.

The highly competitive tendering environment (in respect of which price is often the decisive factor) in KSA as well as a reluctance of employers to meaningfully negotiate can mean that contractors are unable to properly price risk, thus meaning that they are exposed if the risks come to pass.

Although whether or not to execute a particular contract is ultimately a commercial decision, willingness to accept onerous contractual terms can constitute a de-facto condition to entering the KSA construction market (particularly further down the contractual chain), while commercial pressures to fill order books can be compelling.

A further risk that is often encountered (and under-estimated) concerns the design approval process, which frequently requires direct interface and collaboration with key stakeholders[1].

In our experience, designers (particularly from an international background) can be unfamiliar with the nuances and the particular requirements of the Saudi regulatory and design approval environment.

Obtaining approvals can be a time consuming, repetitive and complicated process and its complexities can be easily underestimated by the unwary.

While onerous forms of contract and one-sided risk allocation can quickly result in contractual rights accruing in favour of employer, it can be prudent for employers to carefully consider whether or not it is actually beneficial to the project to strictly enforce its contractual entitlements.

For example, a delay may have been caused on account of the occurrence of a contractor risk event (i.e. unforeseeable ground conditions). However, the deduction of delay damages may be counter-productive as this step is likely to create an adversarial relationship, disincentivize the contractor to expeditiously perform and deprive the contractor of much needed cashflow.

(iii) Contract administration

As in other jurisdictions, concerns have been expressed regarding the adequacy of the administration of some projects in KSA.

If a FIDIC-based construction contract is being used, it is likely to be administered by the engineer, appointed by the employer.

Although the engineer is required to act “fairly” when making determinations, we are aware of allegations of bias towards the employer being raised on a number of occasions.

Perceptions of bias can create an adversarial contracting environment. It is therefore important that employers impress on the engineer the need for the contract to be administered fairly if the engineer is operating under the misconception that one-sided administration of the contract is beneficial to the employer.

If the contractor considers that an engineer has erred in making a decision, it is important that the contractor strictly follows the prescribed procedure for challenging the decisions that it disagrees with. This requirement is made all the more important if the contract contains prescribed notice periods and accompanying time bars in respect of contractor’s claims.

Aside from issues of impartiality, it is imperative that the engineer (or contract administrator) diligently and proactively supervises the contractor’s performance, particularly by measuring actual performance against the requirements set out in the programme and/or the method statement.

If issues of non-performance can be identified early, it is invariably far easier to address such incidences at their outset by ensuring that appropriate rectification measures are put in place[2]. However, the implementation of and the on-going adherence to such rectification measures needs to be closely monitored.

Alternatively, if confidence is lost in the contractor’s ability to actually complete the works (i.e. on account of liquidity issues, including if the contractor has under-priced the works) it may well be prudent for the employer to take decisive action.

Among other things, a well-drafted construction contract will provide for clear grounds for termination[3] and also outline the consequences of termination.

However, a construction contract should not be terminated without a coherent and 'stress tested' contingency plan being in place, which addresses the appointment of a replacement contractor (as well as the obtaining of the necessary licenses and approvals for the replacement contractor to proceed with the works) and also anticipates the terminated contractor's likely combative response to its termination.

Concluding remarks

The foregoing is merely a snapshot of some of the issues that we perceive are currently at play in the KSA construction market. However, each situation needs to be evaluated on its own merits. We therefore recommend that contracting parties carefully consider their own 'red-lines' and ensure that these are adequately negotiated and addressed under the contract that is ultimately executed.

For further information please contact [Euan Lloyd](#).

[1] Such as utility providers, neighbouring landowners and regional authorities.

[2] For example, by requiring to contractor to submit an accelerated programme that clearly sets out how the contractor will recover the delays.

[3] De-scoping of works may also be an option depending on the terms of the construction contract.