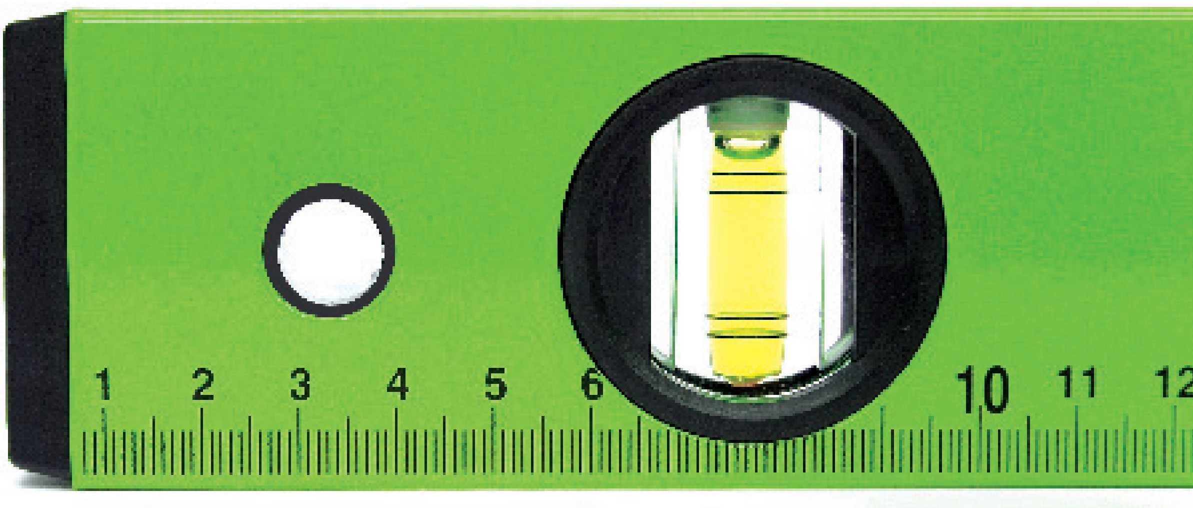
GCC powers of construction 2009
An expert diagnosis



More than 80 years in the Middle East

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A way forward
Insights on the GCC construction industry

Welcome to the first edition of the GCC powers of construction, a Deloitte publication which provides industry insights into the current market in the region. In the last few years the world's attention has been focused on the Gulf region as large construction projects with ever-growing, ambitious dimensions dominated media headlines. High liquidity and pent-up demand fueled a construction industry boom of impressive proportions.

At the time, it seemed as if nothing could stand in the way of the rampant up cycle. Even by the beginning of 2008, when the world found itself amid an economic downturn, confidence remained high that the GCC region would be immune. In the following months, that confidence evaporated as an increasing number of projects were postponed or halted, including some of the region's most iconic.

Now, one year on, the industry has had time to adjust to the fallout from the credit crunch. And the good news is that the mood and outlook remain optimistic.

True, there have been those who were significantly impacted by the crisis , such as in Dubai, once the example of ambitious high-rise office and residential constructions, which is now seeing a shift away from luxurious projects toward construction potential in infrastructure and industry. Yet, others in the region are becoming a source of focus.

Qatar's economy, buoyed by gas-rich resources, is fueling investment in infrastructure and construction industry development. As a result, its construction sector is poised for 17 percent growth in 2009. Saudi Arabia is also an immense source of potential, with 50% of the Gulf's current construction projects taking place within its borders. The large population, pent-up demand for affordable residential housing and government drive to diversify the economy away from oil all point to a bright future for construction in the kingdom.

Abu Dhabi, already a leading construction force in the region, shows great promise for the future, too. The emirate's 2030 plan includes a vast range of projects in energy, transport, industry, health care, education, government, agriculture and much more. If there is a trend that can be pinpointed as emerging, it is that of governments using their reserves to stimulate their economies and thus creating opportunities for the construction industry. As a result, education and health care as well as infrastructure are likely to be the sectors where most demand for building will lie in the future.

Yet, for the developers and contractors the impact of the credit crunch isn't only being felt in a shake-up of demand. Many of them face new challenges and uncertainty in the months and years ahead as a result of lessons learned from the economic downturn. Managing cash flows with greater care, seriously assessing the risks of entering new markets and addressing rising finance and insurance costs number among these.

Helping businesses manage risks and uncertainty is just part of how Deloitte continues to serve the construction sector, acting as a partner for future success. Throughout more than 80 years of uninterrupted presence in the Middle East, Deloitte has been at the heart – and the forefront – of construction and real estate activities in the region.

Our reputation as a premier professional services firm is a direct result of our values and how we live them. At a time when the region is re-examining its practices to date and adjusting to new economic realities, Deloitte's insight and services continue to play a major role in the construction industry.

In producing the GCC powers of construction publication, we have sought to offer a pertinent overview of where the construction industry is today and where it is heading. Along with analysis from our experts, it is my hope that this new publication by Deloitte will be a useful guide and tool for those both in the industry and observing it.

Omar Fahoum
Chairman and chief executive of Deloitte Middle East

Meet the senior executives
The Arabtec group

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The Arabtec group "Arabtec" is one of the largest groups of construction and construction-related companies in the region. During the boom years, from 2007 to 2008, overall revenues increased by 56% and net profits by 87%. The results for the first quarter of 2009 have already seen a slight softening as a result of the downturn. But our view of Arabtec is still positive. Why? 45% of the GCC region's economy is heavily dependent on oil income, and the recent drop in oil prices would lead to 2009 revenues being half of what they were in 2008. That said, as per the IMF's May 2009 report on the region, most Middle East oil exporting economies are expected to maintain high levels of public spending, with forecast growth expected to be between 5% and 7% as a result of having a growing, young and dynamic population.

In order to support this expanding population, we foresee that there is a need for the region's infrastructure to further develop with huge investment planned by the GCC countries. In the UAE, we have seen this trend developing over a number of years.

The Emirate of Dubai, for example, has always been very forward-looking and service-oriented, and created the Jebel Ali Free Zone in the mid-1980s in order to attract businesses seeking fewer restrictions on conducting operations in the region. Dubai was also the first city in the region to make it possible for expatriates to own property, thereby attracting expats to the region for the long-term. These initiatives as well as an aggressive marketing plan for Dubai, all saw the Emirate's social infrastructure develop, growing at unprecedented levels which helped to fuel the boom we experienced in the construction industry. We are confident that there will continue to be a significant market for real estate in the region because of the large size and needs of the population across the GCC countries. Currently, there are not many affordable units available and there will be a growing need to change the mix of products/units on offer to cater for these needs. In Dubai, plans for future real estate development will start to be more realistic, with robust feasibility studies being undertaken to support the decision for any new construction.

In contrast, although it has more reserves, Abu Dhabi, has traditionally been more conservative in its expansion plans. Construction activity has however recently started to increase with huge growth potential in the capital but at a steadier pace. In Abu Dhabi, the supply of real estate currently does not meet existing demand and we believe that the prospects for the real estate industry in the UAE's capital are very good. The Kingdom of Saudi Arabia has a much larger population, with a significant shortage in facilities and a high demand for housing and infrastructure. The KSA government foresees that there is a requirement for a few million housing units in order meet existing demand. It is here that we see a wealth of opportunities for the construction industry in the region.

Ultimately, we believe that the GCC countries will experience positive growth in the future because the demand is there. The growth however will not return to the same levels that were enjoyed prior to the final quarter of 2008. The impact of the slowdown has not changed Arabtec's strategy. From the date Arabtec became a public company our strategy was to expand geographically and to diversify the types of services that we provide. This has been evidenced through our acquisition strategy which commenced in 2007. Our vision is still on track, although the circumstances in Dubai are causing us to look at new markets earlier then we might otherwise have done. We are currently exploring opportunities in India, Egypt, Libya, Algeria and Russia, as these countries have the liquidity to push through the development initiatives that their governments are driving. Nevertheless, we continue to proceed with caution when considering our options in countries outside the UAE as there are numerous barriers to entry such as language, resource availability and legal requirements – all of which require large investment, in both time and money from Arabtec.

In the meantime the challenges are to also deal with the impact of the economic downturn, which has seen some clients taking the opportunity to slow down the pace of work on certain projects. On projects that have not yet commenced, clients have taken the opportunity to delay the start of these. The economic downturn has also triggered the renegotiation / re-specification of contracts. Clients are focusing on obtaining more value in achieving the end product. This naturally has a knock-on effect on us. We are also building efficiencies into the services we provide and we are focused on looking for value engineering opportunities for our clients.

We have seen this trend occurring predominantly on the smaller projects, while large-scale prestigious developments are still proceeding on the same terms. In the last six months, for projects that have not yet commenced and are still planned to go ahead, we have seen clients asking to re-price these contracts. The growing trend in pricing has been a move towards a cost plus model, in the private sector, or a fixed price lump sum model in the public sector and with larger industry players. This means that taking on the larger projects, where liquidity tends to be more secure, ultimately results in the contractor bearing the bulk of the price risk on movements in the cost of materials. Some clients are allowing for escalation clauses to be built into the contracts; however these instances are not the norm any more and the contractors still have to work hard in obtaining the best possible price for those projects that are in the offing.

Consequently, we will probably start to see some consolidation amongst the smaller players in the industry as well as the demise of the some of the minor, more opportunistic players who will not be able to survive the downturn.

Demand over the last few years has meant that the smaller contractors grew in size and will now most likely shrink back to original pre-boom levels or disappear altogether. Mega contractors will need to restructure and look elsewhere to redeploy any excess resources they may have. The focus for the industry over the next few years will be on infrastructure projects – where there is a planned spend of US$ 2 trillion in the GCC, predominantly in KSA. This is the reason why Arabtec formed the JV between Arabtec Saudi Arabia and Prime International Group Services Ltd and CPC Services Company (a member of the Saudi Bin Laden Group). Ground has already been broken on the first project in Saudi Arabia for construction of the Princess Noora Abdul Rahman University in Riyadh, which is to have a total built up area of 250,000 square meters comprising of 46 buildings. Our joint venture in Saudi Arabia has also been awarded the SAR 2 billion contract for the construction of the Lamar Towers in Jeddah.

We also believe that mega contractors should seek to diversify their operations. Our acquisition of the Target Engineering business in 2007 is our gateway to the construction of civil works and related activities such as sub stations, marine walls, reclamation work and dredging. We currently see these as areas where there is a demand for expertise. We are therefore exploring various possibilities with Target Engineering in Abu Dhabi and in Doha.

Qatar will still continue to experience growth and this is backed by very healthy reserves generated through gas resources and the results of our subsidiaries in the country have illustrated this. We foresee this trend to continue in Qatar. Overall, we believe that our geographic expansion and diversified service offerings are our key competitive advantages over other industry regional players.

Regionally, contractors will still face a number of operational issues which we need to continue to find innovative solutions for. In the UAE, for example, towards the end of the construction boom, we were finding it increasingly difficult to secure skilled labour e.g. employing certified heavy equipment operators was a particular challenge, as they are required to be certified locally by the municipality before being allowed to operate any of the machinery. The shortage in supply of cement and rebar in the UAE resulted in us forward purchasing to avoid delays and then importing whenever necessary after satisfying the local quota purchasing requirements. Obtaining visas in new markets, cultural barriers and understanding the local mentality are also challenges that need to be faced.From an administrative perspective, pre-agreeing the price on variation orders has always been a constant struggle in the industry in this region. The pricing tends to be agreed and finalized at the end of the project. This again has an impact on cash flow as the work would not be certified along with the original contract value in spite of it being done. This has affected the cash flow issues many contractors have faced over the past few months as they have essentially funded these variations, which in some cases tend to be significant.

The economic downturn, the operational industry challenges and cash management means that the larger and more experienced contractors, who strategically manage their way through these challenging times and position themselves to take advantage of the opportunities which the GCC countries offer the industry, will survive. The key is being suitably positioned to seize the opportunity.

Riad Kamal
Chief executive officer at Arabtec, United Arab Emirates

Meet the senior executives
Construction Products Holding Company ("CPC")

How would you describe the group and its culture?

CPC is a subsidiary of the privately owned Saudi Bin Laden Group. We specialize in the manufacture of a wide range of construction products throughout the region. As such we are part of a leading diversified construction group with a strong presence in the Middle East and beyond. Whilst a major global organization, the group is still essentially a family business with several third generation members taking an active role within the company. As a family business there is a strong culture throughout the organization based on honesty, integrity and reliability. We have an excellent management team and loyal workforce backed up with solid systems and internal controls. We pride ourselves on being highly receptive to customers' needs and our ability to deliver. I am convinced that these are key contributing factors to the success of the business and the recurring work that we receive.

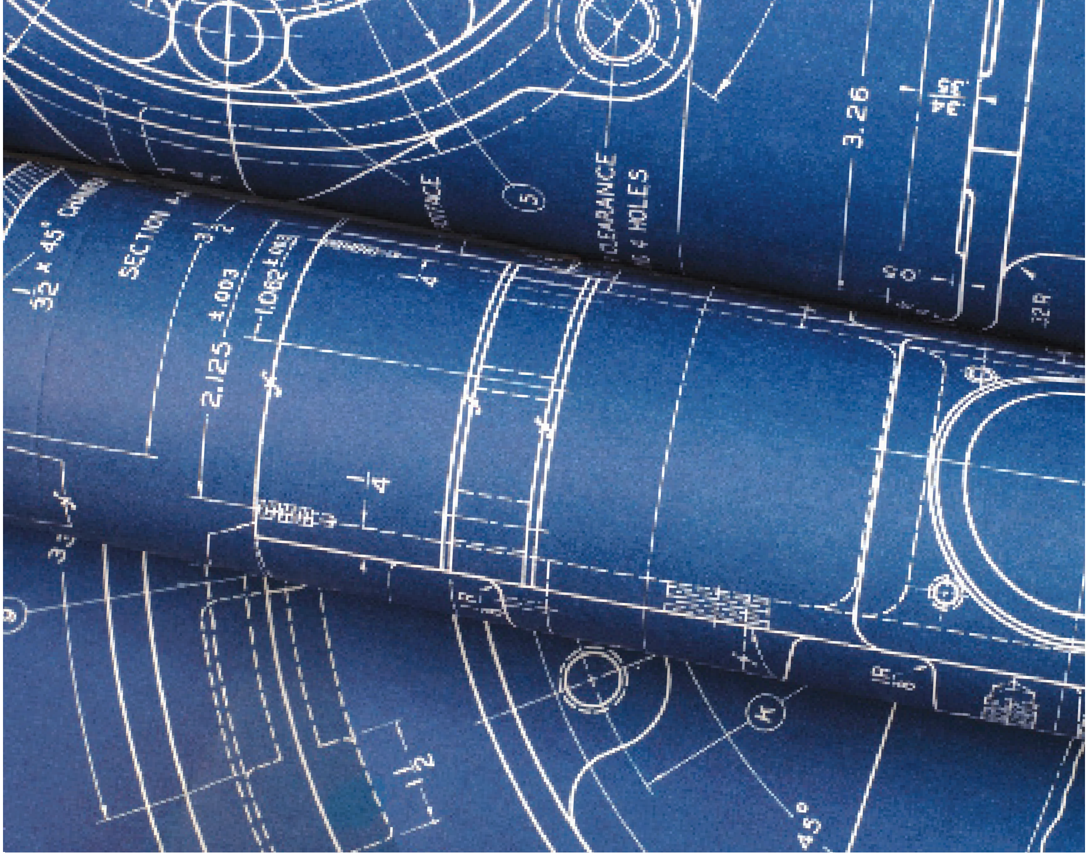
Turning to the KSA market over the medium term, how do you view its prospects?

We are extremely optimistic and have a very strong pipeline. Compared to other construction markets, for instance Dubai (which is suffering from oversupply, particularly in residential and commercial), we see strong demand across the board from both the public and private sector. This demand is built on a strong economic base combined with a young growing population and need for improved infrastructure.

What specific factors do you believe will drive growth over the medium term?

The residential market is very important and probably the most exciting. Demand for residential units between 2009 and 2013 is likely to grow from 500,000 to 800,000 with planned supply of below 100,000 over the same period. There is, therefore, a huge market opportunity to address, particularly in the affordable segment in the 600k – 900k Riyal range. Fuelling this strong demand will be the new mortgage law which will open up home ownership to the majority of the population.

With a total population of 27 million, including 5 million foreigners, only one in five Saudis currently owns a home. We would expect strong participation from both the public and private sector. Outside residential we anticipate increased activity in a number of publicly funded sectors, in particular healthcare, education, roads and other infrastructure projects.



Any clouds on the horizon?

Not really. You hear about manpower shortages but it is not a problem we have encountered. The construction workforce is, in general, fairly mobile and it is possible to pick up slack from those areas where it has become quiet. Raw materials are abundant and prices are falling. We don't see any major constraining factors to hinder our growth.

There is a perception that the KSA construction market is a difficult market to participate in.

I would not say difficult but it is essential to understand the system and how it works. On top of that it is necessary to be persistent in follow ups with the relevant authorities to ensure the smooth passage of a project. If you play by the rules it is possible to get things done.

Moving further afield, which regional markets excite you the most?

We see huge potential in Africa, particularly in the northern countries such as Algeria and Egypt. There is a massive demand for improved infrastructure and housing driven by strong population growth. In addition to that we are also very positive about Syria. Moving closer to home, whilst Dubai is recovering from a speculative bubble that burst, we believe Abu Dhabi has excellent prospects.

Mutaz Sawwaf
CEO of CPC in Saudi Arabia

Expert view from Deloitte: The credit crunch and impact on the GCC construction industry

At the height of the boom in 2008, the Middle East had been the largest importer of steel, when demand rose 39 percent over 2007. The UAE was the largest steel importer among the Gulf countries where imports in 2008 rose 45 percent compared with 2007. It was costing contractors USD1,700 for a ton of reinforced steel (rebar) and close to USD110 a ton for cement in mid 2008. We saw contractors struggling to source materials, driving contract prices to new levels, in some cases seeing the original tender prices almost triple as a result of these increases.

Contractors started to negotiate for compensation due to the escalation of these costs, which no one could have predicted one or two years ago. Margins on contracts also rose to new levels as the demand for contractors outweighed the supply; we saw margins on mega contracts rise to double digits, where historical margins had been in single digits. For a while it looked like the Gulf would be unaffected by the global economic downturn and then in the last quarter of 2008 we saw construction projects worth trillions of dollars being postponed, with the UAE being hardest hit as a number of residential developments and iconic projects were halted. This, and less demand globally, resulted in the prices of steel and cement plunging by 70% and 80% respectively.

For the first six months or so since the downturn affected the GCC, there was hardly any buying of construction materials; this started to pick up again towards April 2009. But the region is still expecting to see a 20 per cent decline in the demand for steel and cement this year, followed by a growth of just 2 per cent in 2010 and 10 per cent in 2011. The industry was hard hit as project financing dropped substantially due to the lack of liquidity in the financial system.

In addition the regional banks stopped all project finance, and this together with the impact of the correcting real estate market aggravated the available lending and the contractors' healthy order books suddenly dwindled as projects were either postponed or canceled altogether.

However, these cancellations might be countered to a large degree by a high level of public sector spending on infrastructure, education and hospitals throughout the GCC, with contractors changing their focus away from Dubai towards Abu Dhabi, Saudi Arabia and Qatar.

Managing the risk

As contractors change their focus to Abu Dhabi, Saudi Arabia and Qatar and move away from the residential boom in Dubai to the infrastructure and industrial sectors in Dubai, they will need to deal with the following challenges to close out existing projects and to structure new projects:

- Advanced payments are now a thing of the past, contractors will have to carefully manage their project cash flows;
- Assessing the strength of the customers' and subcontractors' financial positions;
- More difficult variation and claim negotiations;
- Rising finance and insurance costs;
- Managing cash flows when collections from customers are very slow and customers are pushing for discounts if they settle on time;
- Customers re-tendering to reduce project costs, putting pressure on contractors to pick up the price risk in lump sum contracts with lower margins than before; and
- Understanding the bureaucracy and legal systems when setting up business in new markets with a good grasp of the risks involved.

Is there any good news?

If construction companies are able to change their focus to participate in the sectors and countries where the spending will be, it is almost certainly not doom and gloom. The markets are showing some positive signs that the impact of the financial crisis is slowly being mitigated by sound policies being implemented by the governments through the financial stimulus given to the banks to generate liquidity and by the reserves the Gulf nations have saved up during the boom times.

For a while the industry and the markets seemed to be in shock and everything seemed to grind to a halt, but now that everyone has had a chance to sit back and assess what has happened we see some positivity creeping back into the industry with big projects coming on board in Abu Dhabi, Saudi Arabia and Qatar stimulating this optimism for the GCC. It is estimated that the oil exporting countries have amassed US$1.3 trillion in oil earnings between 2004 and 2008. Government spending on infrastructure and industrial projects will also almost certainly create the demand for contractors and commercial companies to grow, with these countries using their reserves to stimulate their economies - the unanswered question is how long can this last. Luxurious real estate developments will be scaled down to meet the demand and encourage investment in property which will generate more realistic returns.

The bond issue by the Dubai Government was a very positive step and has created the impetus for other GCC countries to do the same in order to stabilize their economy through this type of funding. This coupled with wealthy Sovereign Funds who are investing in equity will give the economies in the GCCs the support and stability they require to sustain the downturn and focus on growth. The construction industry will no doubt see consolidation over the next one to five years with the smaller players finding it difficult to weather the challenges outlined above. The construction industry in the region has low barriers to entry, which resulted in smaller players being able to enter the market at a time when contractors where in short supply, so this will no doubt happen again when the cycle returns to a boom era. In conclusion, the construction and infrastructure market is not immune to the credit crunch. We are not sure if we have seen the full effects – but it would appear that the effects have now bottomed out. The next 12 to 18 months will be an interesting time for the industry and the GCC countries as the IMF predicts a growth rate of 2 per cent for the Middle East this year, down from 5.2 per cent last year, and the growth rate for next year is forecast to be 3.7 per cent.

So why focus on Abu Dhabi, Qatar and Saudi Arabia?

The regional drive to develop schools, hospitals and affordable housing is expected to provide the strongest opportunities in the industry over the coming years, especially in Saudi Arabia and Abu Dhabi. This is followed by power projects, water and wastewater projects and roads and bridges. The Qatar construction sector is poised for 17 percent growth in 2009, as gas revenues continue to provide the country with significant funds to re-invest in infrastructure development and construction projects.

In addition to residential units, Qatar has also seen an increased demand in the office space market as global oil and gas companies, the banking and financial services sector and government agencies expand and seek office accommodation in the country. The UAE is a leading builder in terms of infrastructure projects in the GCC with almost US$105 billion worth of projects been planned and under construction, the majority of these being in Abu Dhabi. This together with Abu Dhabi's industrialization plan for 2030 is a positive sign for the future growth of the industry in the Emirates. Abu Dhabi's 2030 plan, which has been broken down into defined settlements, includes looking at recommended patterns of transportation, infrastructure, government services and health care whilst considering ways to ensure ecological protection and cultural development.

They will then develop principles, policies, and programs that will complement these plans and create a phasing strategy for the Plan, its vision, and its goals. Some of the proposed projects will include:

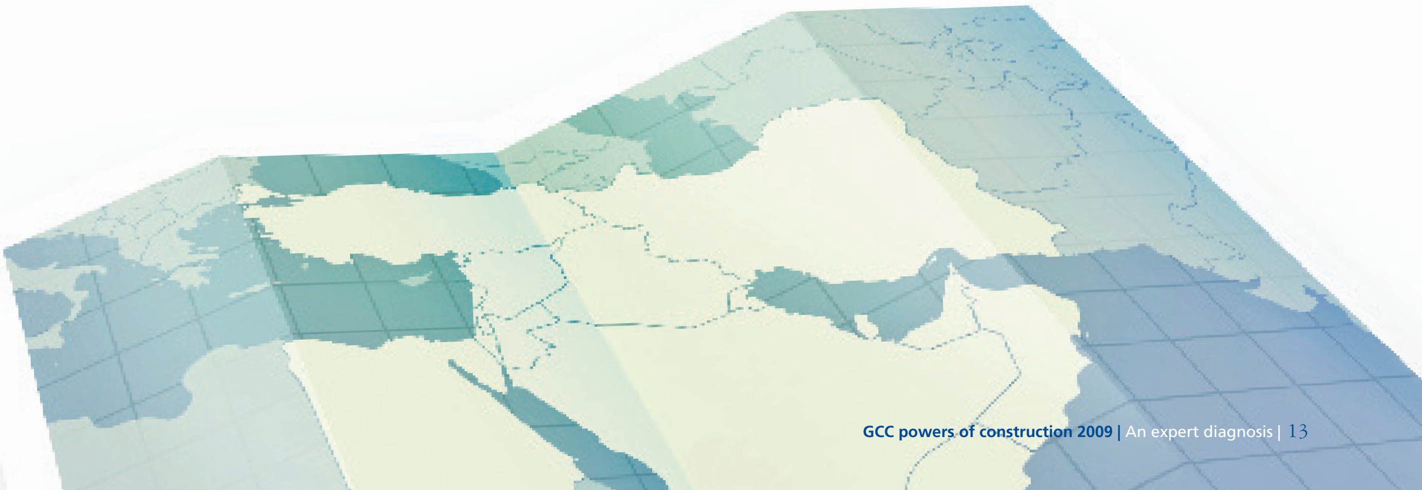
- Multiple oil and gas projects and expansions;
- Airport expansion;
- Multiple industrial projects;
- Sports centers, maritime center, abattoir and sheep farmyards, mosques, grand mosque and Corniche facilities, education facilities for boys and girls, police department, central souk;
- ADNOC nitrogen plant;
- Mirfa hotel expansion;
- Delma Hospital;
- Solar Power facility;
- Government and Civil Defense projects; and
- the list goes on.

Saudi Arabia has recently been looking at relaxing foreign investment laws including those governing partnerships, which the government is realizing would be beneficial to attract foreign investment.
A number of regional firms have therefore expressed a desire to move into the Saudi Arabia construction market, with 50 percent of the Gulf's construction activity currently coming out of Saudi Arabia.

This change in strategy from many of the contractors is necessary to offset the slowdown they are experiencing in other parts of the Middle East and globally. Real estate in Saudi Arabia, which has a population of 27 million people, is considered to be one of the biggest opportunities in the region. There is a strong demand from the Saudi population for affordable residential developments amid a population; which has a growth rate of 2.5 per cent a year; as 65 per cent of families do not own their own home. The shortage of affordable housing has forced people to live in unplanned settlements in cities like Jeddah. These opportunities have resulted in an increase in international developers entering the Saudi market. It is estimated that 1 million new homes will be needed in Saudi Arabia over the next five years. KSA's current five year plan which covers 2005 – 2010, has a focus on economic diversification, education and the inclusion of women in society, resulting in investment in projects like the Noura Bint Abdu Rahman University for Woman in Riyadh worth a total of US$11.5 billion. Construction in Saudi Arabia is being driven by the government's plans to diversify the economy - housing, education, tourism, water, agriculture and infrastructure projects are all part of this agenda.

In conclusion, the commercial changes that the financial downturn have brought about and the burden of risk on the contractors, mean it is not going to be easy to manage the risk, but it is possible and the opportunities to make money in the GCC do exist.

Cynthia Corby
Audit partner, United Arab Emirates



Expert view from Deloitte

The credit crunch and impact on the UK construction industry

It is interesting to note that the impact of the economic downturn has resulted in one of the world's maturest construction industries, the UK, and one of the world's newest construction industries, the GCC's, all turning their attention to their countries' infrastructure needs as a means to survive the economic downturn. The article below sets out how the UK market will deal with the downturn.

How will the UK's construction industry perform in difficult markets?

The UK construction industry is undoubtedly feeling the effects of the recession and the fundamental question being asked by individual companies is whether they will survive its effects. In this article we set out why we believe that the UK industry should be in a better position than ever to tackle a downturn in activity. Our proposition is based on the following key facts:

1. The warning signs were evident well before the effects of recession took hold.

2. In the past 15 years companies have taken steps to diversify activities both geographically and operationally to such an extent that whilst their pure construction divisions may suffer, their other activities should cushion the fall and allow management to react in a timely manner.

3. Companies will need to reap the benefits of their transition several years ago from a 'bid lean and manage hard' ethos to an enlightened tendering and customer relationship management philosophy.

4. Improvements in governance and information technology since the last dip in the cycle should have reduced the incidents of unforeseen surprises in their balance sheet and enable companies to react more quickly to the economic environment; and

5. The state of the county's infrastructure is such that government and privatized utility companies must continue to invest.

Should or will survive?

Before we expand on these five critical foundations for survival, it is necessary to examine the current state of the nation. It goes without saying that the UK is going through a torrid time and all the economic indicators point to a deep and long recession. The most optimistic forecaster appears to be The Chancellor of the Exchequer who in his April budget predicted that in 2009 the economy would shrink by 3.5% (a fall off of 6.3% from the previous peak in 2008) followed by a 1.25% and 3.5% growth in the next two years. Many commentators have poured scorn on these projections, especially as in the first quarter of 2009 the economy shrank at the fastest rate in 30 years, which was the year that Margaret Thatcher came to power. To contrast the Chancellor's predictions, the International Monetary Fund sees a 4.1% slump in 2009 followed by a further albeit minor contraction in 2010, however, at the time of going to press more mixed messages were being aired with some cautious optimism. This does not bode well for the construction industry as its industry cycle traditionally tracks Gross Domestic Product (GDP) with a lag as the backlog order books unwind. However, the situation could be even worse because industry figures indicate that in this recession the downturn started earlier and that 2009 will see a double digit fall off in output. Official National Statistics indicate that Construction Output fell 2.4% in the first quarter compared to a 1.9% fall in GDP.

With this as a gloomy backdrop the key message is perhaps a truism, being that the best prepared companies should survive. Undoubtedly corporate failures and construction workers will add to the growing unemployment lines but because the industry has been in a similar, although not as deep, trough as recently as 1992 the foresighted have put in place the foundations required to survive the storm.

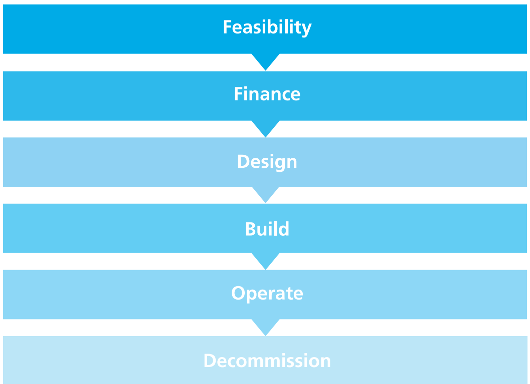
The warning signs

Fundamentally the industry is cyclical and although subsections of the industry or areas of the country can exhibit different trends at any one time, the whole industry will always demonstrate that characteristic. Further, as the industry has limited barriers to entry there is little that can be done from the supply side to flatten that cycle.

As we will see below, individual companies limit their exposure to particular markets by diversifying into different industry segments and geographical areas but when the whole country, or indeed the whole world, is suffering together this portfolio mitigation is less effective. Notwithstanding the current turmoil, the UK's GDP cycles have been less severe since 1992 but they have existed. Foresighted companies should have expected a swing and structured themselves in terms of their markets and fixed cost base in readiness to respond quickly. No one can survive for the long-term in a market unless they appreciate its basic fundamentals.

Diversification

Significant diversification occurred in the UK following the 1992 slump with a number of companies expanding the range of their operations along the infrastructure life cycle. The life cycle of any major asset moves from initial feasibility and finance, through design and build, to operate for the life of the asset and eventually decommissioning.



With the advent of the Private Finance Initiative in the UK in the early to mid nineties, construction companies looked to take an equity interest in the special purpose vehicle used to design, finance, build and operate the relevant assets for periods that extended to thirty or more years. Their interest in this market was not only to profit from the equity return, but to secure downstream services for their operations. In addition, the level of finance required from banks in the form of non-recourse debt and the sheer cost of bidding these contracts created a barrier to entry for many smaller companies in the industry. Further, with the growth of the outsourcing market in the areas of building facilities management, road and rail infrastructure and utility transmission assets, UK construction expanded into the operate stage of the life cycle, with many re-badging themselves as support service companies. Both the finance and operate markets are less cyclical that the traditional design and build segments and, together with the long-term nature of a number of the contracts, gave market participants more secure long-term cash flows. It is these markets, and particularly the operate segment, that should provide a significant number of companies with more stable income streams and hence the ability to see out a downturn in the construction market.

A change in bidding ethos

Prior to the last downturn many construction companies bid fixed price contracts aggressively, sometimes close to nil net margin, to secure the work and then managed the build hard in order to obtain margin upside from variations and claims. Whilst many would deny this, margins across the sector were extremely low and the time taken to close out a contract extended often requiring contract arbitration or litigation.

This bidding method was employed by both main and subcontractors. When a downturn arose this caused considerable difficulties because working capital assets, which were regularly overstated by imprudent profit recognition policies, could not be liquidated as quickly as was needed. Since then companies have taken a different approach to bidding. Numerous annual accounts and analyst presentations reinforced the message of enlightened tendering and stressed a concentration on long-term customer relationships. Enlightened tendering essentially referred to only bidding those contracts where a reasonable risk adjusted margin could be obtained and not chasing turnover to cover a fixed overhead base.

There are evidently benefits to pursuing these policies at any stage of the economic cycle, but in a downturn working capital should be liquidated more rapidly and customer relationships should reduce the tendering risk from those companies that are desperate to maintain workforce utilization levels.

Governance and information technology

The UK has suffered too many well publicized examples of working capital mismanagement in the past fifteen years particularly from public companies who have sought to satisfy analysts' expectations of annual double digit growth.

Returning to a previous point that the construction cycle tends to follow GDP, for companies to produce growth at a rate significantly in advance of the country's growth there either needs to be a gain in market share or reliance on an asset such as intellectual property that leads to a long-term competitive advantage. With respect to gaining market share, the construction industry continues to be highly fragmented with limited economies of scale and as such significant movements in market share are difficult to maintain for the long-term.

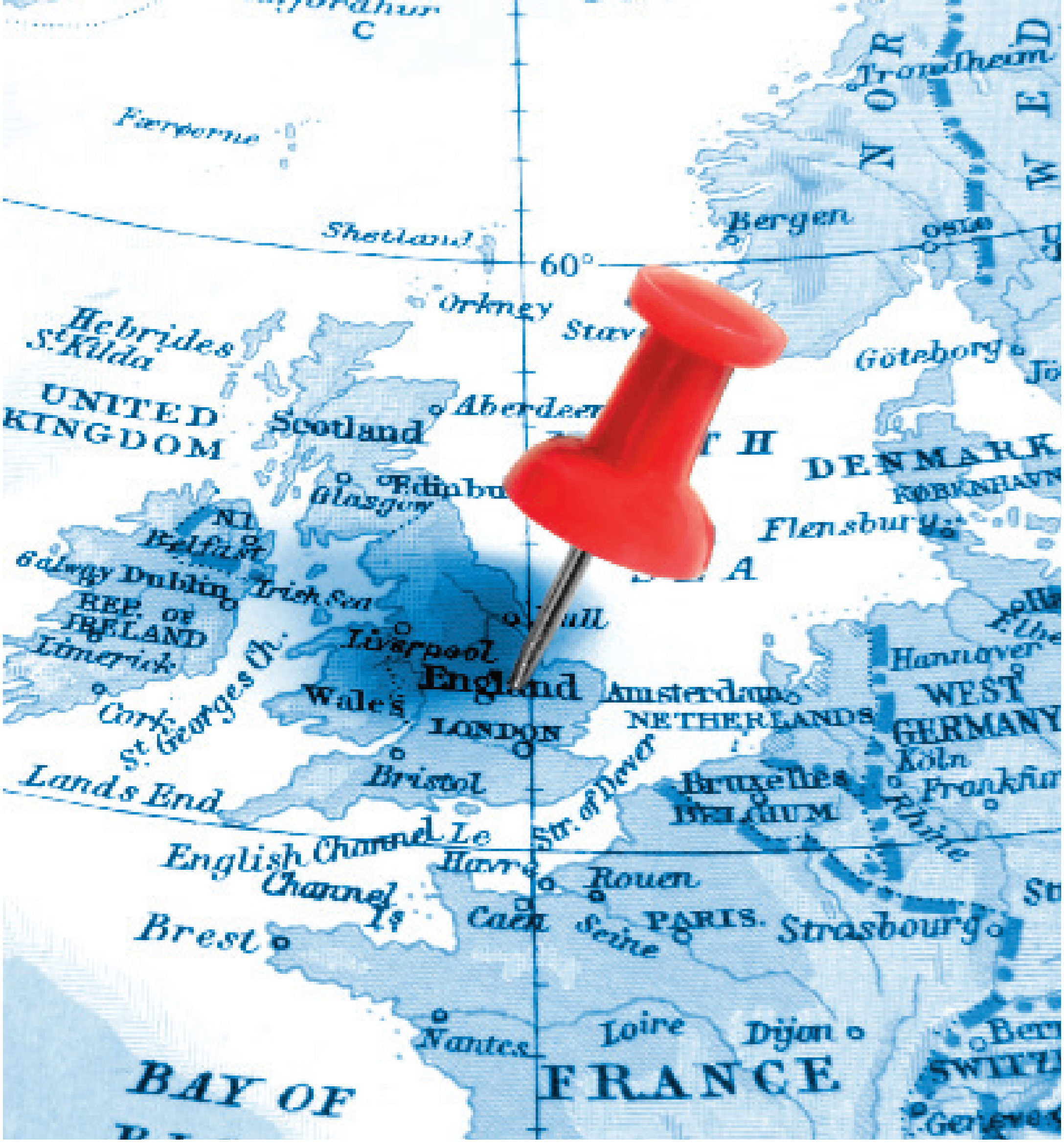
Long-term growth thus comes from expanding the range of activities and geographical spread, be that in the UK or overseas. Without this, requests for double digit growth cannot be satisfied.

Further, a company trades off its assets and in the construction industry these are its people, its client base and its brand name. There is no real intellectual property or other assets that require a capital outlay. Long-term growth thus comes from expanding the range of activities and geographical spread, be that in the UK or overseas. Without this, requests for double digit growth cannot be satisfied. Unfortunately the pressures on top management were such that governance was relaxed and more unjustifiable judgements on contract valuations were taken which eventually became exposed with resulting performance reversals.

Clearly it would be wrong to simply blame asset write-offs on a lack of judgement on the part of senior management because in the industry, judgements on recoverability are made daily by every contract manager; the larger and more geographically spread the company, the more difficult it is to manage. A strong tone from the top and rigorous governance procedures play a critical role in managing the business, as does effective and transparent information on the judgements being made. Whilst many companies in other industries had taken advantage of the huge advances in information technology that occurred throughout the nineties, the construction sector was slow to react as the technology providers took time to customize their products to the industry's information needs. As a consequence, the effects of the judgements made at every level of the organization were not wholly visible. Even in today's technology environment, the level of unagreed contract variations taken to value or unrequired provisions are difficult to uncover through information analysis alone. However, the advances made have been sufficient enough to provide senior management with a fighting chance. This combined with stronger governance and lessons learnt should mean that balance sheets across the industry are in a stronger position; unexpected and unwelcome shocks should not recur.

The UK's infrastructure

Returning to the market for construction it is undoubtedly the case that demand has fallen away. This is particularly true in the private sector build market where office developers and retailers, amongst others, would find it extremely difficult to raise finance even if they wanted to. In a difficult economy you maintain your existing asset base hard in an attempt to extend its useful life. However, we continue to need an effective infrastructure and it is no secret that the UK's infrastructure has been suffering from previous underinvestment.



Whilst there remains a risk that the UK governments, be they national or regional, will cut back on capital budgets, this would firstly be irresponsible in an economic environment that needs fiscal stimulus and secondly, after the privatizations that took place in the 1980's and 1990's much of the decision-making on utilities and infrastructure has been taken out of the government's hands. A great deal of that which remains is also now initially being financed by the private sector banks through PFI schemes allowing government to pay for these assets and the cost of financing them over an extended period.

Whilst government may wish to develop fewer schemes, the state of our infrastructure would not allow this to be a long or even medium-term policy and the banks who finance these schemes, whilst raising the cost of the debt, realize that the returns they receive are significantly more secure than some of their other markets and products!

Summary

In summary, the UK construction industry will suffer along with other industries and as demand falls, supply will have to contract. This reduction may mean that all companies receive the same relative share of a smaller cake but unfortunately that rarely happens. However, those companies that fully understand the dynamics of their industry - ie. those that have diversified from a significant reliance on the highly cyclical areas of their market; have strong customer relationships, especially with the public or quasi-public sector; and have effective governance procedures and information technology - should be well positioned not only to withstand the recession but to profit when the market returns.

Jack Kelly
Audit partner, Deloitte & Touche LLP, UK

Strategy, governance, risk mitigation and dispute avoidance
The building blocks for survival in the current climate

Start right, finish right.

Building upon these four simple words could have helped both contractors and owners survive these troubled economic times. With a booming global economy just a few months ago, and a "contractor friendly" commercial environment as a result of a race to build landmark projects and the subsequent need for supporting infrastructure (power, roads, and services), many involved in the construction industry focused on simply jumping into the race – and cashing in.

Let's look back to just a few years ago, when the construction industry truly became global – there were large contractors from the Far East operating in the Middle East and South Asia; we had large US based contractors operating in combat zones half way around the world; and European contractors continuing to expand operations across the globe. This placed an immense global demand on materials, resources, equipment and expertise – all of which were coming at a premium, with owners that were willing to pay for it. The key elements have never changed – the construction process still involves owners, designers, contractors, and specialized subcontractors – and they still face the same challenges: different ways to deliver projects with varying contractual types, global demand for labor, technical and management resources.

Projects are best delivered when there is a strong level of trust amongst all of the entities involved, and the risk of the project is placed in the hands that are in the best position to control it.

However, understanding and aligning the interests of all these entities, involved in what is now an accepted global construction industry, is key not just for the success, but for the survival of all involved in today's economy. Around the world and in the GCC in particular, there has been tremendous attention paid to Dubai and the challenges the Emirate faces as a result of a loss of liquidity in the markets and its impact on high profile construction projects. With little in the way of natural resources, Dubai has exploded on the global scene with bold ambition, blessed with great timing of very cash-rich global markets. However, even in the midst of a global recession, the economies of countries such as Qatar and Saudi Arabia continue to expand, and place increased demand on infrastructure and services for their citizens.

Strategy

Many projects fail not simply due to bad planning or lack of resources and expertise, but due to an inability to manage expectations. By starting projects under the label of design-build or fast-track construction, or beginning construction with incomplete designs, owners, financiers and other stakeholders are convinced that a project will be delivered in the most optimum settings possible.

Setting the expectation, for example, that scope variations will simply result in additional cost but not impact the delivery, or that a fixed price or guaranteed maximum price contract limits the risk of the vested entities, will result in a label of 'failure' by all invested in the project. Projects are best delivered when there is a strong level of trust amongst all of the entities involved, and the risk of the project is placed in the hands that are in the best position to control it. However, scope changes and poor design very quickly deteriorates this trust level, every issue is interrogated, entities begin contractual positioning, and project control is lost. In fact, any savings in terms of time and cost that can be achieved by overlapping design with construction and fast-tracking activities is quickly lost if the owner, designer and contractors do not buy-in to the system and understand that the scope must be adequately defined in order to achieve the objectives successfully. If the scope isn't defined, contractors will price in the risk into their tender, very likely negating the cost benefits of expediting construction. Further, the lack of time or quality estimators further limits confidence in a design budget. And as we have now seen, most projects have been consistently exceeding their budgets. But have these projects indeed failed? Or is it simply that a false sense of "success" was promised in the initial stages, and the current failure in project delivery we are experiencing may not be as dramatic on some projects as is suggested because of this lack of managing expectations? Another key issue for project execution is resources – with such a rampant demand for construction, it was clear to many objective observers that at least one of the three critical metrics for a project (cost, schedule or quality) was going to suffer during the boom period. Due to a lack of resources globally, financial institutions were not the only ones that were over-leveraged - so were contractors with a lack of quality project managers and skilled labor.

Couple this fact with contractors and subcontractors seeking massive advance payments to guarantee their availability to work on a particular project, and the risk exposure for owners quickly returned to their laps even with fixed price contracts.

Governance

The current economic climate has drawn increased scrutiny to topics that only a few months ago were glossed over, as high profit margins fueled by a mentality of "build it and they will come" had become the hallmark of the economies of the GCC over the past several years. As a general perspective, a 'one size fits all' view of corporate governance has been adopted by many quickly growing companies in the region, leading to a box-ticking exercise in the context of risk management. Effective risk management depends on being able to quickly assess market indicators, something further challenged in the GCC by hyper developing economies and a lack of publicly available data. Further emphasis on proper transparency will also encourage good business practice. Regulators such as the Dubai Financial Services Authority (DFSA) not only require compliance but also the reporting of material developments which provide indicators on the market, and appropriate preparation for the release of financial information, which should increase the availability of information to better assess market indicators to make more informed decisions. Values of ethical dealings will preserve reputation, a "currency" for trade that when translated commercially takes years to develop and only minutes to destroy. Avoiding conflicts of interest in commercial dealings will enhance governance and maintain a company's reputation while reducing the impact of the stress of individuals personally benefiting through the larger company's actions. The best governance however lines up the interests of all the parties involved in an inherent manner, some principles which include:

- Preserving integrity

  No longer just a public relations effort, preserving ethical and corporate responsibility in all business activities is necessary to make effective decisions, for risk management and for avoiding legal disputes and lawsuits. A first step would be to develop a code of conduct for executive management that promotes ethical and responsible decision-making, but encourages accountability for this conduct at all levels of management.

- Encourage transparency

  Companies should make publicly known the roles and responsibilities of the board and executive management to provide shareholders with a comfortable level of accountability. They should also develop policies and procedures for financial reporting that may go beyond regulatory requirements, and hire reputable professional service firms to independently verify the integrity of this information. Disclosure of any issues that may arise concerning the organization as a result of this should be disclosed in a timely and consistent manner to ensure that all stakeholders have access to clear, factual information.

- Recognize interests of stakeholders

  Organizations should recognize that they have legal and other obligations to all legitimate stakeholders, and acknowledge these in policy documents as well as general assembly meetings.

- Responsibilities of the board

  The board needs to have the appropriate level of industry expertise, business acumen, skills and understanding to be able to deal with various business issues that do arise and may potentially arise to be able to effectively review and challenge management's performance.

The success of entities involved in a construction project or program – governance at the project level - is rooted in the development of effective policies, procedures, processes, systems and tools to drive financial, management, and contractual excellence by all participants involved, requiring effective:

- **Program development**
  There is a need to define and implement goals, processes, tools, systems and metrics for performing the project from the design phase through to completion of construction, and to utilize project management systems to facilitate real-time evaluation of progress.

- **Procurement and contract administration**
  There is a need to develop and implement project planning, procurement, contract administration, and project finance systems, applying construction industry and international best practices.

- **Financial management**
  There is a need to monitor all project expenditures on an earned value basis to verify that they comply with contractual requirements and schedule milestones, and develop cash flow and cost forecasting models.

- **Construction oversight**
  There is a need to monitor performance of the construction contractor and subcontractors, and to assess compliance with contract performance requirements, including the project schedule and technical specifications.

- **Executive reporting**
  One must be in a position to develop real-time project status reports, evaluating performance against established project metrics, presenting cash flow and schedule forecasts which will identify risks to project completion upon which strategies can be developed to mitigate project risk.

Risk mitigation

Given the many technical and financial challenges that high-profile, fast-track projects have experienced over the past year, it is a strategic imperative for owners, developers, contractors and other stakeholders to have access to accurate information and to secure professional advice to safely navigate through current conditions and to be in a position of strength once the economy recovers. Returning to the project level, the following issues have limited the success of projects and the entities involved from achieving successful completion and their business objectives:

- Ineffective and incorrect contractual structures selected for project delivery
- A lack of clear roles, responsibilities, and relationships among the entities involved
- Lack of a system that establishes clear metrics for performance, and that in a timely manner identifies discrepancies between planned and actual performance
- Absence of a project management system that provides accurate information
- Failure to implement proven business management, internal control and progress reporting systems and processes

The presence of these "gaps" in organizations and projects places even more importance on the identification and management of risks as an important aspect for the successful management of any project.
At the project-level, risks can present themselves in a number of areas, including:

- Technical and performance
- Program and financial
- Health, safety and security

In the context of these areas, a risk management plan should identify potential risks, set criteria for rating risk levels, and set procedures for responding to and monitoring risk response.An effective risk management plan describes how risk identification, response planning, and risk monitoring and control will be structured and performed during the program's life cycle. This plan should address the following points:

- Methodology the approaches, tools and data needed to perform risk management;
- Roles and Responsibilities specifies the lead and support personnel for each response action;
- Reporting Formats describes the content and format of the risk response plan;
- Tracking System documents how risk activities will be recorded, including lessons learn

Dispute avoidance

The current turbulent economic environment has given rise to an unanticipated increase in construction disputes resulting from:

- Major changes implemented on projects;
- Variations resulting from poor quality designs & plans;
- Deficiencies in contracts, and
- Inexperienced new entrants in the market.

All of these factors limit the successful completion of projects, and are currently further encumbered by losses in capital that are preventing the completion of many of these projects. In many cases, at best production has simply slowed down; in most cases however, all parties are at a loss and attempting to reconcile losses.

One thing is certain, an incomplete or stopped project is bad news for all entities involved. Disputes typically arise when the owner and the contractor have differing views regarding a project-related issue, although a number of stakeholders can be involved including Insurers, Brokers, Developers, Government authorities, In-house legal counsel/Attorneys, Subcontractors, Suppliers and Consultants. In order to avoid disputes, let's first re-cap typical disputes that can occur on a project:

- Construction delay
  Claims typically relate to unanticipated project events and/or circumstances which extend the project and/or prevent work from being performed as originally planned.

- Labor productivity
  Claims typically relate to a loss of productivity when it takes more labor and equipment to do the same amount of work, thereby increasing project costs.

- **Design and construction defects**
  These can be the result of the owner, designer or contractor. Examples include when an owner chooses materials or hardware or provides material not sufficient for the purpose intended; the architect/engineer specifies the incorrect material, or fails to specify the materials to be used; the contractor's quality control and workmanship is poor or the contractor didn't follow the proper construction/installation guidelines; or the material supplier's product is insufficient or defective.

- **Acceleration claims**
  Acceleration claims are typically encountered on construction projects when efforts are made to increase resources or the planned level of effort to recover the project schedule after the project has suffered delays.

- **Suspension and termination claims**
  Contracts/projects may be suspended for a number of reasons e.g. Contractors may submit suspension-related claims if the duration of the suspension is long enough to delay the project or impact progress.

- **Differing site conditions claims**
  These occur when conditions at a construction site differ materially from those that existed at the time of contracting or as represented in the contract documents.

- **Change/variation claims**
  These are the most typical causes of disputes and are a result of unclear bid documents, owner directed changes, late, incomplete, or defective drawings; specifications, and other contract documents.

Efforts to avoid disputes on a construction project can occur throughout the project lifecycle – but placing emphasis on this topic right from the start will pay numerous dividends down the road. The majority of disputes that arise on a project are a result of scope changes or variations, which is why it is essential that all stakeholders understand the benefit of absolutely minimizing any changes to the project and "sticking to the plan" by starting off on the right foot.

- **Design requirements**
  From the conceptual stages, all design requirements should be clearly and completely defined. While fast-track projects begin construction without design elements clearly defined, it is easy to comprehend how this may result in contentious scenarios further in the project life cycle. Ideally, requirements would be set forth clearly in a series of design briefs, including the scope of the given design activity, relevant design standards, relationships and interfaces with other design elements, design phase deliverables, and the design verification process for all entities involved.

- **Definition of responsibilities**
  Efforts must be made to ensure that the responsibilities and authority for design, construction and management functions are clearly and completely specified from the planning stage throughout the project duration. This role definition is essential to minimize cost, and prevent overlap and duplication of roles and align the interests of all stakeholders.

The lack of dependence on upcoming projects for revenue further encourages privatization opportunities as governments do not need to rely on additional project-related services as avenues for generating revenue.

- **Design change control**
  All design changes need to be properly approved and documented, and carried out in a controlled manner. Design change control procedures should be specified in the Design Management Strategy Plan agreed to by all stakeholders at the inception of the project.

- **Value engineering**
  A potential pitfall of value engineering efforts is that a short-term gain may result in a long-term loss. It is essential that the most appropriate solutions are adopted, looking at the entire project life cycle and end-use of the built facility so they represent optimal outcomes in terms of quality, cost, and time.

- **Project controls**
  A key program management effort will include the delivery of correct and accurate project control systems. Typical responsibilities include planning, estimating, cost control and reporting – all of which are essential once a change is introduced to project.

- **Cash flow forecasts and project reporting**
  Project revenue is not expended in a linear fashion, therefore factors such as the method of procurement, the impact of long lead items, status of advance or mobilization payments, inflation, and retention and retention release needs to be carefully accounted for. By conducting project cost and financial control reviews periodically during performance, all stakeholders greatly improve their ability to receive the greatest return on their capital project investment.

- **Contract administration**
  In the rush to design and construct projects, challenged further by new entrants and poor quality procedures, project documentation has not been administered appropriately or effectively. When re-examining a project issue or potential dispute, in order to understand the facts retroactively it is essential that issues are documented and organized efficiently.

The following actions are essential to document, and therefore avoid, construction disputes in regards to contract administration activities:

- Reviewing the contract, understanding the scope of work, and knowing the parties' responsibilities;
- Identifying the change or potential change;
- Providing notice of the change in accordance with the contract;
- Documenting the change, including costs and schedule impacts related to the change;
- Preparing and pricing the change request;
- Negotiating and resolving the change and executing a signed change/variation order.

Looking Forward

Even though many projects have not followed the "Start right, finish right" approach, there are some aspects unique to the GCC that will allow the construction industry to bounce back quickly. From a physical perspective, many countries have a solid infrastructure to build upon and develop further. Since the economic slowdown, there has been a shift in market penetration from Dubai to economies such as Abu Dhabi, Qatar and Saudi Arabia – the common element of these locales is they are driven by oil- and gas-based revenues with robust economies and available capital. Further, the lack of dependence on upcoming projects for revenue further encourages privatization opportunities as governments do not need to rely on additional project-related services as avenues for generating revenue. The fall of confidence in the regional real estate sector will see a significant change in the type of projects that drive construction activity, with government-funded infrastructure and building projects set to provide the best opportunities for the GCC construction industry. While there may be a shift in the short-term away from more commercial real estate projects, efforts to develop schools, hospitals and affordable housing is expected to provide the strongest opportunities in the coming year, particularly in Saudi Arabia, Abu Dhabi and Qatar.

With high profile public-sector building projects around the GCC giving rise to new opportunities, including for example major public transportation such as the Abu Dhabi metro program, other investments will continue in the development of power, water and wastewater projects, as well as large scale road and bridge projects. Further, the implementation of greater regulation as it becomes more accepted should reduce risk and ultimately restore and then sustain investor confidence in the development and construction markets.

However, as many of these new companies that entered the construction market have now received their first "battle scars", it is the hope of many that learning from these difficulties will influence their success and sustainability in the new economy. For example, as a first step predominantly Muslim-owned companies in the GCC may revert back to Shariah tenets to restrict overleveraging themselves and decrease indebtedness, spurring them to make more critical and prudent decisions which will ultimately prevent them from overstretching themselves financially in the future. The key is that this sort of practice is not only good from a religious perspective, but from a purely financial position as well. Many involved in construction projects in the GCC may not have started right, but with increasing levels of capital, a strong infrastructure, and confidence engrained into their collective behavior to design and construct world class projects, they have the ability to learn from these difficult economic conditions to finish right.

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Contracting out: Cancellation of projects in the GCC

Reversal of fortune

Since peaking in July 2008, levels of activity in the Gulf construction industry have declined dramatically. With some estimates putting the value of Gulf construction projects suspended or terminated at US$1.9 trillion, the potential for this abrupt reversal of fortunes to cause an outbreak of claims and disputes is very real. There is no doubt that the level of disputes has increased since Autumn last year.

The number of new cases reported by the Dubai International Arbitration Centre, for example, is 180 for the first six months of 2009 compared to 100 new cases in the whole of 2008 and 77 new cases in 2007. This upward trend cannot be explained by the surge in construction activity during the last few years alone. In truth, the outcome of the numerous suspensions and terminations will depend on various factors, most notably the willingness or ability of parties to compromise. This article explores recent trends and some common scenarios in order to shed some light on what the future may hold.

During the boom years, speed of delivery was a key commercial driver and no more so than in the real estate sector.

Options available

With the viability of many real estate projects in doubt, a number of "win win" solutions have been offered up by the industry. Examples include payment in kind - in the form of units, floors or even buildings - debt for equity swaps and charges over fixed assets.

Party	Options available	
Owners	• Re-negotiate price and payments • Adjust programme • Reduce scope • Re-tender provisional sum items	• Suspend or terminate for convenience • Suspend or terminate for cause • Relax bonding and security arrangements
Contractors	• Reduce the rate of progress • Renegotiate with subcontractors • Suspend for non-payment	• Terminate for default • Reduce overheads • Attachment orders, arbitration, courts
Subcontractors and consultants	• Same as contractors • Withhold copyright /design	• Withhold plant and/or equipment

Whilst, in practice, few of these arrangements have proved viable, a number, such as reducing the level of capital tied up in projects (for example by restructuring advance payment and security arrangements) have proved more useful. In many cases, however, parties have simply agreed to go their separate ways. If agreement cannot be reached, the options available to the project participates will include some or all of those identified in the table below. The extent to which these options are available depends on the nature or existence of any agreements between the relevant parties.

Legal framework

During the boom years, speed of delivery was a key commercial driver and no more so than in the real estate sector. In consequence, many projects proceeded on little more than an exchange of correspondence. Letters of intent and letters of acceptance proliferated, sometimes as a stop gap but often as a permanent substitute for the time consuming and sometimes difficult process of preparing a detailed contract. Whilst the laws of the Gulf states as applied by the local courts generally recognise such arrangements as contractually binding, subject to satisfying certain minimum conditions, few letters of intent provide mechanisms for suspending or terminating projects in circumstances such as those with which the industry has been confronted since the end of last year.

In such circumstances, termination and suspension will be governed in the United Arab Emirates by various provisions within Federal Law N° 5 of 1985 (the "Civil Transactions Code"), such as Articles 271, 272, 273, 381, 877 and 892, broadly requiring termination to take place under court supervision. Similar provisions are contained in Law N° 19 of 2001, Law N° 22 of 2004 and Law N° 67 of 1980 which are the Civil Codes for Bahrain, Qatar and Kuwait respectively.
Court supervised suspension and termination is not, however, the only option. The standard FIDIC conditions, which form the backbone of the majority of formalised construction contracts in the Gulf,

contain a contractual regime allowing owners, contractors and consultants to terminate or suspend projects in certain circumstances. Such provisions, in general, strike a balance between the competing interests of the project participants. By virtue of the freedom of commercial parties to govern their contractual relationship as enshrined in the legislative regimes of the UAE, Qatar, Kuwait and Bahrain (for example, see Article 2 of UAE Law Nº 18 of 1993) the FIDIC regime prevails over the provisions of the Civil Transactions Code. The FIDIC Conditions, where applicable, provide a more comprehensive and cohesive framework within which suspension and termination of projects can be managed.

Termination

Pursuant to the contract

The most straightforward way to terminate is pursuant to the terms and conditions of the relevant contract. Pursuant to the FIDIC Conditions of Contract for Construction, 1999 ("Red Book"), termination may be for default of the other party or for convenience of the owner. In either case, termination does not in fact bring the contract to an end but, rather, acts as a trigger for a change in the rights of obligations of the parties.

The grounds on which an owner is entitled to terminate by reason of a contractor's default are found at general condition 15.2 of the Red Book. The grounds are relatively generous to an owner.

For example, an owner can terminate by virtue of any of the following:

- Failure to comply with a Notice to Correct issued under general condition 15.1 in respect of any failure to perform an obligation under the contract;
- Failure without reasonable excuse to proceed with the Works with "due expedition and without delay";
- Failure to comply with a notice to rectify defects.

A notice to correct can be issued at any time but must grant the contractor a reasonable time within which to rectify the failure. The effect of a notice of termination for default is that the rights of the contractor to be paid are suspended until the owner can ascertain the costs of completing the Works. In addition, the owner is entitled to recover any loss and damage incurred (excluding loss of anticipated profits or other consequential loss) and any extra costs of completing the Works. An owner is – not the contractor – is also entitled to give a notice of terminate for convenience. However, this right is accompanied by a prohibition on terminating in order to arrange for the Works to be carried out by another contractor. The more limited grounds upon which a contractor is entitled to give a notice of termination are found at general condition 16.2 of the FIDIC Red Book and include:

- The contractor does not receive the amount due under an interim payment certificate;
- The engineer fails to issue an interim payment certificate within 56 days of receiving the contractor's payment application; and
- There is a prolonged suspension of the works.

The dispute resolution provisions of the Contract will remain in place, even after a notice of termination is issued by either party.

Pursuant to laws of the Gulf

Where the contract is silent on termination, a party may be able to establish a termination right for an alleged breach of contract pursuant to the applicable local laws. For example, pursuant to UAE laws a party may establish a termination right where:

- there is mutual agreement of the parties or a judicial order;
- a party does not perform its obligations and the non-defaulting party requires by notice to the defaulting party, the contract to be performed by the defaulting party or cancelled;

- there is a force majeure event that makes the performance of the contract impossible;
- there is "compelling necessity" for the party to undertake performance of its obligations itself (or appoint a third party to do so); and/or
- if any cause arises preventing the performance of a construction contract or the completion of the performance of a construction contract, either party may require the contract to be cancelled or terminated.

Similar termination rights exist in Bahrain, Qatar and Kuwait. See for example, Articles 210, 219 and 437 of the Kuwait Civil Code, Articles 140, 145, 148, 590, 591 and 611 of the Bahraini Civil Code and Articles 183, 184, 188, 688, 704 and 707 of the Qatari Civil Code.

In addition, Article 611 of the Bahraini Civil Code and Article 707 of the Qatari Civil Code entitle an owner to terminate a construction contract at any time and for any reason provided that the owner compensates the contractor for the expenses it has incurred, the works completed and the profit the contractor would have earned if it had completed the works.

The UAE Civil Code does not contain an equivalent provision. Several general principles govern a party's right to terminate where there is a breach of contract. These include:

- the contract must give rise to reciprocal and interdependent obligations;
- there must be a real breach – ie it must be shown that the other party failed to carry out its contractual obligations;
- unless the applicable Civil Code article expressly provides otherwise, the breach should be brought to the notice of the party in default; and
- the party seeking termination must not himself be in default.

Suspension

Pursuant to the contract

Both the contractor and the owner have a right to suspend the works under the FIDIC Red Book. Pursuant to general condition 16.1, the contractor is able to suspend the works where the owner has failed to pay a certified interim certificate provided that the requisite notice period for suspension is given. A suspension does not prejudice a contractor's termination rights.

If the non-payment is rectified then a contractor is obliged to recommence the works. Pursuant to general condition 8.8 of the FIDIC Red Book, an owner is entitled to suspend all or part of the works at any time and for any reason. Provided the cause of the suspension is not the responsibility of the contractor, the contractor is entitled to claim additional time and cost as a consequence of the suspension.

Pursuant to laws of the Gulf

If a contract is not in place or is silent about parties' rights to suspend the works, then Article 247 of the UAE Civil Code, Article 191 of the Qatari Civil Code and Article 150 of the Bahraini Civil Code provide a right to suspend the works provided it can be shown that the other party is failing to perform its obligations. Pursuant to these Articles, any person having an obligation may refrain from fulfilling it for as long as a prior and connected obligation owed to him by another remains unfulfilled.

Unlike suspension in accordance with the contract, where a contractual right to suspend is typically expressed to arise upon failure to pay an amount due under a certificate or to certify a contractor's payment application, no such qualification is found in the above provision.

Force majeure

Current market conditions have prompted some to advance alternative grounds for termination and suspension to those specifically contemplated by the FIDIC Conditions. Chief amongst these alternative grounds have been force majeure and exceptional circumstances.

Force majeure

Force majeure is defined in the FIDIC Red Book at general condition 19.1. Although general condition 19.1 provides an "open" definition, economic hardship is not expressly contemplated as a basis on which to rely on force majeure for relief from either party's ongoing performance obligations. The UAE Civil Code, at Article 893, provides that: "If any cause arises preventing the performance of the contract or the completion of the performance thereof, either of the contracting parties may require that the contract be cancelled or terminated as the case may be."This provision allows an opportunity outside of the contractual framework for a party to rely on force majeure as a result of economic hardship. There are, however, a number of challenges that face any party intending to place reliance on Article 893 or similar provisions in the laws of other Gulf states.

Exceptional circumstances of a public nature

In the current economic environment, some reliance has also been placed on Article 249 of the UAE Civil Code which provides: "If exceptional circumstances of a public nature which could not have been foreseen occur as a result of which the performance of the contractual obligation, even if not impossible, becomes oppressive for the obligor so as to threaten him with grave loss, it shall be permissible for the judge, in accordance with the circumstances and after weighing up the interests of each party, to reduce the oppressive obligation to a reasonable level if justice so requires, and any agreement to the contrary shall be void."

Whilst there is no indication that Article 249 is confined to contracts with government bodies, the references to "circumstances of a public nature" creates some uncertainty around the qualifying circumstances and, in particular, whether there is a requirement that there should be some element of state intervention. This uncertainty is not present in the laws of Bahrain or Qatar. Article 130 of the Qatari Civil Code and Article 171(2) of the Qatari Civil Code refer to "exceptional and unpredictable events of a general character" and "general, exceptional events that cannot be foreseen", thus removing the ambiguity surrounding the term "public nature" in the UAE Civil Code. The question of whether the liquidity crisis is both exceptional and unforeseeable is open to debate as is what constitutes grave loss. If a court or an arbitral tribunal concludes that the circumstances satisfy Article 249 or the equivalent provisions in Bahrain and Qatar, the power to make an adjustment is entirely discretionary.

Commonsense prevails

Notwithstanding the challenges presented by the market conditions and predictions of a burgeoning number of disputes in the real estate and construction sector, the reality, at present, is that the floodgates have not opened. There is little appetite for a resort to legal remedies. The majority of cancellations and suspensions have been managed by agreement. In other cases, the contractual mechanisms are sufficiently clear that, sooner or later, a resolution is likely to be achieved. Of the remainder some will inevitably prove intractable but the signs, at present, are that the industry is currently in the process of working its way through the challenges and will eventually emerge, wiser and stronger.

August 2009

Michael Grose
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Profiles

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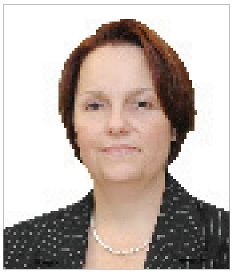

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