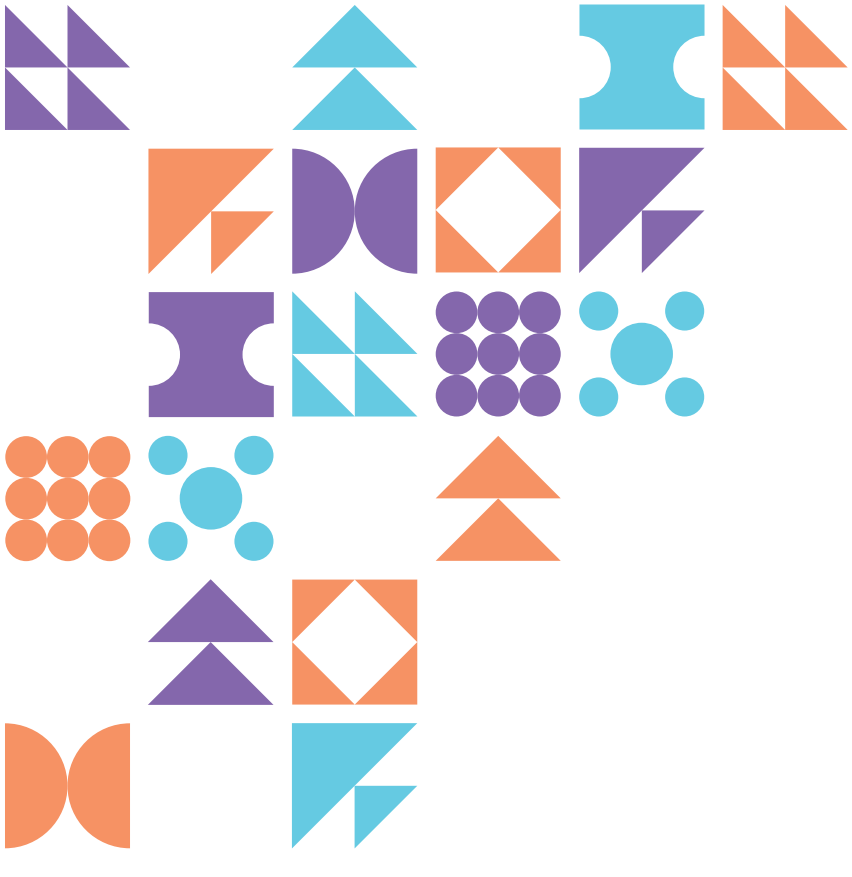
Project Management Institute® Kingdom of Saudi Arabia

RULES OF CREDIT IN CONSTRUCTION CONTRACTS

by Diego Lopez



INTRODUCTION

The aim of Capital Projects is to deliver value to a Company, this value can be measured both in terms of costs and capabilities defined as scope. It is essential that when executing projects, every dollar spent is aligned with the progress of the agreed scope.

Rules of Credit are critical in construction contracts to measure progress and monitor associated payments. Not only do these rules allow for clear alignment between work done and fund disbursements, but they also help to efficiently manage large-scale projects. In companies like Aramco, where infrastructure investments are critical to expanding oil and gas production capacity, Rules of Credit play a key role in ensuring project success.

DEFINITION OF RULES OF CREDIT

Rules of Credit refer to the guidelines by which the physical progress of a project is evaluated, assigning value to each milestone met. These milestones are reflected in a percentage of the total contract and serve as the basis for determining when and how much the contractor should be paid for completed work. Proper application of these rules is essential to keeping the project on schedule and on budget.

CREDIT RULE PROFILES: FRONT LOADED, BACK LOADED AND BALANCED

Depending on the structure of the contract and the needs of the parties, Rules of Credit can be designed with different approaches. The three most common profiles are:

I.Front Loaded Rules of Credit: This profile prioritizes more significant payments in the early phases of the project, ensuring that contractors receive a larger proportion of the funds at start-up.
•Advantages for contractors: Higher cash flow at the beginning, providing access to funds to purchase materials and hire staff.
•Considerations for the client (Aramco): Greater financial risk by providing funds in advance of the associated physical progress.

II.Back Loaded Rules of Credit: In this profile, the most important payments are concentrated towards the end of the project, when most of the works are close to completion.
•Client benefits: Less financial exposure in the early stages.
•Challenges for contractors: Lower liquidity in the early stages, which can affect their ability to operate normally.

III.Balanced Rules of Credit: The balanced profile attempts to adjust payments to more closely reflect the contractor's actual spend during the progress of the project. In this approach, payments are distributed as the contractor incurs both direct and indirect expenses.

•Advantages for both parties: Ideally, this method ensures that the contractor receives the necessary funds based on actual costs incurred, which could mitigate risks of illiquidity or delays in the works.

•Implementation challenges: It is difficult to pinpoint how and when contractors spend money, especially due to the variability in direct (labor, materials) and indirect (administrative, logistical) costs in different phases of the project. This makes it difficult to define a payment structure that accurately reflects the contractor's expenses. In addition, contractors may not always have complete transparency into their cost management methods, which increases the risk of planning errors.

Saudi Aramco, a company that has been carrying out large infrastructure projects for decades, have adopted a hyper model of Credit Rules that combines both the frontloaded and balanced credit rules in order to reduce the financial pressure of its contractors. This is done through down payments in the contracts that allow contractors to have a strong financial cash flow in order to perform their agreed scope.

VALIDATION AND VERIFICATION

IMPORTANCE OF CERTIFICATION PHASES

To ensure proper project control, certification phases must be well-defined and easily measurable. Certification is the process by which the progress reported by the contractor is validated, confirming that the work performed meets the required standards and the stipulations of the contract. An accurate certification ensures that payments are made only for completed and approved work.

ENGINEERING PROJECT CERTIFICATION

A common challenge in construction projects is to correctly define the certification phases, especially in complex areas such as engineering. A critical phase, for example, is the start of construction drawings, which is often a difficult process to quantify and control. Since engineering involves multiple revisions, modifications, and adjustments to the drawings, measuring the actual progress of this phase can be subjective if the evaluation criteria are not clearly defined.

To mitigate this risk, it is crucial to establish concrete milestones that are verifiable, such as:

•Delivery of approved drawings: Clearly define when a drawing can be considered "started" or "complete". For example, delivering 100% of construction plans for review could be considered a measurable milestone.

•Intermediate approvals: Divide the engineering process into subphases with partial deliverables, so that progress can be certified in shorter, more manageable stages.

•Quality control and adjustments: Incorporate periodic quality controls to verify that the work is aligned with the standards before moving on to the next phase.

By using clear and measurable milestones, certification phases can be managed more accurately, reducing the possibility of discrepancies between contractor and client as to the actual progress of the project.

CHOOSING THE CREDIT RULE PROFILE

The decision on whether to adopt a front-loaded, back-loaded, or balanced profile in Rules of Credit will depend on several factors. A balanced profile, which allows the contractor to have the necessary cash flow in the early stages without overburdening the client financially, is generally the best option in large projects. By tailoring Rules of Credit to the specific nature of the project, Aramco can ensure both adequate liquidity for the contractor while limiting excessive financial risk to the client.

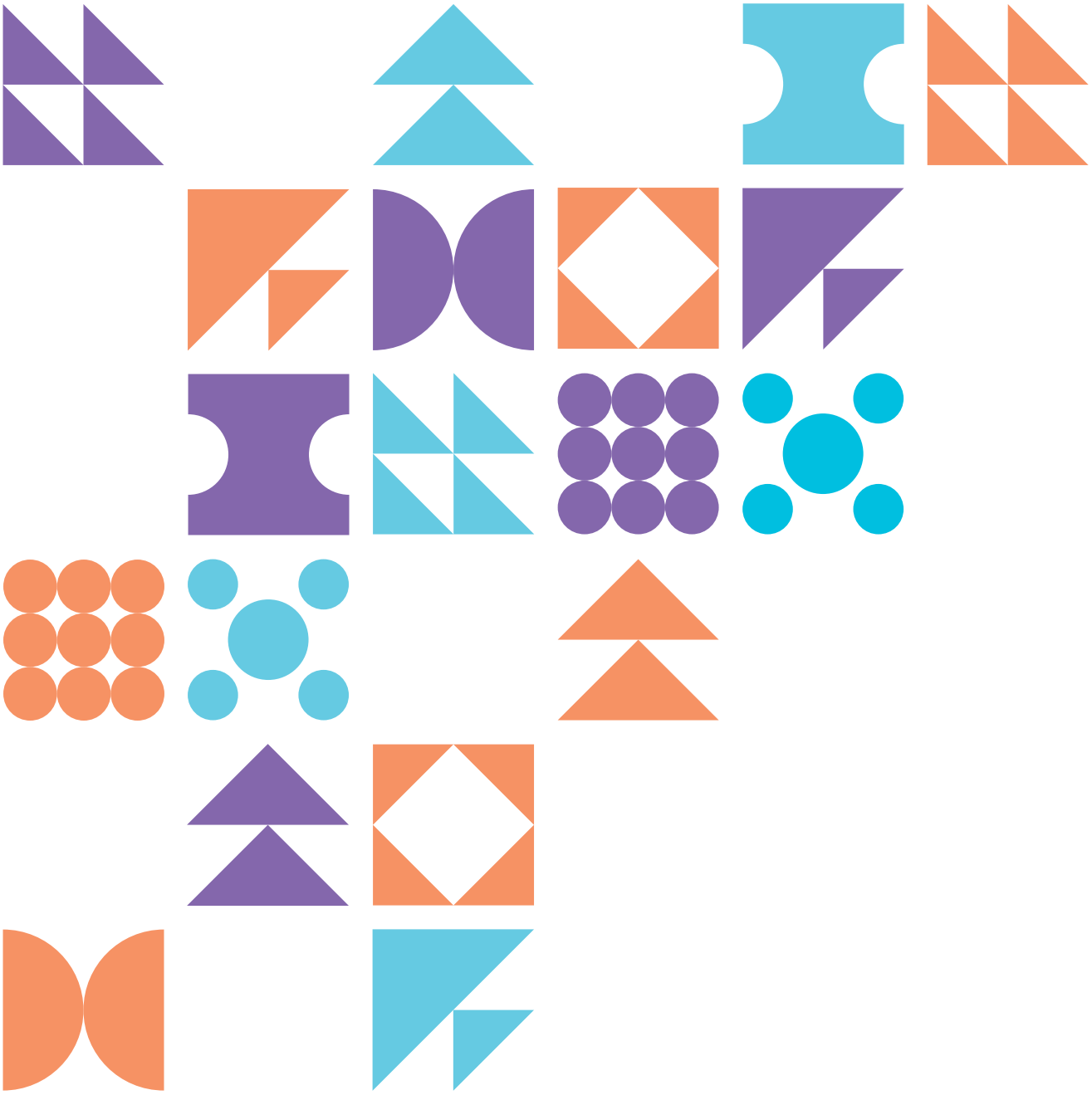
CHALLENGES TO CONSIDER

The main challenge is to find a profile of Rules of Credit that guarantees the continuity of the project and motivates the contractor to comply with its obligations until the end of the work, without suffocating it financially. A scheme that is too front loaded can represent a financial risk for the client, while a back loaded scheme can put the contractor in a bind, affecting their ability to operate. The balanced profile, although in theory it could offer the best fit between the needs of the contractor and the client, presents difficulties in its implementation due to the lack of visibility and control over the contractor's actual expenses.

From **Marjan** Increment Projects Department, our director Khalid Al Sulaim indicates that "balance is essential: the contractor must receive the necessary funds to advance the work without compromising its financial stability, but it is also crucial to maintain sufficient stimulus for the project to continue according to plan."

CONCLUSION

The design of Rules of Credit is a crucial aspect of the success of any construction project. The challenge lies in establishing a balance between the financial profile that allows the continuity of the work and sufficient incentives for the contractor to remain committed until its completion. Correctly defining certification phases and clearly measuring milestones are equally important to ensure that payments are made based on tangible and verifiable progress. A balanced approach to the structure of Rules of Credit can ensure that the project progresses smoothly, benefiting both Aramco and its contractors.



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