

## RELATIONAL CONTRACTING: A PROGNOSIS FOR THE UK CONSTRUCTION INDUSTRY?

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### **KEYWORDS**

Relational contracting, procurement

### **Summary**

The paper explains the idea of relational contracting and examines its future as an innovative procurement tool for the UK construction industry. It proceeds by analysing the forces that foster long term collaborations between contracting parties and illustrates these by examples where it can be found in other industries. The paper then compares these industries with UK construction, in particular to its applicability to adopt this approach as an alternative procurement route to the conventional ones currently available. It examines thoroughly both theoretical aspects and current practice to establish whether the industrial and cultural systems in UK construction is indeed ready for these forms of collaboration. Empirical evidences to this effect are supplied from a research sample of clients and contractors in the industry.

### **Introduction**

"Relational Contracting" in its various guises like "Long Term Partnering", "Collaborative Contracting" and many other similar terms is increasingly popular in various industries. Its attractiveness rests on the fact that it goes against the ingrained acceptance of Adam Smith's specialisation contracting or Hobbesian attitudes towards legal and economic cooperation in business relations, but yet remains to thrive in capitalist societies. A plausible explanation to its popularity stems from a continued admiration towards "Eastern" style contracting, namely the Japanese attitudes towards economics and business that challenges accepted Western norms. Such interest brings forward countless studies to explain and adapt these new concepts and encourage Western industry to take on these challenging systems. Numerous explanations are on offer exemplified by works by Asanuma (1988), Ikeda (1987) and Morris and Imrie (1993) all of which argued for relational contracting as an ideal solution that offers the benefits of vertical integration and yet maintains the flexibility afforded by competitive markets. Relational contracting is then marketed as a compromise in between the pressures for integration, privity and other market forces that dictates the organisation of any particular business organisation. The dynamism of these organisational influences are shown by the developed framework adopted for this study as shown in Fig. 1.

By fostering a supportive hand towards their limited long term contracting partners a higher level of innovation, training and capital investments are possible, thus creating a synergy in the specified collaboration. These forms of contracting, taken up as an alternative procurement route, has not gone without notice in the construction fraternity. Cooperative, lengthy associations typified in Japanese construction (Levy, 1990) are now found breeding successfully in many American partnerships such as DuPont-Flour Daniel, Union Carbide-Bechtel, Shell Oil-R.M.Parsons and many others (NEDC, 1991). For the UK, the exact extent of these forms of relationships are well documented but nonetheless lacks the proper objectivity characterised by academic research. This study forms part of a preliminary research into the applicability, success, or otherwise of relational forms of contracting here. It hopes to distil the environmental and cultural characteristics in relational contracting before

pursuing a sample based study on current practice in order to ascertain the true possibility and extent of filtration of relational contracting into the UK construction industry.

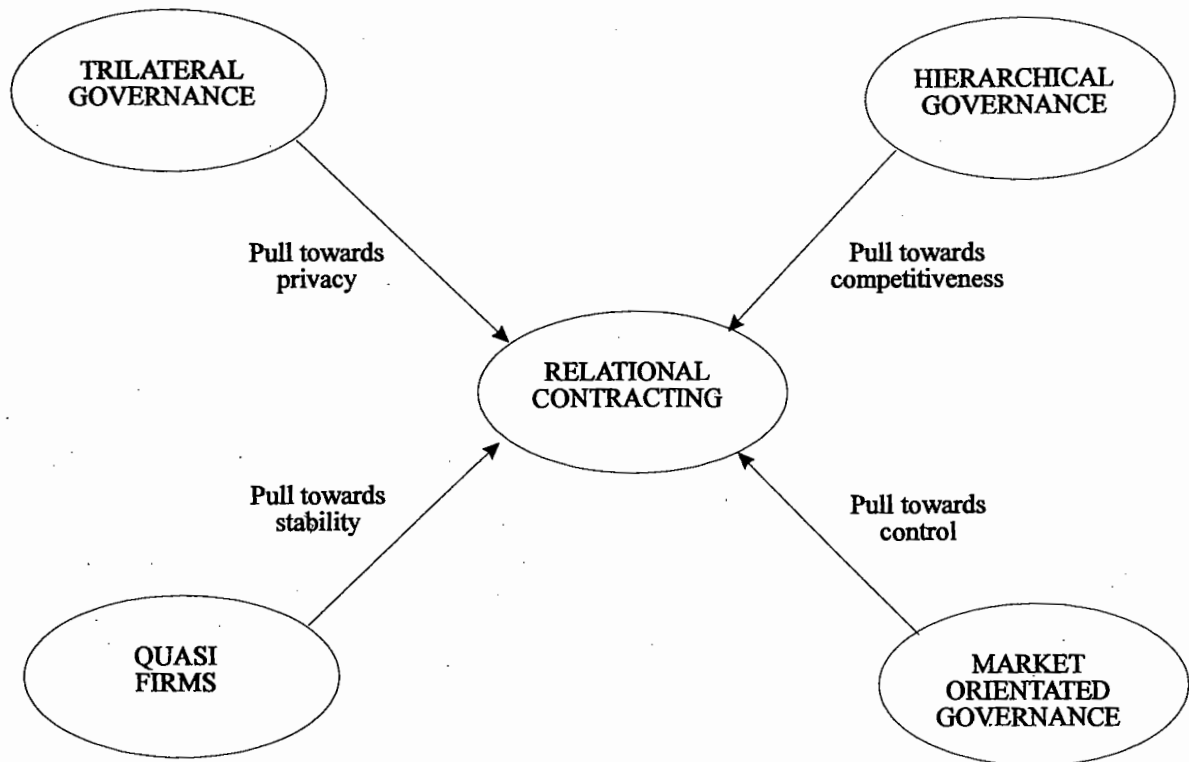


Figure 1: The Dynamic Forces in contracting

### **Building Long-term Relationships**

The idea of "relational contracting" depicts the existence of long term relationships between the parties of the contract, based upon a series of short term transactions. Such relationships might be a deliberate creation at the outset or borne out of the interaction between the parties over time. It views the contract not as a discreet single transaction but more of a continuation of previous and future transactions. This view is in contrast with both the legal contractual models and neoclassical economics; both of which tend to study contracts in its isolated existence.

Attempts to explore relational contracting theories started with numerous works by multi-disciplinary researchers like MacNeil (1978), Macaulay (1963) and Williamson (1975). Primarily they observed that in most long term contractual and business relationships, the legal mechanisms offered by the specific contracts are not followed strictly but the parties themselves govern the transactions within mutually accepted social guidelines. While argued to be commonplace in the business fraternity, it implies that businessmen operate within a dynamic standpoint constantly pulled by legal (contractual), economic and behavioural forces. These situations were discovered to be more pronounced in complex, lengthy and evolving transactions where the circumstances underlying the contract may change over time. Here it seems, the need to maintain relationships is more important than the short term gains seized by enforcing the appropriate contractual machinery.

Construction contracts fit comfortably into that category. Not only operating with bespoke products and complex production lines, the high risk of open assembly and limited

information available to the parties at the outset of these contracts deems it a natural breeding ground for relational contracting conventions. Indeed there are clear examples from Japan for instance where relational contracting has become a preferred procurement route even in government contracts. Public accountability there is measured not solely in the economic benefits of short term competition but instead on the quality of both the product and the construction process.

This approach is termed in Japanese as "Amoe", loosely interpreted as "cooperation and dependency". By definition, it concentrates on the long term prosperity offered by an efficient coalition of organisations, where the client, contractor and subcontractors maintain an on-going relationship throughout a long series of projects. Here potential project based disputes, for instance enforcing vaguely worded contracts or performing extra work, are handled with negotiations between the parties. There are narrated examples where if a project is running into delay, often the contractor will not hesitate to accelerate their works even at times where the expense of the acceleration to the Japanese contractor exceeds the liquidated damages provisions in the contract (Levy 1990). The client will in turn acknowledge this cooperation by awarding future contracts to the contractors. The overall result will be in a manner such that the short term losses incurred are compensated in the end. Apart from a high level of cooperation typified in the execution of a typical Japanese construction contract, there are also continual financial and workforce training supports between these separate entities, (Ota 1991, Levy 1990).

In short relational contracting satisfies three requirements:

The existence of a long term organisation which incorporates several separate business entities

The lack of any formal employment contract or any form of formal governance between these entities

The expectation of continual future dealings which will exist between the entities

### **Enabling Conditions**

There seems to be a variety of conditions under which relational contracting occurs. In construction, it is an optimum solution to reduce bids preparations and other pre-contractual costs associated with open tendering. By reducing the search, bidding and negotiations stages in the procurement process, the client and contractor will be better able to focus their attention on other prequalification issues such as quality, manpower and safety. The possible savings here can be considerable as can be seen from an example for such preparation costs in a survey undertaken by the Construction Industry Employers Council (UK) this year.

Tendering Costs in Pounds Sterling	5m	10m	15m	25m	40m	60m	80m
Presentation Brochure			1500	1500	1500	1500	1500
Enquiries	3000	4000	5000	6000	7000	8500	10000
Estimating	4000	5000	7500	9500	12000	15000	20000
Tender Planning	4000	4500	5000	5500	7000	9000	10000
Legal & Insurance	2000	3000	3500	4000	5500	7000	8000
TOTAL	13000	16500	22500	26500	33000	41000	49500
TENDER%	0.26	0.17	0.15	0.11	0.08	0.07	0.06

By negating the contentious need for open, mostly impersonal tendering practices, even further savings are possible during the relational contract where competitive bidding can be reduced or eliminated totally. Traditionally, the construction industry will operate on individual contracting; what has been termed as "spot contacts" (Kay, 1993) or "exchange contracts"

(Atiyah, 1986). They use an instantaneous exchange at the time of the contract while keeping the parties themselves at a distance throughout its performance. While this promotes greater competition and lower tender costs, fostering arm-length relations breeds opportunistic tendencies by propagating a lack of trust, reduced collaboration and promoting information asymmetry between the contracting parties. The correlation between this and traditional tendering can be seen by the flow diagram below, Fig. 2.

## OPPORTUNISTIC TENDENCIES

Generating extra surveillance costs

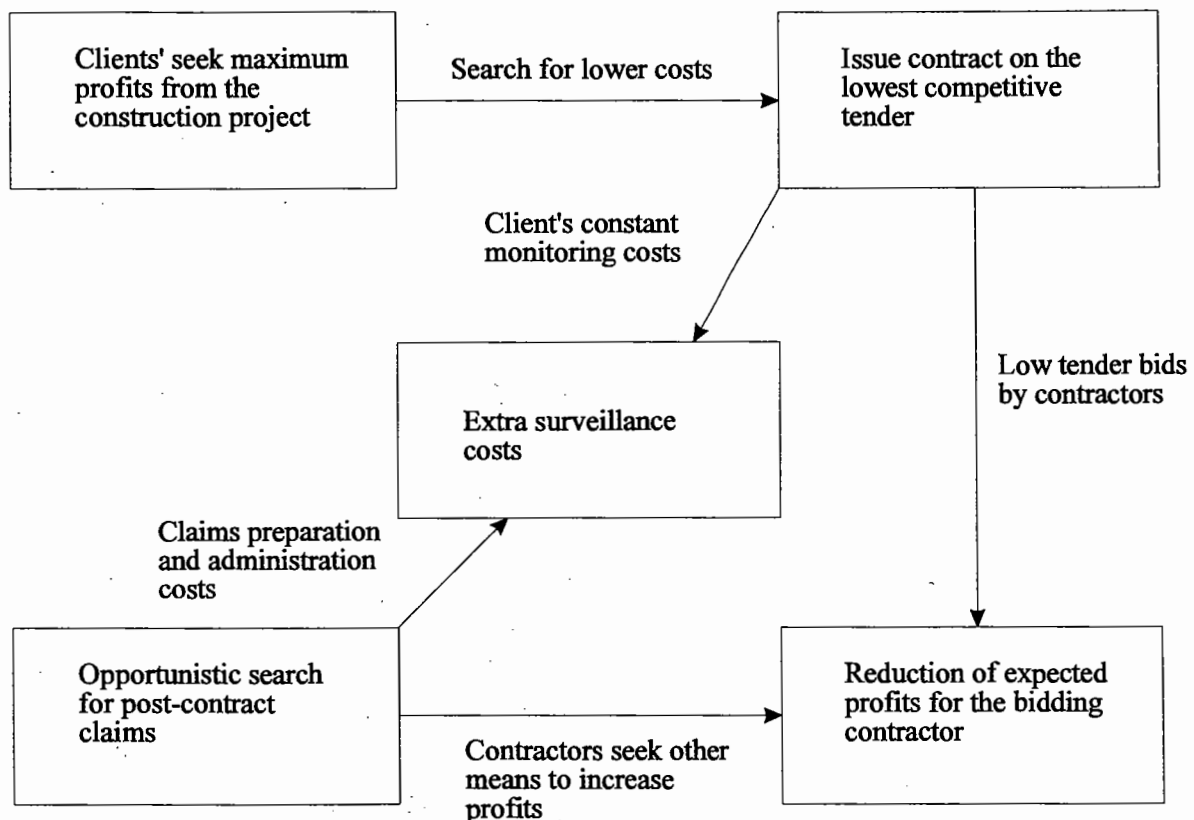


Figure 2: Flow Diagram for Traditional Tendering Process

The need to minimise transaction costs (search costs, negotiation costs, tendering costs, enforcement costs, etc.) have prompted some coalitions (here the client, contractor and subcontractors) to remain constant across a series of transactions (projects). In economic terms, where transaction costs are high, it is cheaper to operate within a hierarchy rather than rely upon the market allocation of resources. This hierarchical governance is the basis for the idea of relational contracting. Even if it is not strictly a hierarchical organisation, the emergence of cooperation and dependency depends on such needs for savings but yet borders on direct permanent employment contracts. This demarcation between direct employment (hierarchical) and close relationships (relational) has been explained by Ouchi (1980). He suggested that the most efficient means to reduce transaction costs in cases where it is not viable to expand subordinate employment is by continuing transactions between separate firms but with common goals. This is achieved by a union agreement of goals and supplemented with non-specific contracts based on a long term interdependence between the parties. It is

very similar to the concept of relational contracting. Thus, it is the quest for eliminating transaction costs that drives firms to be in co-existence in long term relationships.

Apart from the voluntary creation of long term coalitions, relational contracting can also be forced upon its constituents. It may come into existence where there is a high degree of investment specialisation in a particular business venture; what is technically termed as "high transaction specific investments". These are investments made by one party, the product of which has no alternative uses but for the buyer. Similarly the buyer has no or little alternative products. Here the seller and buyer are "locked" into a specific transaction or a string of transactions.

Where there is a high degree of asset specificity, i.e., the investment is unique, the cost of finding alternative suppliers may be large. With an underlying interest to maintain the business relationships, going to the courts to resolve a dispute is usually curbed. This is replaced by a preference to other kinds of commercial pressure to enforce the agreement (Beale and Dugdale (1975); Eaton, Jonathan and Gersoritz (1981)). It can be evident in an intimate market, where there is a small number of participants with mutual long term interdependence, reflecting the closeness of their relationship and the discretion with which it is conducted.

An example of this type of intimacy was discovered by Beale and Dugdale (1975) when they conducted a research into the use of contracts in the engineering machinery industry. They discovered that there was a consistent preference to contract between established partners instead of open tenders. In those organisations, similar to the Japanese contracting practice, there was only limited importance attached to legal penalties, while parties resort instead to various other forms of sanctions. The engineering industry was highlighted in contrast to the high incidence of litigation in the commodity trade industry. An explanation was offered that the high interdependence prevalent in the engineering industry, due to the specific nature of transactions and investments provided the right conditions for relational contracting to take place.

It is clear that effective long-term relationships can only be built up in certain industrial environments. It is necessary therefore to investigate the economic characteristics of an industry before any prescriptions can be made with regards to its genuine contracting framework.

### **Relational Contracting in UK Construction**

Although said earlier that the typical forms of contracting in the UK are mainly adversarial, there is a growing awareness for change in some industries inclining towards building long term relationships. Progression towards this has been steady, as evidenced by observed changes in technical, personnel and managerial assistance structures (Helper, 1989; Rubery, et. al, 1987), more rigorous and long term views towards auditing potential suppliers (Trevor and Christie, 1980) and accepted balance between long term quality and bidding price (Georgeu and Matheiu, 1989). There are also narrated evidences where relational contracting has proved to be successful in UK industries for example the iron ore industry (Daintith, 1987), some engineering machinery producers (Beale and Dugdale, 1975) and the motor industry (Morris and Imrie, 1993).

The construction industry is not sluggish to echo this sweeping development. There is an emerging attention being placed on transaction costs (Winch, 1990), a new interest on behavioural factors in contracting where opportunism is concerned (Cherns and Bryant, 1984) and a high level of former experience between client and contractor has been found to be efficient in reducing conflict in construction projects (Gardiner and Simmons 1992). Besides that, an increased opportunity for elaborate owner-contractor-subcontractor evaluation has also been found to be able to increase the chances of success in a project (Russell and Jasekskis 1992). There is also a call from major institutional research to encourage long term

relationships between contracting partners exemplified by promoting joint ventures and partnering in the Latham Report (1994) and NEDC (1991) and changing current short term views in working practices to aim for more long term quality and reliability (NEDO, 1986),

Indeed there are also evidences to show that the construction industry does not lag and perhaps in some instances lead other industries in building hybrids of relational contracting. Eccles (1981) contends that relational contracting exists in the house building sector in the guises of quasi firms. Here contractors, subcontractors and even clients maintain an on-going relationship based upon cooperation and trust. Although there is yet no evidence on how the behaviour of these parties correlates to the legal behaviour proposed by advocates of relational contracting, there seems to be indicators that the house building sector behaves in a non contentious manner. In addition to that, Turpin (1972) and NEDO (1967) have suggested that some existing public procurement systems do promote mutual trust and cooperation by the creation of successful long term relationships between clients and contractors. One manifestation is in the form of serial contracting, which according to Morris (1969), is an example of a type of relational contracting in the construction industry.

### The Survey

The study therefore attempts to gather some tangible evidence to investigate the true infiltration of relational contracting in the UK construction industry. The study focused on two main issues namely whether relational contracting is indeed beginning to be practised in the UK and if so, if it is different from the main forms of collaborative ventures found in Japan and American construction.

Questionnaires were sent to a hundred major contractors and clients to measure the strength and character of these long term relationships and followed by interviews to randomly selected subjects from the sample. Space precludes a comprehensive presentation of the methodology involved here.

The results of the survey are presented as follows:

Table 1: Existing Relationships Characteristics in Sample

Mean values in observed sample

Relationship Characteristics	Client-Contractor	Contractor-Subcontractor
Current level of claimed long term relationship (%)	35.7	40.1
Length of relationships accepted as long term (years)	8.2	5.2
Value of contracts currently procured by long term partners (000 pounds)	2825.7	700.4

The results demonstrates that there is currently a high level of long term relationships in the construction industry already. These relationships are shown to be built over a period of six to eight years. Interestingly, they are longer between the client-contractor than the contractor-subcontractors. Perhaps a simple explanation of this discrepancy is due to the dynamic nature of the construction industry that imposes few barriers to entry and yet affords little protection against small companies' failure. The DOE statistics for 1990 show about 200,000 registered contractors within the industry, about half of it being one man operations. It further shows that an average of 10% of the companies go into liquidation each year, but with more net entries each year (about 10% growth overall). The effects of this are more pronounced in small companies, predominantly sub-contracting organisations, and thus contributes to the lower records in longevity of contractor-subcontractor associations.

A further analysis then dwells into the nature and attitudes of the sample towards their current long term partners as opposed to the more traditional forms of contracting. The purpose of this is to investigate whether the UK construction industry's purported model of long term and relational contracting fits into the models offered by both academic theory and current practices in other industries including Japanese and American partnering.

Table 2: Current perceptions of sample towards their existing long term relationships

	Positive (score 3-5)	responses (%)	Negative (score 1-2)	Responses (%)
	Client Sample	Contractor Sample	Client Sample	Contractor Sample
Current long term relationship characteristics				
Dependence on clients for negotiated contracts	74	59	26	41
Dependence on contractors for improved quality	69	65	31	35
Nature of relationships dictated by cyclical market forces	39	52	61	48
Only effective if built for more than 5 years	39	35	61	65
Observed savings in tendering and other precontract costs	47	80	53	20
Observed increases in quality standards	50	84	50	16
Fewer recorded contractual disputes and conflicts	73	90	27	10
More observed compromises on legal aspects	17	94	83	6

The results are separated into two categories, namely contractors' and clients' attitudes. Generally there is little deviation in the two and also there are close similarities between observed results and expected forecasts from the theoretical review. There is a high degree of realised savings by eliminating excessive tendering procedures although when asked to elaborate, the sample agreed that these savings will only be possible in the long run. Also as expected, there are fewer disputes in long term relationships following the norms of "business customs" or extra-contractual mechanisms shown earlier. However, there was a surprising but notable difference between the clients' and contractors' contentment in avoiding confrontation by compromise. Clients in the sample and interviews expressed a preference to follow legal and contractual sanctioning procedures in cases where disputes materialise; as opposed to contractors who were more willing to settle the disputes expediently by all possible means. This observation throws a new light on UK construction practices whereby a complete long term collaboration is still hindered by in-built adversarial attitudes. Certainly further research into this area is wanting, but quite outside the scope of this paper. Perhaps it is reasonable to suppose that contractors whose survival can be seriously impeded by having a circle of protracted legal claims, will try as much as possible to settle disputes at their earliest possible stages. As clients are not willing to share this supportive alliance, it is clear that the UK construction industry is still at its infancy in accepting relational contracting.



practices in its pure sense.

### Conclusion

Certainly relational contracting as a procurement mechanism offers many advantages to both the client and contractor. It nonetheless requires specific environmental and cultural variables that allow it to be nurtured adequately. Amidst all those, are numerous claims of its healthy adoption by the UK construction industry. The research attempted to verify such allegations by first looking into the enabling conditions for relational contracting in its various guises and then to investigate whether such practices can be adopted naturally by the construction industry here. The objective results show only a weak indication to support such claims and proved that relational contracting influences has only been taken up partly but is continually limited by the volatile nature of the industry and the adversarial attitudes of its constituents. Clearly negative attitudes like opportunism and the relative lack of importance of long term reputation are hurdles in maintaining long term business relations in the construction industry. Throughout the study however there are some difficulties in obtaining objective data on long term practices both in the UK and also Japanese and American examples. Perhaps this is not justifiable as there are also countless pitfalls of relational contracting if it is taken up haphazardly in an unfriendly environment such as in the UK construction industry. Its volatility and opportunism tendencies will hamper possible net benefits and therefore it is worth a cautionary note to the industry to look at its needs and characteristics before offering a headstrong recommendation for long term partnering.

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