NOTE: Butterworths - Project Alliances in the Construction Industry

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Project Alliances

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[64,010] 1. Development of alliancing

The Australian construction industry has, over time, utilised a number of innovative variations to "traditional" contract arrangements. Recourse has been had, for example, to arrangements such as design & construct; design, novate & construct; partnering; and project management. Guaranteed maximum price provisions have been, from time to time, incorporated in these types of contracts. All of these systems have their merits, but none, including partnering, has attempted systematically to create a radically different, non-adversarial relationship between project participants.

In addition, the industry has been a willing participant in schemes involving new methods of financing through, for example, the outsourcing of infrastructure projects to the private sector using build own operate (BOO) and build own operate transfer (BOOT) structures.

"Partnering", or "cooperative contracting" as it is sometimes called, does not have a universally recognised meaning. However, the word "partnering" has been widely accepted in Australia to mean the provision of work or services in accordance with principles developed in the 1980s by Charles Cowan who was at the time an army officer with the United States Corps of Engineers. Partnering is essentially a set of provisions based on notions of fairness, reasonableness and good faith. These provisions are used together with contractually binding terms and conditions, but such partnering provisions are not intended to give rise to any legal liability.

As a result of dissatisfaction with traditional project delivery strategies, the oil and gas industry in the late 1980's began to use "project alliances" in the development of energy reserves in the North Sea. British Petroleum (BP) came to the conclusion that a change in corporate attitudes and practices was essential for the profitable development of new projects.

BP became so convinced that it had chosen the right strategy (project alliancing) to convert its Andrew oil field from an uneconomical prospect to an enormously successful venture that BP commissioned a British journalist Terry Knott to record the Andrew story. Knott's book is entitled *No Business As Usual -- An Extraordinary North Sea Result* , British Petroleum Company plc, London, 1996: see Appendix 1 at [64,215].

In Australia during the mid 1990s, project alliances were adopted for four major projects in Western Australia, namely:

- the Wandoo oil alliance contract for Ampolex ($480m);
- the East Spar gas field alliance contract for Western Mining Corporation ($250m);
- the Port Hedland iron ore alliance contract for BHP ($700m); and
- a major project in South Australia -- the Roxby Downs metal ore alliance contract for Western Mining Corporation ($400m).

Wandoo was the first project alliance in Australia. Prior to adopting an alliance contract for the development of the Wandoo oilfield, Ampolex sent two senior managers to the United Kingdom to talk to clients, consultants and contractors who had been involved in project alliancing. The Ampolex managers found that the alliance teams were extremely enthusiastic about their projects, the traditional walls between client, designer, fabricator and installation contractor had been broken down and they were able to point to extraordinary savings in costs and time.

Following this visit, Ampolex decided to use project alliancing for the development of the Wandoo oil field because they believed that:

(a) there was a high probability that development costs could be reduced through alliancing;
(b) an alliance offered the participants the opportunity to share the time and cost risks of developing Wandoo; and
(c) oil companies in the North Sea were carrying our large projects with minimum management teams as a result of alliancing.

The Wandoo alliance was highly successful. Savings were achieved in time and money and quality was not compromised. The project won the 1998 Australian Construction Achievement Award.

In June 1994, Western Mining Corporation (WMC) decided to adopt a project alliance for the development of the East Spar gas field. WMC had also sent representatives to the United Kingdom to learn about alliancing and they were as equally impressed as Ampolex with the benefits of project alliancing.

WMC is satisfied that the East Spar alliance provided the necessary flexibility to allow new facilities concepts to be developed while maintaining costs and time within the schedule targets. The culmination of a successful project was the receiving of the National Award for Excellence in 1997 from the Institution of Engineers Australia.

The Wandoo and East Spar projects were undertaken in an environment of cooperation, trust and respect. Clients, consultants and contractors had an equal voice and they all shared the common goal of delivering the required results within the time, cost and quality criteria.

In 1997, the NSW Rail Access Corporation awarded project alliance contracts for the maintenance of rail infrastructure (originally, 15 contracts valued in total at $600m were prepared, but only 3 have been awarded). In 1998, Sydney Water Corporation awarded an alliance contract for the Northside Storage Tunnel project ($375m), the Commonwealth is using an alliance contract for the construction of the National Museum and Institute for Aboriginal and Torres Strait Islander Studies on the Acton Peninsula in the ACT ($95m) and the Western Australian Water Corporation has adopted an alliance process for a new waste water treatment plant ($140m) at Woodman Point, south of Perth.

A further demonstration of the advancement of project alliancing in Australia is evidenced by BP's clean fuels alliance contract at Bulwer Island, east of Brisbane. Valued at an estimated $450m, this project was initiated in 1998 and involves a single alliance agreement which overlays 3 sub-alliances and individual "implementation contracts". On a one-to-one basis, these implementation contracts spell out the work to be carried out and the dispute resolution method to be utilised in the event of any disputes.

There have been a number of rail maintenance contracts awarded in the late 1990s in South Australia, Victoria and Western Australia which are essentially project alliance contracts.

"Strategic allowancing", on the other hand, is a contractual arrangement between two or more entities, but often only two, and which extends beyond a specific project. The success of such arrangements depends on trust; an appreciation of the expectations, strengths and weaknesses of each party; and the mutual striving for agreed objectives and outcomes. Strategic alliances are premised on the mutual expectation that the parties will be doing repeat business with each other.

2. Fundamental characteristics

[64,020] 2.1 Definition of a project alliance

Essentially, project alliancing is a collaborative, incentive-driven method of contracting. All participants work cooperatively to the same end, sharing the risks and rewards of bringing in the project within time and under cost, while respecting principles of good faith and trust. They keep an open book approach to costs and accounting.

A "project alliance" may be defined as:

> an agreement between two or more entities which undertake to work cooperatively, on the basis of a sharing of project risk and reward, for the purpose of achieving agreed outcomes based on principles of good faith and trust and an open-book approach towards costs.

In other words, project alliancing involves the mutual commitment and best endeavours of all participants to achieve agreed goals using teamwork and open-book costing of the work and to share the gains of achieving those goals or

bearing the losses of not doing so. Whilst the agreement between the parties is legally enforceable, liability is nevertheless limited by the terms of that agreement.

[64,025] 2.2 Requirements of a project alliance

Basically, project alliancing requires the participants to create between themselves an entity or legal vehicle to carry out the project on behalf of the various alliance parties. They agree on a target cost (the anticipated cost of completing a project) and may also agree on other targets or key performance indicators (KPIs).

A project alliance creates an arrangement between two or more entities and some of the fundamental requirements of a project alliance are:

- a commitment to common objectives and outcomes;
- a sharing of information, knowledge and skills;
- the best person for each task;
- a cooperative fulfilment of obligations;
- mutual trust and respect;
- a willingness to share losses and profits;
- achieving gains through innovation;
- open-book accounting;
- a no-blame, non-adversarial culture; and
- an efficient use of expertise.

[64,030] 2.3 Successful alliancing

The key to successful alliancing very much depends on:

(a) the quality of the individuals;
(b) the commercial drivers; and
(c) the spirit within the alliance.

The individuals -- best person for the job

Although project alliancing is strictly a business relationship, the essence of a project alliance is the people who create the particular enterprise, not the contract itself. Alliancing is first and foremost about establishing the best team.

Once the prospective participants have agreed to enter into a contractual relationship, their first task should be to establish a team made up of the best individuals available for each project task. These individuals can come from the work force of any of the participants or from outside the alliance. The degree of commitment, integration, motivation, skill, teamwork and trust brought to the alliance by these individuals will determine the level of success of the alliance.

In order to give these essential "team" characteristics the best chance of developing and generally to form an efficient alliance, the project management will need to relocate the selected individuals in separate premises -- in effect to cut them off from their usual employer -- and to mould them into a new group for the duration of the project.

The commercial drivers -- sharing of risks and rewards

The participants will normally agree to share risks (losses) and rewards (profits), measured by reference to KPIs. The most important KPI -- certainly the one which is invariably present -- is the "target cost", representing the total estimated cost of bringing the project to completion. The target cost is established collaboratively by all the participants in the alliance through an "open book" assessment of each participant's anticipated costs. This assessment will probably include an analysis of each participant's historical costs of completing similar or comparable projects.

As with any other KPI agreed between the participants, the target cost has the dual purpose of being a measure of performance and a creator of incentive. Together with any other agreed KPIs, the target cost is the yardstick by

which the performance of the alliance is measured, thus determining whether the alliance participants will or will not share the rewards of meeting or exceeding the project's goals.

The process of establishing the target cost is thorough-going and depends upon the full cooperation of each participant in order to obtain a genuinely transparent record of that participant's normal project costs. Unless it represents a fair estimate of the cost of realising the project, the assessment of the performance of the alliance -- by comparison with the target cost -- will be distorted.

As a general rule, clients will agree to pay all the direct costs of the other participants, even if the target cost is exceeded. To that extent, therefore, the risk of the alliance participants is underwritten by the client. Clients will normally also agree to pay for predetermined corporate overheads where the target cost of the project is not exceeded. These overheads will be reduced or not paid if the target cost is exceeded, in accordance with a predetermined risk/reward curve.

Again, where the project is completed in line with or for less than the target cost, clients may also agree to make a further payment based on a predetermined corporate profit element. The corporate profit may reduce or increase as a function of the degree to which exceptional results are or are not achieved, in accordance with the risk/reward curve agreed between the participants.

As already stated, other KPIs may be factored into the risk/reward calculation to determine whether the alliance has achieved exceptional results or not. Some alliances have included, in the risk/reward regime, an assessment of performance in areas such as:

- time of delivery;
- safety;
- the environment;
- industrial relations;
- community relations.

The inclusion of several KPIs may require inclusion of a weighting factor, in the risk/reward formula used to assess payment to the participants. Thus the importance to the alliance of each KPI will be reflected in the weighting attributed to it in the formula.

The alliance contract should provide very limited grounds for adjustment of the commercial drivers, risk/reward regimes and the payment provisions. Grounds for increasing the target cost and granting extensions of time should be quite limited, as the essence of a project alliance should be:

(a) cooperation for the mutual benefit of the participants; and
(b) a focus on performance, not on reasons for non-performance.

The spirit within the alliance -- commitment to the alliance

The agreement must be read in a spirit of trust and an attitude of "what is best for the alliance is best for my organisation". If the contract is read pedantically, then the alliance will be in trouble. The parties may well find themselves in the typical position of an adversarial relationship. Certainly, the contract provisions will set down the alliance principles and the parties may further have recourse to signing a "charter", declaring, as it were, their intention to behave in accordance with the alliance spirit. In the final analysis, however, the day to day behaviour and attitudes of the individuals will determine whether their organisation is a genuine alliance entity or not.

[64,035] 2.4 Selection based on "soft dollar" criteria

One of the more radical principles of project alliancing is the selection of participants on the basis of factors other than price. The client chooses the entities it regards as most able to deliver value for money by considering such matters as:

- technical experience and expertise;
- whether the entity would be flexible, cooperative and trustworthy;
- project alliance experience;

- current commitments;
- financial and management resources;
- industrial relations and safety record;
- claims and disputation record;
- quality and time record;
- relationships with subcontractors and suppliers;
- environmental management;
- insurance claims;
- risk management.

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