

Contracts

Alliance Contracts: A Glimpse of the Future

In the last few years a host of new delivery structures has been developed for construction and engineering projects. Each has offered different allocations of cost, time and design risks.

In the right circumstances, two of the newest structures - *design, construct and maintain* and *alliance contracting* - can offer considerable advantages over traditional project delivery and the more common design and construct, managing contractor and construction management delivery structures. In particular, they can more effectively reduce disputation.

Unlike *partnering*, whose rhetoric is often not matched by contracts that still use adversarial risk allocations, these two structures use hard construction contracting issues to provide a financial incentive for co-operation. And, best of all, they can often be combined very productively.

The motivation for an alliance

As everyone is painfully aware, traditional and D&C lump sum construction contracts have become breeding grounds for disputes because the financial interests of the owner and the contractor are fundamentally opposed.

While alternatives involving fee-for-service remuneration, such as EPCM, reduce this adversarial relationship, they provide much less scope for the construction manager to be held responsible for substandard performance. Alliance contracting is an attempt to strike a balance between these two extremes.

An *alliance* is simply a long-term relationship between two or more entities pursuing *mutual* goals. To give this alliance the best possible chance of success, it is essential to give the contractor performance-based remuneration so that its financial interests and those of the owner become more closely aligned and *it is in both parties' financial interests to co-operate*. At the same time, the contractor is left with enough risk to motivate it to put its best team on the job. Importantly, in alliance contracting, the *hard* contractual issues of risk allocations and remuneration which directly affects the parties' bottom lines are used to encourage co-operation. This is in stark contrast to *partnering* which, in Australia, suffers from the misconception that the only escape from adversarial contracting is to focus on *soft* issues such as the building of personal relationships and the matching of corporate cultures.

For example, the release of the NSW Department of Public Works and Services' new C21 contract was

accompanied by rhetoric about seeking to change the culture of the construction industry by promoting co-operative contracting and partnering. But C21 is actually quite traditional in its risk allocations. Its inherently adversarial structure is quite inconsistent with the department's stated objectives.

Like any other delivery structure, alliance contracting has its limitations.

A lump sum contract is still the best way to deliver most one-off construction projects. And it is not enough for an owner to think an alliance is appropriate: the contractor must see it as strategically advantageous as well.

But alliance contracting comes to the fore with long-term contractual relationships, especially when:

- at the outset, the owner cannot specify its needs clearly enough for a lump sum tender to be made;
- the contractor is reluctant to put a firm price on long-term risks;
- the owner needs flexible access to the contractor's resources.

A typical example is a contract for the maintenance of capital assets such as buildings, infrastructure and equipment.

In Australia *alliance contracting* has been adopted by Rail Access Corporation for the design, construction and maintenance of all NSW rail infrastructure, and by Ampolex and BHP, among others.

Its advantages are:

- easier achievement of best practice benchmarks;
- easier resolution of differences of opinion;
- through long-term familiarity with the owner's operations, an ability by the contractor to offer expert advice as well as construction, engineering or maintenance services;
- lower contract administration costs;
- lower costs in developing performance-based standards, compared with the costs of developing prescriptive scopes of work;
- avoidance of the high cost premium normally associated with the out-sourcing of risks;
- a greater ability to vary the scope of work;
- a greater ability by the owner to focus on its core business.

The main difficulties are:

- a lack of local industry skills in operating in uncertain conditions where the scope of work cannot be fully prescribed; and
- the shallowness of the market, given the need for service providers to have substantial financial standing.

Alliance contracting is not suitable for everyone. The potential to share advantages can come at the price of increased project costs. Parties must find a comfortable risk allocation formula for that scenario. For this reason, alliancing may prove difficult for the public sector to embrace given the accepted process for spending public funds involving open competitive tendering against prescriptive contract conditions (unlike the flexibility found in most alliance contracts).

Some alliance contracting issues

The selection of a partner is the first critical step. Expressions of interest can be used to assess financial and technical criteria, the contractor's culture, its preparedness to risk its overheads and profit, its willingness to share information freely and to undertake internal partnering and dispute-resolution initiatives.

An owner can use functional specifications and performance-based remuneration to achieve competitive results and to enable service providers to devise innovative solutions to its problems. Prescriptive scopes of work are not only difficult to specify for long-term relationships but will dissuade many service providers.

Remuneration structures must combine contractor accountability with financial incentives for both parties to co-operate, so many alliances use hybrids with lump sum, reimbursable and fee components. Some of the contractor's remuneration must be at risk against the achievement of performance indicators.

Gainshare/painshare arrangements are common. In one example, all the participants have put their entire corporate overhead and gross profit margins at risk against the achievement of agreed project cost objectives for both the construction and operation phases. If the project comes in at less than the target costs, all the participants generate extraordinary profits. Cost overruns are shared by all participants, including the owner, up to a cap fixed at each participant's gross margin, with any further cost overruns being borne by the owner.

Although the contractor's liability can be a contentious issue, there is no reason why it should not be liable for those risks that are clearly within its control. What must be guarded against are unreasonable attempts by an owner, exploiting a superior bargaining position, to place as much risk on the contractor as it can. This is counter-productive because it elicits defensive responses and stifles innovation. In an alliance contract, agreed performance indicators for cost reductions, customer service, safety, production rates and so on effectively act as warranties by *both* parties because their achievement determines both the contractor's remuneration and the owner's achievement of its goals.

In an alliance, there must be unrestricted sharing of information between the parties and total confidentiality *vis-a-vis* outsiders. The ownership of intellectual property developed during the alliance should be addressed by both parties.

Decisions are usually made by a committee with equal representation of the owner and the contractor. The ambit of this body's responsibilities needs to be carefully defined. Alliance or not, it is inevitable that disputes will arise. Alliance contracting is not a cure for all conflict and it should never be assumed that the parties will always be able to reach agreement. There has to be a binding solution available when this situation arises, usually through an independent third party such as an arbitrator or an expert.

Termination of an alliance contract should normally be possible only for insolvency or a serious breach. Any provisions which allow termination for convenience must be drafted so that the contractor has an opportunity to realise the fruits of its investment.

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