

RELATIONSHIP CONTRACTING: WHAT IS IT AND WHERE IS IT GOING?

Brad Cowan, CPEng, MBA, MPD, RPEQ, GAICD
John Davis, BE(Civil), MBA, RPEQ, MAICD

Southern Pacific Alliance Network

1. INTRODUCTION

Relationship Contracting has been available as a style of infrastructure delivery management since the 1980's. It has been formalised into a number of streams; some of the better known ones are 'Partnering' and 'Alliance Contracting'. It is useful to reflect on the origins of the various forms of relationship contracts, viz. partnering from the road construction industry in the USA and alliance contracting from oil and gas exploration and production in the North Sea.

Other industries, seeing the benefits demonstrated on 'headline' projects, have been eager to explore the relevance of relationship contracting to their needs, for infrastructure and service delivery. This paper explores the different styles of relationship contracting that have developed and are emerging, their advantages and disadvantages and relevance to some of these emerging areas.

The paper also highlights some of the learning from recent alliance contracts and poses some of the questions alliance contracting must answer if it is to be a sustainable, infrastructure and service delivery vehicle.

2. PROBLEMS WITH TRADITIONAL, ADVERSARIAL CONTRACTS

Under a traditional construct-to-design contract, the client defines, develops, designs and documents the project before releasing a tender for construction. The successful construction company usually delivers the project for a fixed fee by a target deadline. Other variants of these contract processes, from design & construct through to build-own-operate forms, all have in common the fundamentals of a price-for-risk allocation between the principal & contractor; and variations from the assumed allocation are testing through an *adversarial* framework: your risk vs. my risk.

Project development has been well served by traditional contracts for a long time. However, as projects become increasingly complex, other issues apart from cost and total delivery time motivate them. Issues that need to be addressed in modern project development include:

- community requirements and desire for involvement in planning
- native title
- political issues
- disparate stakeholders, interest groups
- the inherent uncertainties in "brown field" sites

- environmental issues
- uncertainty in scope definition

Failure to address these issues properly can result in time and cost overruns. Of course, complex projects have been around for a long time. However, it can be argued that they have never been well served by ‘traditional’ adversarial contracts. At a fundamental market theory level, the construction company wants to increase its margin while the client wants the project delivered for the lowest cost possible. One party’s loss is another party’s gain. At worst, the assumption of inappropriate motive leads to layers of supervision and constant testing of contract boundaries.

Of course, acute examples usually result in project participants resorting to litigation. A recent example is Transurban’s disputes with its subcontractor Transfield-Obayashi during construction of Melbourne’s CityLink project. The underlying risk allocation definition and testing led to behaviours such as barricading of construction sites (which are not achieving any project goal) which had to be resolved with court injunctions; as the parties sought to protect their individual interests. This ultimately led to delays and contributed to the project’s budget blowout. Nonetheless, many traditionally delivered projects continue to be successfully delivered. Even large adverse outcomes for the contractor are sometimes accepted, for example the losses suffered by Vivendi when taking over the under-bid contract of US Filter for Coliban Water’s Aqua 2000 project.

But are there alternative approaches that avoid or at least mitigate the potential ‘downsides’?

3. ALLIANCE CONTRACTING AND PARTNERING DISTINGUISHED

Alliancing shares relationship goals with the partnering concept; although they originated as contracting tools from different places; viz. the partnering approach from the US Army Corps of Engineers and the Alliance approach from the U.K. oil & gas industry. Partnering places emphasis on trust and open lines of communication through a “partnering agreement” which is a moral charter linked to the formal contract. Alliancing, on the other hand uses a mutually negotiated formal contract/agreement to provide a financial incentive to achieve the desired outcome.

Hence, in a partnering contract the parties agree to work closely together but are only ‘morally’ obliged to do so. The adversarial contract remains the binding legal agreement; and greater profit for one party may be sought by creating a loss for the other party relative to the commencing price/risk agreement. An alliance contract, on the other hand, creates conditions where working together is the fundamental structure of the contract; and the parties can only profit or lose (relative to the commencing price) together. In effect, this means that parties “want” to work together to accomplish project goals.

One can think broadly of the Alliance project as a single project company with limited capital, where the principal provides the parent company guarantee should there be a shortfall in capital requirements.

4. CHARACTERISTICS OF PARTNERING

Partnering is an attempt to formally bring a focus on relationships into traditional contracts. It is designed to sit beside the contract, providing a framework for the day-to-day relationships based on an agreed partnering charter (project mission and objectives). The teams are developed to operate on a fix-it-first, best-for-project culture and a practical issue resolution framework agreed and implemented.

This does not change the risk allocation and responsibilities in the associated contract, but usually leads to open debate on issues, quicker issue resolution and simpler variation management. The relationship is regularly monitored and corrective action swiftly taken to maintain the 'health' of the relationship.

4.1 Typical Structure of a Partnering Agreement

4.1.1 The Partnering Teams

The partnering relationship is implemented by two teams;

The Partnering Steering Committee [PSC]
The Partnering Coordination Team [PCT]

The PSC, sometimes called the Partnering 'Board', is typically comprised of equal numbers of representatives from all projects participants. The PSC functions to:

- set strategies, goals and objectives for the partnering relationship,
- agree and promote a mission and beliefs, and
- review the performance of partnering participants.

Each party must be present for any PSC decisions. Decisions are only implemented if they are supported unanimously by the PSC, thus effectively ensuring that views from all players are taken into account.

While the PSC oversees the direction of the project, The Partnering Coordination Team looks after its day-to-day operations. This team is also comprised of members from all project participants, but not necessarily in equal proportions.

The functions of the PCT include

- resolution of issues or difficulties between project participants,
- review of personnel,
- review of work quality,
- review of opportunities (design, operations or maintenance) and resulting cost savings or qualitative improvements,
- monitoring of performance against agreed performance indicators, and
- reporting of progress to the PSC.

4.1.2 Performance Management

The success of the partnering relationship is judged by comparing its performance against a set of performance criteria. Common criteria include cost, facility performance and construction time.

However, some projects may be judged against other criteria such as community satisfaction or environmental impact (Beenleigh Water Reclamation Facility [Gold Coast Water & Vivendi Australia] being one example). The flexibility in choosing criteria allows many different types of project to work successfully using a partnering approach.

4.2 Advantages and Critical Conditions

4.2.1 Advantages

- ☑ Can lead to an efficient, enthusiastic project management team
- ☑ Is generally successful in managing projects which run on time and on budget
- ☑ Can reduce impact of adversarial nature of the contract.
- ☑ Reduce number and size of variations and costs of their management
- ☑ Marginal cost to set up a partnering relationship
- ☑ Partnering agreement is a managerial not legal agreement, so does not affect the standing of the formal contract.

4.2.2 Critical Conditions

- ☑ Requires trust between parties
- ☑ Requires individuals in both client and partner teams who are suitable for working in open and collaborative environments.

4.3 When is partnering appropriate?

Because partnering is a management and not a legal concept, it will only work when the key players in their relevant client and contractor teams **desire a better working relationship**. 'Forced' partnering is a high-risk procurement strategy; and anecdotally about 50% of 'forced' partnering contracts have poor relationship outcomes.

In general projects and service contracts with the following characteristics could benefit from a partnering approach.

- There is a strong interdependency between the parties (client and contractor) for the contract to be efficiently implemented; e.g. upgrading existing operating infrastructure on 'brownfield' sites, or modification to existing business systems
- The nature of the work is straight forward or it is one of a number of similar projects
- The parties are from different parts of the same organisation.
- Where relationships between the parties have had a history of dysfunctional behaviours, and **both** parties **want** to change the outcomes.
- A crisis situation emerges during the contract, e.g. deadlines brought forward, budget slashed, or variations out of control; and **both** parties **want** to facilitate an improved outcome and avoid a 'paper war'.

4.4 What is current state of partnering in Australia?

Partnering is well established in government contracts ranging from \$1M to \$30M, particularly projects in the transport and water industries. It is also being used to develop and manage relationships in service contracts and service level agreements.

Indications are that the use of partnering will increase on smaller projects. An inter-relationship of Alliance and Partnering is expected to develop where the relationship focus of

major Alliance contracts will have a 'trickle-down' effect to implement relationships through partnering with small to medium subcontractors. The IT industry is also starting to show some interest in managing relationships during service contracts.

4.5 The challenges for partnering

To ensure that partnering continues to be and to be seen as a useful adjunct to the normal range of contracts and a credible element in procurement strategies, a number of emerging issues must be addressed. These include:

- (a) Partnering will not work effectively if it is 'institutionalised' into a mindless process. This is a real danger in the current climate on 'forced' partnering being adopted by a number of state agencies in Australia.
- (b) Loss of corporate memory concerning the 'bad old days' of fixed price or lump sum and D&C contracts; ie no-one remembers how bad the relationships were.
- (c) government clients that are unwilling to move away from the master / servant relationship, even whilst using words such as Alliancing, partnering, alignment, etc.; and contractors that unwilling to move away from the 'right to earn a profit' attitude and abandon profit-grabbing subterfuges. Both can 'talk the talk', but neither can 'walk the walk'. They have difficulty in making partnering work for them

5 CHARACTERISTICS OF ALLIANCE CONTRACTING

Alliance Contracting is the formation of a virtual entity for the delivery of a project. The alliance is more than a co-operative relationship between separate and defined companies; for it seeks to establish a separate or virtual entity, where original corporate cultures are left behind, and a new one created for the delivery of outstanding results for a project. This outcome is pursued in two ways.

Firstly, the alliance culture operates on principles of pursuit of innovation to achieve breakthrough results, fix-it-first responses, best for project decisions, in-house settlement of disputes, no-blame culture, open communication and peer to peer rather than master/slave relationship. These principles are the same as partnering but are enshrined within the actual contract and are not left outside the contract as in partnering.

Secondly, these principles are concreted by aligning and merging owner and non-owner parties' financial arrangements/outcomes to a win:win or lose:lose situation; so that all parties share equally/collaboratively in the pain:gain of remuneration and risk. While 100% risking of the contractor's fees and overheads and profits is invariably provided for as measured against the financial success of the project, alliance contracting also uses performance indicators to put remuneration at risk, so that the alliance relationship is also outcome focused to ensure optimal performance.

One can think broadly of the Alliance project as a single project company with limited capital, where the principal provides the parent company guarantee should there be a shortfall in capital requirements.

Summary characteristics of an alliance include:

- Developing a highly enthusiastic team that is handpicked for the project, who work openly and transparently in a fix-it-first, no-blame problem-solving culture,
- Owner pays the direct cost of the project,

- All contractors participating in the alliance earn their profit from the same pool,
- Primary emphasis is on business outcomes with an objective to achieve a “win-win”,
- Equitable balance of risk and reward for all parties,
- Developing a project culture to deliver outstanding, innovative results for the project that are on time and within budget. Culture of on-going continuous improvement,
- Opportunity to seek and achieve rewards based on performance, and
- Parties agree not to litigate if something goes wrong.

The key to alliance contracting is therefore that the project drives the entire relationship, so that the parties become ‘warped’ to suit the project rather than the parties driving the project so that the project becomes ‘warped’ to suit the parties.

5.1 Typical Structure of an Alliance Contract

5.1.1 The Alliance Teams

The alliance relationship is driven by two lead teams:

The Alliance Leadership Group [ALG]

The Alliance Project Management Team [APMT]

The ALG, sometimes called the Alliance ‘Board’ typically consists of equal representatives from all projects participants. The ALG functions to

- set strategies, goals and objectives for the alliance,
- agree and promote a mission and beliefs,
- approve the proposed Target Outturn Cost for the project (estimated completion price),
- review the performance of alliance participants, and
- be the ultimate issue resolution entity for the project.

Each project party must be present for ALG decisions. Decisions are only implemented if they are made unanimously by the ALG, ensuring that views from all players are taken into account. The role as the top-level issue resolution entity for the project is the significant difference to partnering; and as such the representatives of each party are typically more senior than in a typical partnering board.

While the Alliance Leadership Group oversees the direction of the project, the Alliance Project Management Team looks after its day-to-day operations. This team also comprises members from all project participants but not necessarily in equal proportions. Each position is filled on the basis of merit for the job – from any party including the client/owner.

The functions of the APMT include

- preparation of the Target Outturn Cost for the project (estimated completion price)
- preparations of operational plans,
- review of personnel,
- development of sub-contracting procedures,
- management of work quality,
- review of opportunities (design, operations or maintenance) and resulting cost savings or qualitative improvements,
- monitoring of performance against performance indicators,
- resolution of issues or difficulties between project participants, and
- reporting of progress to the ALG.

5.1.2 Performance Management

The success of the alliance is judged by comparing its performance against a set of performance criteria. Common criteria include cost and construction time.

However, many projects are judged against other criteria such as community satisfaction or environmental impact (Sydney Water's Northside Storage Tunnel and Landers Shute Water Treatment Plant being examples). The flexibility in choosing criteria allows many different types of project to work successfully using an Alliancing approach.

5.1.3 Risk & Reward Sharing

Generally, the client will pay the construction contractor, engineering firm and other alliance members their direct costs, which include:

- labour cost
- goods, consumables, small plant and tools purchased for work on the project
- sub-contracted services and utilities from outside sources
- alliance facilities
- site accommodation
- taxes, legal fees, reviewers costs and other similar external costs associated with the project

The estimated finished total of these project costs is called the TOC: 'Target Outcome Cost' (alternatively: 'Target Cost'; or TCE: 'Target Cost Estimate'). All the usual project risks such as wet weather delays, latent conditions etc are included by estimation in the TOC, the focus being on estimating the end point cost, not a typical tender start point. Only a change in the scope of the project will lead to a recalculation of the TOC.

A Project Fee, comprising the normal expected profit and corporate office overhead fee is added to the TOC (using a percentage figure agreed at the tender stage) and becomes a fixed sum for all future purposes when the TOC is approved.

If the alliance achieves or exceeds the agreed criteria or TOC, an increase in the Project Fee is paid out of the savings and divided equitably on a pre-sanctioned basis among the alliance members. Alternatively, if the project runs over-budget, any excess over the agreed TOC is also shared by all participants in the project. This way, all project members win or lose together.

Important features are:

- the contractor's exposure to loss is usually capped at the Project Fee,
- all the key ratios are *pre-sanctioned*, when the Alliance agreement is drawn up, subsequently the outcomes for profit and other adjustments simply 'fall out' of these pre-agreed formulas, and
- to have confidence that the contractors' estimates are the same as actual costs incurred, and for probity on public sector projects, the project accounts are usually audited monthly.

5.1.4 Dispute Resolution

Another key feature of an alliance contract is that parties agree not to litigate; except in very special circumstances such as wilful default. Hence, contracts often include detailed issue/problem resolution systems, similar to those promoted by partnering arrangements. The inability to litigate is designed to force alliance members to look for solutions to problems rather than seek to blame each other for the problems themselves. This, added to the cost risk structure, becomes the foundation of the 'no-blame' culture.

As noted, the usual exception to the 'no litigation' rule occur if one of the alliance members' actions constitutes wilful default - which is defined as "wanton or reckless act or omission which amounts to a wilful and utter disregard for the harmful and unavoidable consequences of their actions".

5.2 Advantages and Critical Conditions

5.2.1 Advantages

- ☑ Can lead to an efficient, enthusiastic project management team
- ☑ Encourages innovation by allowing all parties to share the gains
- ☑ Is generally successful in creating projects which run on time and on budget
- ☑ Very useful if the client can't plan the project properly without outside expertise
- ☑ Pain/Gain sharing arrangement which can create incentives to reduce costs
- ☑ Allows client to have direct input into the project throughout the life of the project
- ☑ Scope for traditional forms of dispute resolution (i.e. litigation) is greatly reduced

5.2.2 Critical Conditions

- ☒ Requires trust between parties
- ☒ Scope for traditional forms of dispute resolution (i.e. litigation) is greatly reduced; a rigorous auditing system is implemented to avoid making the system vulnerable to rorts (although the TOC change control and cost sharing underwrites most of the disincentive to rort)
- ☒ Some members of the alliance get greater exposure to the upside and downside of construction risk & cost outcomes than they would under a traditional contract, usually in line with their capacity to influence the outcome

5.3 When Should Alliance Contracting be used?

A large amount of effort and resources is used initially to develop the alliance relationship, and as such this cost needs to be out-weighed by the benefits that an enthusiastic, specialised and innovative team brings to the project. In general, projects that have the following characteristics will be suited to alliance contracting for this reason;

- high, or diverse risks
- politically, environmentally, socially sensitive project
- prestige or key project that needs to show outstanding results
- projects that need resources and skill from a wide range of areas
- projects of unknown scope etc, that need a dedicated team to work together to develop solutions etc.

- Projects with inflexible budgets and / or timelines.
- When the client has key skills and knowledge to be deployed on the project.

The principal opportunity for use of an alliance contract is any project of any size where it is seen that a highly collaborative, co-operative and innovative approach is required. Nonetheless, each alliance contract needs to be designed to suit the client's and project objectives.

5.4 What is current state of alliance contracting in Australia?

Alliance contracting is well established as a viable procurement alternative in government contracts ranging from medium to large projects in the defence, transport and water industries, as well as private sector infrastructure development and services contracts. Some particular movements in size and style over the last few years are as follows:

- Alliance contract set-up costs have been sized down to suit the small to medium projects in the \$2M to \$30M range.
- Alliance contracts are not as formula driven as they originally were and variants are emerging to suit the client's and specific project or service needs. However most variants are still true to the alliance principles. These variants include;
 - More even balance between technical capability and suitable people and culture.
 - **Program** services alliance contracts where the scope is developed over time and a number of TOCs may be incrementally developed and agreed.
 - Some recent Tender assessments have included
 - Technical concepts offered
 - Risk assessment and management capability
 - Technical innovation capability
 - Clients and their partners recognise the need for support, namely:
 - Client team development
 - Support for the ALG and APMT throughout the life of the alliance.

5.5 The challenges for alliance contracting

To ensure the consolidation of alliance contracting as a credible procurement strategy a number of emerging issues must be addressed. These include:

- (d) After the project is completed and a significant saving has been made, a client may feel that the agreed TOC was too high, rather than believe that the high performance team created and actually delivered 'breakthroughs'.
- (e) The initial project cost implanted in the client's memory is based in the infamous engineer's or architect's 'planning' study and its attendant estimation quality.
- (f) Loss of corporate memory concerning the 'bad old days' of 'fixed price' or 'lump sum' contracts.
- (g) A formula approach to alliance contracting that can allow just good coaching to deliver the best scoring team.
- (h) Keeping the alliance contract setup and maintenance costs affordable. The key areas here are legal, audit and insurance costs.
- (i) Ensuring the alliance contract is structured to deliver the client's needs and the project outcomes.
- (j) Flushing out the client's real needs and constraints.

- (k) Especially for government clients, the ALG must remain strategic and have effective delegations for its members on the ALG to be effective.

6. CONCLUDING REMARKS

The future of relationship contracting is with owners of projects who need reliable delivery of projects and service contracts; especially those that require outstanding, break-through or innovative results. The delivery of outstanding results will be of particular importance in the future in areas of qualitative performance and goals that have in the past been hard to measure and/or achieve, such as environmental protection/maintenance, community satisfaction etc.

Partnering provides the focus on relationships that is a useful adjunct to a well-constructed traditional contract. The alliance approach adds to this by providing the open-book and co-operative environment needed for accountability in public and semi-public projects. Finally, an alliance allows for corporate body (contractor) and public body (client/owner) images and stereotypes to be replaced with the developing personality of the alliance, aligned with the character and success of the finished project.

The secret of success is to select 'Horses for Courses'.

REFERENCES

- Caine, G., (August 2000) *Ensuring Accountability in your alliance contract – National Museum of Australia experience*, Australian National Audit Office, Canberra.
- Defence Materiel Office (2001) *DMO Alliances-Frequently Asked Questions*, Defence Materiel Office.
- Gallagher, J. Fox, P. and Hutchinson, A., (2001) *Project Alliancing – Some Answers*, JMJ Associates, Department of Infrastructure, Victoria
- Goldstein, D., (March 2002) ON SITE, *Relationship Contracting*, Minter Ellison Lawyers
- Ross, J. (2000) *Introduction to Project Alliancing*, Presentation to Institution of Engineers 17th August Brisbane 2000, Australia.