

Relationship contracting

An adversarial culture, disputes over variations and claims, price blowouts and litigation continue to characterise the building and construction industry in Australia, and significantly affects its performance in terms of profitability, productivity and efficiency. Industry wide concerns have led to demands for alternative approaches to project delivery and dispute resolution, and in particular to the prevention and early resolution of disputes.

A host of delivery structures, including project management, construction management, guaranteed maximum price contracts and partnering have been proposed in an attempt to encourage parties to deliver project work on time and within budget. Partnering has attempted to introduce a co-operative approach. While these structures take different approaches to the allocation of cost, time and risks compared to traditional lump-sum contracting arrangements, none of them is a universal panacea, which will deliver a cooperative environment that is commercially attractive to both parties and which successfully facilitates the prevention and resolution of disputes.

Alliance contracting is one method of project delivery that seeks to promote a non-adversarial, mutually profitable environment for project participants. Recently it has offered a new paradigm for principal/contractor relationships. The underlying rationale of alliance contracting is to use the contract itself to motivate the principal and contractor to work together to achieve a mutually beneficial goal.

This paper will cover the following :

- Overview of alliance contracting
- Key elements of alliance contracts
- Risk and risk management strategy
- Remuneration in alliance contracts
- Dispute resolution in alliance contracts
- Partnering v alliancing
- Alliancing v joint ventures
- Fiduciary duties in alliancing
- Why alliance contracting is not suitable for all contracts

What is Alliance Contracting?

In essence, alliancing is simply a consensual relationship between two or more parties who have mutual interests and goals. The underlying rationale of alliance contracting is that the financial interests of the principal and the contractor are aligned, so that the parties have a financial incentive to co-operate in order to achieve the contractual/alliance goals. Parties to an alliance typically adopt a culture of collaboration, and focus on achieving results and resolving problems with a minimum impact on cost and schedule.

Contact:

David Goldstein
Partner
Tel: 02 9921 4307

The alliance contract which is set up to govern this arrangement typically provides for the risk of the contractor's profit and to an extent overhead, to be based on the results which are achieved, rather than on the tendered profit element, or so much of it that survives the risk inherent in the project. From the Principal's perspective, it will be obliged to remunerate the Contractor to the full extent agreed when pre-ascertained objectives have been met. This means that the rewards flow from joint, rather than individual effort. Unlike more traditional principal-contractor contractual arrangements, the alliance contract establishes the parties as having equal standing, rather than establishing a master-servant relationship.

Typically the parties to an alliance contract will form an alliance team which will be the driver of the Alliance and the forum in which representatives of the parties should work together to deliver the results that the Alliance seeks to achieve.

An appropriate structure and strong management of the alliance team are essential to successful alliance contracting. Typically in larger projects, an alliance board (comprising of high level representatives from the individual contracting parties) will be the key decision-making authority. The alliance team is used as a vehicle for implementing those decisions and the daily management of the project. Often a project director is appointed by the Principal to head up the operations of the alliance team.

In Australia project alliancing has been used in both private and public sector projects. Major private sector projects include:

- 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);
- the Roxby Downs Metal Ore alliance contract for Western Mining Corporation (\$400m);
- the Clough-Unithai Engineering alliance contract with Unocal Thailand (\$250m);
- the Abigroup alliance contract for gas maintenance in Victoria with the Texas Utilities Group (\$300m).

Public sector agencies adopting alliance contracting include :

- 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 were awarded);
- Sydney Water Corporation - awarded an alliance contract for the Northside Storage tunnel project (\$375m);
- Commonwealth Government - is using an alliance contract for the construction of the National Museum of Australia and Institute for Aboriginal and Torres Strait Islander Studies on the Acton Peninsula (\$95m);
- WA Water Corporation - has adopted an alliance process for a new waste water treatment plant at Woodman Point. (\$140m);
- Melbourne Water - awarded an alliance contract to John Holland to upgrade Werribee waste water treatment plant (\$27m);
- The Brisbane City Council - has awarded a \$230 million alliance contract to Leighton Contractors to design, construct and maintain a 4.5km bypass that will connect the existing Southeast Freeway to Kingsford Smith Drive.

Reported outcomes from both public and private sector projects to date have included construction works being on time and cost.

How did Alliancing develop?

An early pioneer of alliance contracting was British Petroleum (BP) in the development of energy reserves in the North Sea in the early 1990=s. BP found that its traditional contracting methods emphasised the lack of trust between parties, and in large risky projects, frequently resulted in budget blowouts and time overruns. BP recognised that such outcomes were preventing it from exploiting its energy reserves profitably, and therefore sought a better system of project management which included the co-operation of the parties involved in bring the project to completion.

BP initially set up two project alliances; the Hyde Project and the Andrew Project. The outcome of each of them was outstanding results in terms of both time and cost, and world wide interest in the concept of alliance contracting.

Key elements of alliance contracts

Alliance contracting demands that project participants:

- form outcome focussed 'alliance' relationships;
- have equal access to information;
- have a common view on project risks;
- have a common view on the strategy for managing the risks;
- be committed to common objectives and outcomes;
- share information, knowledge, and skills;
- develop mutual trust and respect;
- be willing to share risks and rewards;
- use expertise efficiently;
- focus on cost control rather than cost monitoring;
- be committed to a non- adversarial culture.

If the concept of an alliance relationship relies upon '*the contract itself to motivate the Principal and Contractor to work together to achieve a mutually beneficial goal*', the elements referred to above must be documented to be the '*drivers*' of the alliance.

The alliance principal must be driven from the top down. Accordingly, the contract should include an alliance mission statement and a precise articulation of the alliance relationship.

The contract should leave no doubt that the alliance relationship is to be driven by the alliance board and the alliance management team. Each of these bodies should have equal numbers of participants from the Principal and the Contractor, and a Chairperson of each body should be provided for.

The provisions which articulate the alliance relationship strategy and which set up the alliance team and the alliance board should deal with the following elements:

- the resolution of disputes at appropriate levels;
- the use of best endeavours to communicate and promptly and inform the other party of anything likely to affect issues of timing, cost or quality (or any other matter of central importance to the alliance);
- the prompt elevation of differences which cannot be resolved at appropriate levels;
- ultimately, unsolvable differences are to come before the alliance board;
- the use of good faith in conducting the alliance relationship.

An alliance structure will usually provide for the establishment of an alliance team whose responsibilities will include planning, organising, leading, coordinating, and controlling activities, with the intent of providing an efficient plan and structure that provides the platform for achieving the alliance's objectives.

The alliance team should consist of representatives from all sides working together to plan and manage the project. This use of an alliance team provides a way of focussing the parties' energies on managing and implementing the project for the benefit of both parties to enable them to proceed from a position of common ground. The alliance team must be backed by sufficient resources. These resources should include individuals with expertise in various disciplines and the experience relevant to the subject of the Contract, along with a knowledge of the project participants.

The advantages of a strong alliance managed team are illustrated by the actions of the Wandoo Alliance in Western Australia, when in April 1995 the bund wall in the Bunbury Casting Basin failed and the basin flooded. Although the incident caused some disruption to the planned schedule, consistent with the *>no blame=* principle, the parties focused on fixing the problem with the minimum impact on cost and schedule.

By implementing an alliance team the parties are in effect agreeing on the procedures for managing and sharing their accepted risks. It is important that the scope of this body's responsibilities are carefully defined. The alliance team's functions and activities will be the effective *'driver'* of the Alliance.

Some of the functions which are commonly entrusted to the alliance management team are:

- planning the management of the works;
- implementing the execution of the works;
- regular meetings at specified times;
- preparation of operational plans to implement the strategies, goals and objectives set by the alliance board;
- reviewing changes to the scope of the works, the subject of the alliance;
- provision of personnel, plant and equipment necessary for executing the alliance's works;
- if necessary, developing subcontract policies and procedures and the subcontractor, approval procedures;
- management of extension of time claims;
- reviewing quality of work and any remedial measures required;
- reviewing budgets and cost overruns if any;
- reviewing engineering opportunities and cost savings;
- monitoring actual performance against key performance indicators;
- reporting on a regular basis to the alliance board.

The function assigned to the alliance board may include:

- setting strategies, goals and overall objectives for the alliance;
- reviewing the performance by each party of their obligations under the alliance contract;
- reviewing each parties performance against the goals set out in the mission statement;
- reviewing the key performance indicators and whether they continue to be appropriate;
- resolving all disputes which are elevated to it, either by its own internal process or by the use of third parties.

It is important for the alliance board to have the power to engage the assistance of Mediators or appropriate consultants to help with the resolution of any matters that the alliance board may feel that it needs assistance with. This is particularly so when the alliance board is the last point of reference for disputes.

Risk management strategy

Risk management strategies under alliance contracting include establishing processes and procedures much broader than simply transferring risk to a third party via an insurance contract. Once the risks associated with the performance of the contract have been identified, risk control techniques are used to prevent or reduce losses. Risk control options include :

- allocation; and
- management.

Allocation

For each potential risk identified, the Alliance team should decide which party will be allocated the risk. Importantly, risk allocation should be done with the objective of risk control, rather than merely to pass on risk. At a 1979 Conference on Construction Risks and Liability the American Society of Civil Engineers collectively concluded that:

- risks belong with those parties who are best able to evaluate, control, bear the cost, and benefit of assuming the risk;
- many risks and benefits are best shared;
- every risk has an associated and unavoidable cost which must be assumed somewhere in the process.

The underlying rationale for these principles is that if the party who is in the best position to foresee and manage the risk is made responsible for it under the contract, that party will be better equipped and motivated to manage the risk. The party bearing the risk will have a direct interest in managing the risk.

Alternative approaches to risk transfer are risk retention and risk sharing. Risks which are beyond the control of either party should generally be shared. For example in most standard contracts, in the event of a force majeure, the principal bears the delay impact and the contractor bears the impact on cost. Such an approach is viewed as promoting a more positive working relationship between the parties. Principals who have used these approaches have reported reduced total project costs and completion on time.

Once risks have been allocated, the risk bearer will have to finance any losses as they occur. Traditionally this has been through the purchase of insurance.

Management

Risk management is important because it recognises that risk is volatile and requires constant management throughout the life of a contract. Allocation of risk must be supplemented by agreement on the processes and procedures for its collective management. Therefore while the contractual responsibility for a risk may lie with a particular party to the contract, all parties are under a legal obligation to collectively manage it, and to an extent in practice they all share it.

Risk management techniques used to prevent or reduce losses include:

- systems and procedures - these are set in place to prevent or reduce losses, and should include emergency, regularly scheduled meetings to identify and solve problems, and the delegation of authority to appropriate levels so decisions on changes and claims can be made promptly;
- contingencies resourcing - most construction projects will have some changes during construction, for example the principal's needs may change as work is being performed. It is easier and faster to implement changes if the necessary funding is set aside; and
- alternative approaches - for example making provision for taking a different route or finding different ways to achieve an objective.

Having allocated and agreed on the procedures for managing and sharing their accepted risks, the parties must ensure that the written contract properly reflects the chosen allocation. The contract should become the document that clearly identifies the spectrum of potential risks and sets out the procedures to be followed in the project's management.

It should be borne in mind that how risks are allocated among parties to the construction process often has a direct bearing on the total project costs. Traditional contracting arrangements have commonly involved a fixed price contract with many of the risks being borne by the contractor. Such a risk allocation process is often viewed by principals as ensuring that the potential risks are

the sole problem of the contractor. Contractors often view the '*profit potential*' as justifying taking on such considerable risks, or have felt driven by a competitive tender in a tight market to do so. Although in theory these ideas may be appealing, in practice they can lead to contractual misallocation of risk, which in turn may be a major cause of building and construction disputes.

In alliance contracting, the financial consequences of risk are often allocated to the contractor only to the extent that the contractor may either lose an opportunity to gain a bonus or perhaps lose some of its profit. Otherwise risks are usually allocated to the owner. That is, the owner pays the actual cost of the occurrence of contingent events which lead to cost increases.

Remuneration in alliance contracts

As discussed above, traditional methods of construction procurement have been considered synonymous with lump sum or fixed prices. By adopting a pricing structure which often sees the Contractor striving, at the expense of the Principal, to safeguard its profit margin and overhead allowance, irrespective of performance, efficiency and co-operation are minimised, along with the incentive to resolve or minimise problems.

Alliance Contracting will often suit projects where a budget is available for the most efficient use against a scope of work which is flexible. Typically, these Contracts may be for a period of years where assets are being maintained or upgraded, funded by annual budgets.

In an Alliance Contract the contractor usually gets paid:

- costs as incurred;
- an amount for overheads; and
- a fee (subject to adjustment) to cover profit margin.

A guaranteed minimum profit on direct costs and overheads is seen to foster a co-operative, non adversarial relationship. However, the incentive to generate the best project results lies in the concept of profit through performance, thus administering accountability. This is:

- performance based; and
- is set by reference to key performance indicators.

Key performance indicators are pre-determined indicators used to determine whether the alliance has achieved exceptional results. Key performance indicators may include :

- time of delivery;
- quality;
- safety;
- cost control;
- the environment;
- performance;
- industrial relations; and
- community relations.

Remuneration measured by reference to key performance indicators ensures that either some or all of the contractors' remuneration is at risk against the achievement of indicators. Contractors are focussed on project results, as the extent of any reward or loss depends on the project outcome. This means the interests of the principal and contractor are commonly aligned. Importantly such a generic approach to remuneration should be supplemented with very limited grounds for adjustment of payment provisions. As noted by Abrahams and Cullen:

'Grounds for increasing the target cost and granting extensions of time should be quite limited, as the essence of a project alliance should be:

- *co-operation for the mutual benefit of the participants; and*
- *a focus on non-performance, not on reasons for non performance.'*

Under alliance contracts, the objective is for all efforts to go towards ensuring performance rather than justifying non-performance.

In the negotiation of Alliance contracts it is common for a great deal of time and effort to be put into the:

- (a) agreement of rates and elements of reimbursable expenses;
- (b) calculation of overheads. The overheads to be paid to the Contractor which are not subject to adjustment against key performance indicators, must be fully understood and agreed to by the Principal;
- (c) the identification of and calculation of the overhead and profit which is to be paid depending upon the achievement of key performance indicators; and
- (d) selection and description of the key performance indicators.

Dispute resolution in alliance contracts

A recurring theme in the alliance philosophy is co-operation between the parties at all levels, and the agreement on numerous steps to drive and implement the alliance objectives.

As mentioned, disagreements or problems that cannot be resolved are sent first into the alliance team. If they cannot be resolved at that level they are evaluated to the alliance board. There is antidotal evidence that in a properly functioning alliance, there is a reluctance to evaluate issues to the alliance board. To do so, is perceived as evidence of failure.

This operational mindset is a sure indication of the *'health'* of the alliance and that the dispute work of the alliance board might, mercifully, be very light.

In the eyes of a black letter lawyer, an alliance contract may contain numerous *'agreements to agree'*. This is a marked difference to standard construction contracts where, through an administering third party, certainty is introduced at every step of the way by a superintendent or Engineer's instruction or certificate which will be effective unless modified, varied or overturned by the operation of the dispute resolution clause.

The difficulty with numerous agreements to agree is that they may encourage an attack on the validity of the contract on the grounds of a lack of certainty, since agreements to agree are unenforceable. To overcome this difficulty it is important that all failures to agree, are via the contract terms referable to the alliance board for final resolution.

Conditions inherent in the construction industry make it likely that disputes cannot be totally eliminated. In the event that disputes cannot be prevented or defused through the implementation of the alliance culture and performance based remuneration strategies, the aim is to resolve disputes quickly and with a minimum expenditure.

Traditionally arbitration has been the most commonly used method to resolve construction disputes. In recent years arbitration has become associated with :

- significant costs in legal fees and management resources;
- an adversarial fault finding approach which does not promote the continuation of good working relationships; and
- lengthy and inflexible formal procedures which reduce communication between parties and control over the resolution process.

Claims that arbitration has become too much like litigation have lead to calls for alternative methods of dispute resolution.

Ideally, disputes should be resolved contemporaneously with the occurrence of the dispute. On - site decisions allow for the resolution of disputes at the lowest level. In construction contracts which take several months to complete, it is advisable that the disputes be resolved on a regular basis and informally while facts are still fresh. This should avoid an accumulation of unresolved disputes which then become a major obstacle to the settling of final project accounts.

The dispute resolution method chosen should suit the parties= objectives. If parties want to preserve their ongoing relationship, then techniques which focus on finding a solution rather than fault-finding should be used. More recently, informal procedures which guarantee independent and respected facilitation and decision making have become increasingly popular. Alternative dispute resolution (ADR) options include:

- for large contracts - Alliance Boards or Dispute Review Boards (e.g comprising of representatives of parties and an independent ADR expert who can develop innovative solutions for dispute resolution and provide a binding solution in the event representatives are unable to reach agreement).
- for smaller contracts -senior executive review, structured mediation and expert determination are more effective.

If the parties are in the middle of a project, the commencement of litigation or arbitration will involve a fault finding exercise which will damage the working relationship required to complete the project. The above ADR techniques address disputes by focusing on finding a solution. These techniques take only a fraction of the time required by litigation or arbitration to resolve disputes. This short time frame translates into an inexpensive process of dispute resolution. A construction ADR expert should be employed to assist the efficient resolution of the dispute where the dispute is technical in nature.

However success of these techniques depends on the parties' commitment to resolving their disputes and there being no abuse of the ADR procedures. The final outcome of any ADR process is a settlement agreement, which is a contract which can be breached but cannot be enforced as in the case of a court judgement or arbitral award. Breaches of settlement agreements have to be resolved by further litigation and arbitration.

It should be noted that general forms of dispute resolution are predicated on there being a continuing positive relationship between the parties. One of the critical risk areas in an alliance is that if the relationship between the parties totally breaks down, the 'alternative' dispute resolution procedures are often ineffective. If this happens, then the dispute can become very difficult and expensive to resolve.

Partnering versus alliancing

Partnering and alliancing both involve two or more organisations 'forming a team' to achieve common objectives, such as a non adversarial approach minimising disputation and reduced project costs.

A key difference between partnering and alliance contracting is that with partnering the partnering commitments are *outside* the contract. The parties enshrine their mutually agreed objectives to work closely and co-operatively in a partnering charter, signifying their commitment to the success of the project. The partnering charter is usually expressed to be of a non binding nature.

Critics of partnering view this process as simply one where in effect the parties are telling each other they will act reasonably and fairly while expressly disavowing any legal obligation to do so. Because partnering is considered to encompass >a methodology and not a contractual process=, while outwardly embracing the pursuit of shared goals, partnering can be difficult to implement successfully. With its focus on contractual issues of risk allocation and remuneration directly affecting parties' financial interests, alliance contracting is considered an effective means of incorporating concepts of partnering in an integrated, more binding way.

Alliance contracting versus joint ventures

There is no settled legal definition of a joint venture. Broadly speaking, a joint venture is an association of parties for a particular trading, commercial, mining or other undertaking, with a view to mutual profit. In the construction industry, a joint venture association is usually for the participation in a single project rather than for continuing business.

Alliance contracting and joint ventures are similar as they both involve the formation of a *'team'* to complete a particular project for the purposes of mutual commercial gain. As with joint ventures, in alliancing each party shares the profits or losses of the project. However, a key difference between the two relates to the final ownership of the product or output of the project. In a joint venture, both parties will own a share of the product of the joint venture proportional to their share in the joint venture. In alliancing, however, only one party will ultimately own the final product or output of the contract.

Notwithstanding the key differences, it is arguable that the law as it has been applied to the formation and management of joint ventures may also be applicable to alliance contracts and relationships because of the similarities between the two.

Fiduciary duties in alliance contracting?

If the law as it has been applied to joint ventures is applied to alliancing, then a key issue which arises is whether the parties to that alliance owe fiduciary duties to each other. Broadly, fiduciary duties are duties of good faith, such as the duty to avoid conflicts of interest.

Traditionally the courts have been reluctant to impose fiduciary duties on parties to contracts. This is particularly the case where the parties to a contract are acting at arm's length, and are acting in their own interests and not in the interests of another party. Also, the importance of freedom of contract, that is, allowing parties to define and limit their obligations by contract, has tended to outweigh the desirability of setting standards of commercial morality on contracting parties through the imposition of fiduciary duties.

However this is not to say that a contractual and fiduciary relationship cannot co-exist. Fiduciary relationships have been imposed to regulate contractual relationships in *'reliance'* relationships that arise in situations such as joint ventures. Fiduciary duties arise are said to arise in these instances because one party relies on the other for advice and there is a reasonable expectation that the other party will act in his or her interests and not have a contrary interest. The scope of these duties is then governed by the agreement made by the parties.

By analogy, whether or not the parties to an alliance would owe any fiduciary duties to each other would depend on the pre-contractual representations and negotiations as well as the terms of the agreement. If it is the case that fiduciary duties will attach to the parties to an alliance, then the practical importance of this arises when these duties are breached. If a party breaches a fiduciary duty, then the aggrieved party would be able to seek equitable relief in the form of restitution. However if no fiduciary duties are owed, then the normal remedy of compensation (damages) would be available for what would simply be a breach of contract.

The issue of whether fiduciary duties exist in alliance contracting is something which has not arisen much in practice, and accordingly there is little guidance on the subject. Nevertheless, when negotiating and setting up the alliance contract, parties should bear in mind that they may owe each other fiduciary duties.

A strategy not suitable for all contracts

Alliance contracting will not work for all projects. It is important that contracting parties give careful consideration to the sort of projects that would be suitable for an alliance.

Alliance contracting generally works well:

- where the project is complex involving numerous contractors, equipment vendors, and technology suppliers-i.e. multiple interfaces.
- when the project has a budget which may necessitate additions or deletions that would not be economic or efficient in a lump sum tendered situation;
- where the project warrants continuing review and/or refinement because of its magnitude, complexity or prestige;
- where the principal=s requirements are not adequately defined or may be redefined during the design/construction process;
- where the funding allocation for the project requires the principal=s detailed involvement in the management of the cash flows or the stage by stage approval of the project;
- where unacceptable risk would be placed upon a single contractor;
- where there are complex staging requirements such as the maintenance of user operations during construction;
- where there is a possibility of disruption during construction which it would be unreasonable to expect the contractor to bear;

Alliancing usually will not be appropriate where :

- the clients, consultants and contractors cannot work as a team;
- the project is a relatively small size, such that the costs of setting up an alliance are out of proportion to the cost of the work. This is because time and significant resources are required to plan and implement an alliance;
- the project is not complex, that is the project is straightforward and fully designed.

Conclusion

Alliance contracting experiences have shown that significant resources are required to plan and implement an alliance. Considerable care needs to be taken to involve the customer agencies throughout the project and much time should be spent creating awareness of the alliance concept. All parties must understand that alliances require significant effort and that time must also be allowed for relationships to develop.

If both parties are committed to working together and sharing the risk, the benefits for both parties in adopting an alliance system of contracting will outweigh the perceived gains to one party in traditional methods of contracting. The challenge in alliance contracting is getting the alliance members to work as a team and to leave corporate identities and egos at the gate.

The challenge and opportunity for lawyers is to keep pace with practices that result in successful alliance contracting and to contribute to by combining an understanding of the construction industry with a lawyer's understanding of contractual process.