

CLAYTON UTZ

Alliancing

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Alliance Contracting

By Owen Hayford, Partner, Clayton Utz¹

1. Introduction

Alliance contracting initially developed as a result of dissatisfaction with the adversarial nature of traditional contracting strategies and a desire to achieve better than 'business as usual' outcomes. In recent years, as a result of the difficult Australian construction contracting environment, it has become increasingly relevant.

For the last few years, the Australian engineering construction market has been (and continues to be) characterised by:

- demand for construction and engineering services vastly outstripping supply - there is no shortage of work and contractors can choose their clients and projects;
- major shortages of skilled labour and building materials; and
- dramatic increases in the cost of labour and materials, and as a consequence, construction costs.

These market forces have made it extremely difficult for contractors to predict with any real degree of certainty construction costs for major projects. This uncertainty has been reflected in the tender pricing submitted by contractors for lump sum fixed price construction contracts, as contractors either decline to submit tenders for such contracts or seek to ensure that their pricing includes adequate contingencies for the risks which they are being asked to bear.

The result has been significantly higher tender prices (or sometimes no tenders at all), forcing some owners to reconsider their positions on risk allocation, and look at alternative and more sophisticated contract delivery models in order to reduce the cost of delivering their projects.

One of these new delivery models which has received particular attention and been widely utilised throughout Australia is alliance contracting. Alliances have been used by a variety of owners in both the public and private sectors for a diverse range of projects. It has been a particularly popular delivery model in Queensland. High-profile alliances include the Tugan Bypass alliance, the Northside Storage Tunnel alliance, the National Museum of Australia alliance and the Collins-Class Submarine Through-Life Support alliance as well as the Australian Rail Track Corporation alliances which are discussed later in this paper.

This paper, after briefly outlining some of the other forms of 'relationship contracting' that may be used as an alternative to the traditional construction contract, focuses primarily on the key features of the alliance contracting model and the commercial and legal considerations that arise from them. It examines the potential advantages that the alliance contracting model offers and the risks that parties to an alliance contract must contemplate. It also considers and explains the differences between pure and hybrid alliances, and between project and strategic alliances. A case study is included to provide a practical example of some of the features and forms of alliance contracting.

¹ The author gratefully acknowledges the contributions of Doug Jones AM and Stuart Connor to this paper.

2. The relationship contracting toolbox

The focus of this paper is alliance contracting, but alliances are only one contractual model in what might be termed the 'relationship contracting toolbox'. The expression 'relationship contracting' embraces a wide and flexible range of approaches to managing the owner-contractor relationship, all of which seek to emphasise points of convergence between the respective interests of owners and contractors. Alliance contracts are one form of relationship contracting, and have developed out of another, earlier, form known as partnering.

Whilst the term 'partnering' has been used in a variety of ways, in the Australian context it best describes the situation where the parties to a traditional construction contract set out in a separate document various guidelines as to how they will conduct themselves. The objectives of partnering are to create an environment where trust and teamwork prevent disputes, to foster a co-operative bond to everyone's benefit, and to facilitate the completion of a successful project.

The partnering process usually commences with a workshop at which the parties seek to identify common goals, establish communication channels, and discuss procedures for handling and avoiding disputes prior to commencement of the contract.

At the conclusion of the workshop, the parties generally sign a partnering charter which 'sits behind' the standard construction contract, and details the mission and common objectives of the parties and demonstrates the commitment of the key people involved. The partnering charter typically states that it has no legal force. It is the non-binding nature of the partnering charter, and the fact that generally no attempt is made to alter the way in which the underlying contract deals with the fundamental issues of risk allocation and remuneration so as to bring it into alignment with the partnering charter, that distinguishes a partnering arrangement from a project alliance.

Another frequently-used form in the relationship contracting toolbox is the managing contractor model. In this model, the owner appoints a managing contractor who is required to subcontract out the majority of the work and manage the overall delivery of the project. Contracts of this type take a different approach to risk allocation than that of the traditional 'design and construct' contract. Most significantly, the managing contractor is generally reimbursed for amounts paid to subcontractors, and paid lump sums for the management and other services which it provides. The approach in relation to quality and time risk varies. Sometimes the managing contractor will only provide a 'reasonable endeavours' obligation in relation to timely completion and the quality of the works performed by subcontractors. In these cases the owner would usually have a direct contractual relationship with the subcontractors, who would give absolute commitments in relation to timely completion and quality. On other occasions, the managing contractor may accept full liability in relation to late completion and/or the quality of the works. Cost savings and/or overruns may also be shared. There is considerable scope for flexibility in risk allocation under this model.

As well as these broad categories, owners with specific needs have developed their own tailored forms of relationship contracting. One notable example of this is the Commonwealth Department of Defence's Comprehensive Maintenance Contract (CMC). As with the managing contractor model, under the Defence CMC the contractor's role is to engage and supervise the work of subcontractors and the contractor is generally reimbursed on a cost plus basis. Additionally, to encourage the contractor to pursue cost savings over the life of the contract, the Defence CMC contains provisions to the effect that the contractor warrants to pursue such savings, and that where cost savings do result from suggestions by the contractor to the Commonwealth the contractor is entitled to the benefit of half of the savings achieved.

In a sense, the project alliance model which has evolved in Australia over the last decade or so years encapsulates many of the concepts developed in the context of partnering and other

relationship contracting arrangements but takes some extra and somewhat radical steps, discussed below.

3. Project Alliances

3.1 Core features of 'pure' alliance contracts

Alliance contracts are typically described as either pure alliances or hybrid alliances. With a **pure alliance** contract, there are 3 core features which differentiate it from traditional contracting strategies:

- The first, and most fundamental, is the *remuneration regime*. Alliance contracts fundamentally alter the remuneration arrangements and risk allocation found in traditional construction contracts, by replacing the lump sum price with a performance based remuneration regime which seeks to closely align the commercial interests of the parties.
- The second core feature is the *no blame, no disputes* clause, under which each party agrees that it will have no right to bring any legal claims against any of the other participants in the alliance, except in the very limited circumstance of a wilful or deliberate default by another alliance participant.
- The third core feature is the requirement for most, if not all, decisions regarding the project to be made by way of *unanimous agreement* between the owner and all of the other alliance participants.

However, not all alliances fully embrace these core features of the pure alliance model.

For example, there are many alliances which do not fully embrace the no blame concept, or which allow decisions to be made other than by way of unanimous agreement, for reasons which are discussed below. These 'impure' alliances have come to be referred to as **hybrid alliances**.

It is important to recognise, however, that these hybrid alliances, whilst different to and departing from the pure alliance model, are no less valid than a pure alliance model. They simply reflect the fact that there is no 'one size fits all' when it comes to contracting strategies.

What is important is that the parties understand the nature and the limitations of the particular contracting model that they are adopting. For instance, if an owner wishes to adopt a hybrid alliance model under which the contractor assumes sole responsibility for particular risks and is held legally accountable for its work, the owner should not expect the same level of innovation and resultant cost savings as might be achievable under a pure alliance model, where the other alliance participants are free to pursue innovative ideas without fear of being sued if things go wrong.

3.2 Radical new approach to remuneration and risk allocation

Remuneration is a fundamental part of any contract, so it is surprising that it receives very little attention in most discussions on alliance contracting.

In a traditional construction contract the contractor's remuneration is on a lump sum fixed price basis, subject to increases (or decreases) for events detailed in the contract. The effect of this traditional approach is to set the interests of the owner and the contractor in fundamental opposition to each other.

The contractor's interest, having agreed a lump sum price, is to minimise costs, often at the expense of project performance, in order to maximise profit. This is in direct conflict with the owner's interest which, having agreed a lump sum price, is to secure maximum project performance even if this is at the expense of the contractor's profit margin.

In this framework disputes and dissatisfaction are almost inevitable.

The project alliance model discards the traditional lump sum price method of remunerating the contractor in favour of a radical new performance based remuneration regime.

Under the typical project alliance model, the contractor's remuneration essentially comprises three discrete components:

- **limb 1 - direct costs:** the reimbursement of the contractor's project costs on a 100% open book basis;
- **limb 2 - fee:** a fee to cover normal profit and (non-project specific) corporate overheads; and
- **limb 3 - gainshare regime:** a gainshare/painshare regime where the rewards of outstanding performance and the pain of poor performance are shared equitably among the owner and the other alliance participants.

The compensation under limbs 2 and 3 relates to the concept of the target outturn cost ("TOC"), which is the estimate of the cost of carrying out the alliance works to completion, and achieving the minimum outcomes in the major project objectives that the owner requires. It includes a contingency for construction risks that may arise and often includes the owner's own costs in participating in the alliance.

The TOC is the end product of the initial phase of the alliance works, during which the participants firm up the scope of works. There is usually some level of negotiation of the TOC and scope adjustment, and often an independent validation that the TOC represents value for money.

Now we consider each of the three limbs in more detail.

- **Limb 1 - Direct Costs**

Direct costs are all specific costs and expenses directly incurred by the non owner participants ("NOPs") in performing the alliance works, excluding profit and overheads. The owner pays the NOPs 100% of these costs, regardless of whether they exceed the TOC.

There are usually a number of agreed principles for the calculation of these including the demarcation between what are direct costs, and what are corporate overheads and the business as usual treatment of a number of specific costs, such as wages and salaries and plant hire. For consultants, there is often an agreed multiplier which is applied to the salaries of fee earners to determine the consultant's direct costs.

- **Limb 2 - Fee**

Before the alliance contract is signed, perhaps the most significant issue for commercial alignment is the percentage fee the NOPs will be entitled to. The fee is intended to cover the profit margin and contribution to overheads which the NOPs would expect to derive for 'business as usual' performance.

Currently in the alliance market, the fee may either be calculated on a fixed or variable basis. For constructors, the fixed model is used, which is the multiplication of the pre-agreed percentage by that part of the TOC which is attributable to the constructor's work. This avoids the situation where a constructor can earn a greater fee by incurring more direct costs. For designers, the fee is often calculated on the variable model, by applying agreed percentage to the actual direct costs which the designer incurs. This avoids the designer being reluctant to take on additional scope after the TOC is set because it will not receive an equivalent increase in fee.

- **Limb 3 - Gainshare/Painshare**

The object of the gainshare/painshare regime is, as the name suggests, to share with the NOPs the benefits or disbenefits derived by the owner from excellent or poor performance by the alliance as a whole and, by so doing, align the commercial objectives of the NOPs with those of the owner.

It does this by setting out gainshare entitlements or painshare liabilities of the NOPs by reference to the performance of the alliance as a whole against the project objectives. The project objectives almost always include time and cost, and usually include a range of other non-time or cost key result areas ("**KRAs**") such as community and stakeholder management, traffic management, safety, environment, quality and whole of life costs. These are commonly referred to as performance KRAs.

Gainshare for the cost objective is usually the simplest with the NOPs sharing a proportion (usually 50%) of cost overruns or underruns against the TOC. Variations on this include varying the percentage for early cost underruns (to minimise the opportunity for the NOPs to make windfall gains by picking low lying fruit) or setting aside part of the cost overruns as a top-up to the pool available for gainshare for successful outcomes in time and performance KRAs.

Time is usually dealt with on a project specific basis as there is often significantly different value outcomes for early or late completion on different projects. For example if an asset is needed to link into an existing network and cannot be used before a particular date there may be little value in early completion, but significant loss in late completion.

Outcomes in the performance KRAs are often more difficult to measure. Often a points system is devised to measure the alliance's performance against these KRAs. There may be clear objective project outcomes that can be measured by the alliance (such as road ride quality, in the case of a road project) or outcomes may be more subjective such as community satisfaction with the project, which can often be measured by survey.

Importantly, the total amount payable by NOPs as painshare is capped at the NOPs fee entitlement. This way, each NOP effectively puts 'at risk' its profit and contribution to overheads, but not its direct costs. Components of painshare are often capped at lower amounts than the overall cap, although cost overrun painshare is usually capped at the full amount of the fee. TOC gainshare is self-funded in that it is simply a share of cost underruns. The pool available for distribution of schedule and performance gainshare is made up of a seed amount provided by the owner, sometimes topped up by a proportion of cost underruns.

Sharing of risks

At first sight, the requirement for the owner to pay all the costs incurred by the NOPs - regardless of whether the project comes in over or under the TOC - might seem to suggest the

owner solely bears the risk of increased or unforeseen costs. However, the risk is in fact shared between the owner and the NOPS as any cost overruns will cause the actual outturn cost to exceed the TOC, thereby reducing the gainshare payment or increasing the painshare liability, and hence reducing the profit derived by the NOPS.

Potential cost savings for owners

Project alliances are often said to deliver projects at a lower cost than would have been possible under a traditional lump sum construction contract. How is this possible? It is suggested that the possible cost savings are attributable to the following features of project alliances:

- Firstly, the lump sum price under a traditional construction contract will typically include an amount to cover costs which the contractor may incur if risks which it bears under the contract eventuate (commonly referred to as the 'contingency'). Under a lump sum contract, the owner pays this contingency amount, regardless of whether or not the risks which it is intended to cover materialise. Under an alliance contract, the NOPS are always reimbursed their direct costs, so there is no need to charge the owner a contingency on account of the risk of incurring unexpected direct costs. Although the TOC will typically include a contingency for unexpected direct costs, the owner only pays these direct costs if the risk eventuates and the costs are incurred.
- Secondly, there is a potential for a reduction in the direct costs due to the *no blame, no disputes* clause. This clause is discussed in more detail at section 3.3 below, but essentially the no blame, no dispute clause allows the participants to innovate and take risks in the pursuit of cost savings and enhanced project performance without fear of legal claims if they fail. This no blame culture, coupled with each NOP's entitlement to share cost savings under the gainshare regime, should result in increased innovation and resultant cost savings which would simply not be achievable in a traditional, adversarial contracting environment.
- Thirdly, the collective sharing of (nearly) all project risks, together with the no blame regime, creates an environment which facilitates good risk management practices. Everyone can talk openly without the need to protect their respective legal positions. In this environment, risks are more likely to be identified, and appropriate strategies put in place to mitigate and manage them. As a consequence, the financial impact of risks which do eventuate are likely to be less. This may (or may not) result in a lower outturn cost for the owner depending on whether such risks would have been allocated to the contractor under a traditional construction contract, the additional payments the owner would have been required to make to the contractor under a traditional construction contract as a result of the risk (or the additional internal costs the owner would incur in defending claims arising from the risk) and the contingency amount which the contractor would have included in its lump sum price on account of the risk.
- Fourthly, the owner's internal contract administration expenses may be less on account of the non-adversarial nature of the relationship which reduces the resources required for managing and defending claims and disputes. However, alliance contracts typically involve higher tender and contract establishment expenses, which may outweigh these cost savings.
- Fifthly, if there are variations to the scope of the project (particularly variations which would not justify an adjustment to TOC or performance targets - see section 3.5) the cost of such variations is likely to be less under a project alliance than under a traditional construction contract.

- Finally, because the liability of the NOPs to the owner is capped at loss of its fee, the owner may consider that the fee should be set at a level lower than amount of profit and contribution to overhead which the contractor would expect to receive under a traditional lump sum contract where the risks borne by the contractor are much greater.

No guarantee of a lower project cost

Although there is potential for the owner to derive cost savings, there is no guarantee that the adoption of a project alliance will result in the delivery of the project at a lower cost than would have been achievable under a traditional lump sum contract. Indeed, given that the owner is obliged to pay all of the direct costs incurred by the NOPs, the owner's cost exposure is potentially unlimited (subject to its right to terminate the contract). It is for this reason that the adoption of a project alliance by the owner can be said to require a 'leap of faith' on the part of the owner that the potential efficiencies available under a project alliance structure will be realised and result in a lower outturn cost or better project performance.

Owner pays for mistakes of NOPs

Compounding the above issue is the fact that under a project alliance, the owner is obliged to pay the costs incurred by the NOPs in redoing work which they fail to do properly the first time. Whilst such additional costs will be at the expense of each NOP's fee and gainshare entitlement, the direct costs of the NOPs are guaranteed. This is a feature of the pure alliance model which some owners have found to be a difficult pill to swallow and which has caused them to explore some of the variations to the no blame regime discussed below.

Need for care in structuring gainshare/painshare regime

In structuring the gainshare/painshare regime, it is important to try to avoid a situation in which poor performance against any single KRA will wipe out the entire fee; otherwise, having fallen behind in one area, the NOPs may have no financial motivation to achieve any of the owner's other project objectives. Of course, even in these circumstances the NOPs would not be free to 'walk away' from the project, as to do so would be a wilful default (discussed below) to which liability would attach.

3.3 No blame, no disputes - but consider the ramifications

Under the *no blame, no disputes* clause found in the pure alliance model, each alliance participant agrees that it will have no legal claims against any of the other alliance participants, except in the case of narrowly defined *wilful default*.

The purpose of this clause is to encourage the alliance participants to come out of their comfort zone, to take risks, and to accept stretch targets in the pursuit of extraordinary results, without fear of legal claims if they fail.

However, the ramifications when things go wrong can be far reaching.

No blame may mean no claim and no remedy

For example, because the entitlement of each NOP to its fee and potential gainshare payment depends on the performance of the other alliance participants, if any one of them fails to perform adequately then all of them will suffer - but none of them will have any claims against the non-performing participant.

Furthermore, the inclusion of this clause also means that the owner will have no remedy against the other alliance participants for losses suffered by it as a result of the negligence, or inefficient or defective work practices, of the other alliance participants.

Whilst the no blame, no disputes clause applies to both the owner and the NOPs, it generally involves a greater concession on the part of the owner given that on many alliances it is the NOPs that carry out most of the work, with the owner's main obligation being that of payment (a breach of which is usually defined to constitute a wilful default).

Difficulties with traditional insurance policies

Issues may also arise under typical insurance policies as a result of the no blame, no disputes regime. Consider the example of standard material damage policies: typically when an insurer pays a claim, it has a right of subrogation such that it can step into the shoes of the insured party and seek recovery of that part of the claim that came about as a result of the negligence of another alliance participant. However, because of the no blame, no disputes clause, in a pure alliance contract a participant that suffers loss will have little or no legal recourse against the participant causing that loss. There is one school of thought that the result may be that the insurer is entitled to reduce the claim payment to the insured alliance participant to the extent that the insurer has lost its expected right of recourse against the negligent participant. However, this can be readily overcome by requiring the insurer to confirm that the material damage policy will respond notwithstanding the no blame regime.

The no blame, no disputes clause can also give rise to problems in relation to design insurance (and other forms of professional indemnity insurance). This is because most insurances available to designers are liability-based insurances under which the insurer will not pay unless the designer is *liable*. Under a no blame, no dispute clause the designer (like all participants) will only be liable for wilful default, which most design insurances specifically refuse to cover. As a consequence, it may be that even though loss is suffered by the alliance participants as a result of a design defect, there is no 'trigger' for a claim against the design insurance policy.²

Accordingly, if the owner is to have any comfort in this area, it will require some tailored form of insurance. Indeed, new insurance products specifically designed to respond to the unique structure of an alliance contract, and the nature of the relationship between the alliance participants, are emerging in the Australian market. However, these tailored policies tend to be (comparatively) expensive; the exact cost will of course depend on size and complexity of the project, together with the insurer's assessment of the allocation of risk.

Alliancing without a no blame, no disputes clause

Given these ramifications, some owners have adopted alliance structures without the no blame, no disputes clause, or with a no blame, no dispute clause providing for broader exceptions than those allowed for under the definition of wilful default.³

Some will argue that the no blame, no disputes concept is an essential ingredient of the project alliancing approach. Certainly, if the owner wants to achieve a high level of innovation from the NOPs (which necessarily involves risk taking), then the inclusion of a no blame, no disputes clause will assist in achieving this objective. However, there does not seem to be any reason why some of the benefits of the pure alliance model, such as the ability of a carefully structured gainshare/painshare regime to align commercial interests and drive desired behaviour, cannot be obtained (at least in part) without such a clause.

² Note, however, that this concern only arises in terms of the operation of the insurance as between the participants. As discussed below, a no disputes regime does not prevent liability arising to third parties. Therefore the trigger of legal liability remains appropriate in respect of losses incurred as a result of damage caused to third parties by the professional negligence of alliance participants.

³ Examples of alliances that do not feature such a clause include the Australian Rail Track Corporation alliances which are discussed later in this paper

Limits of the no blame, no disputes clause

Even if a no blame, no disputes clause regime is incorporated into the alliance structure, it will not have the effect of preventing any and all liability from being incurred by the alliance participants.

Most obviously, the no blame, no disputes clause only has effect between the alliance participants, and cannot limit any rights which third parties might have to bring a claim against one or more alliance participants arising out of the conduct of an alliance participant. As with any contract, an alliance contract will only bind the parties to it. However, many pure alliances provide that uninsured liabilities to third parties will be treated as direct costs which the owner must reimburse.

Even as between the alliance participants, there are some matters for which it is not legally possible to exclude or limit liability. An example of this is liability which an alliance participant might incur to another alliance participant under section 52 of the *Trade Practices Act 1974* (Cth), which prohibits corporations from engaging in misleading or deceptive conduct. Liability under section 52 cannot be excluded or limited by contract. Nor could one alliance participant enforce a promise by another participant to waive any rights to commence proceedings arising out of a contravention of section 52.

3.4 Issue resolution and the requirement for unanimity

Another unique feature of the pure alliance model is the establishment of joint decision making bodies, such as an *alliance board* comprising representatives of the owner and each NOP, and the requirement that all decisions be made by these bodies by unanimous agreement.

The alliance board is analogous to a board of directors and fulfils a high-level management and decision making function. Important decisions concerning the alliance, such as whether adjustments should be made to the remuneration regime following a major change to the scope of the works, are referred to the alliance board for resolution. The alliance board is also required to consider and resolve any differences of opinion which cannot be resolved within the integrated project team.

Whilst the establishment of such a body is not unique to project alliances, the requirement for all decisions of the alliance board to be made by unanimous agreement is. The requirement for unanimity means that each participant has a right of veto, and if unanimous agreement cannot be reached, no decision is made. The pure alliance model does not include a deadlock breaking mechanism.

This arrangement is considered by many to be crucial to the success of the alliance approach. They argue that the need to achieve unanimity to proceed (and the absence of a deadlock breaking mechanism) forces the parties towards mutually acceptable solutions. The requirement for unanimity coupled with the *no blame, no disputes* clause takes away the options of "I'll do it your way, but I'll claim it" or, "You'll do it my way, and if you don't like it, claim it".

On a practical level this may be correct. However it is in the interests of all parties that an alliance contract be a legally enforceable agreement. Contractors in particular have a lot to lose if the alliance contract is held to be unenforceable as they would lose the benefit of the no blame clause. An inability to resolve a dispute which cannot be resolved within the alliance can bring uncertainty to the ongoing legal basis of the alliance. A court will not enforce an agreement to agree. Accordingly, if an alliance contract is dependent upon the alliance board reaching unanimous agreement in relation to a matter which needs to be resolved in order for the alliance to continue, then the parties run the real risk that the agreement will be legally unenforceable in the event unanimity cannot be achieved. This risk can be minimised by

including a deadlock breaking mechanism to provide a course of action if unanimous agreement cannot be reached.

The alternative view to those who argue that a deadlock breaking mechanism is contrary to the spirit of alliancing, is that having such a mechanism which is only to be used as a tool of last resort increases the incentive for the alliance board to come to unanimous agreement. This is because it would be a matter of professional embarrassment for the individual members of the alliance board if they had to resort to that mechanism.

The absence of an ability to quickly resolve deadlocks at the alliance board level can also result in significant delays to the progress of the project, although this will have commercial ramifications for the NOPs where a schedule KRA is included in the gainshare regime.

Some owners have also made the observation that the requirement for unanimity has resulted in a loss of ownership and control over the project.

It is for these reasons that some alliance contracts incorporate variations to the pure alliance model involving:

- in some cases, the ability to resort to a deadlock breaking mechanism outside the alliance to resolve those deadlocks which can't be resolved within the alliance; and
- in other cases, the owner reserving the power to unilaterally make certain types of decisions, but on the basis that the 'knock-on' effect of the decision on, say, the remuneration regime will be determined by the normal decision making process.

One of the deadlock breaking mechanism that some alliances have adopted is the so called *swing-man* dispute resolution process. Under this process, deadlocks that cannot be resolved unanimously by the alliance board are referred to an independent third party, and each alliance participant submits to the third party its position as to how the deadlock should be resolved.

The independent third party must then choose which of the competing positions it prefers, having regard to the terms of the alliance agreement. The independent third party is only entitled to choose between the competing positions submitted to it by the alliance participants, and is not entitled to impose its own solution on the parties. The position chosen by the third party is treated as final and binding on the participants.

The theory behind this form of deadlock breaking mechanism is that the parties will be discouraged from putting extreme positions to the independent third party, for fear that the third party will prefer the position of the other party, and that this will assist in achieving a resolution which all participants can live with, minimising any ongoing damage to the alliance relationship.

3.5 Scope changes

In a pure alliance, the risk of the vicissitudes of the project which arise are to be shared by the participants. This means that a number of situations that would be treated as variations under a traditional contract are not cause for amending the remuneration regime under an alliance. If costs increase, or time blows out, the NOPs are paid their additional direct costs, but painshare and gainshare are adjusted under the gainshare regime. This includes alterations to the alliance works to deal with such vicissitudes.

However the owner retains the ability to require significant changes to the scope of the alliance works, and if the alliance board unanimously considers that this has occurred, the remuneration regime (including the TOC) is adjusted. Typically, all modifications to the remuneration regime are to be determined by unanimous decision of the alliance board.

The line between what is a "significant change to the scope of the alliance works" and what is a vicissitude of the project can be a fine distinction, and often the alliance participants workshop possible examples in scope change benchmarking workshops during the selection process or when the TOC and other performance targets are being established.

3.6 Termination

The pure project alliance model usually gives the owner the right to terminate the agreement for convenience (that is, without cause), subject to the owner reimbursing the NOPs for all direct costs incurred by them prior to and as a consequence of the termination, together with a portion of the fee and gainshare/painshare payment based on the proportion of the works completed at the time of termination.

Also, if a NOP commits a wilful default or becomes insolvent, then the remaining alliance participants acting together will typically have the ability to suspend any further payments to the defaulting NOP until the default is remedied, and/or to exclude the defaulting NOP from any further participation in the alliance and engage a third party to replace the defaulting NOP.

This right of exclusion for wilful default or insolvency is considered important given that non-performance by any one alliance participant will affect the gainshare/painshare payment, and hence the rewards, available to others.

Consistent with the no blame, no disputes concept found in pure alliances, the owner does not usually have the right to exclude a NOP from further participation for a breach which does not constitute a wilful default. However, as mentioned above, some owners are adopting alliance structures which do not incorporate the standard no blame, no disputes concept. In these cases, owners may also consider it appropriate to include in the contract a right to terminate for serious breaches falling short of a wilful default, with the defaulting participant forfeiting its entitlement to any fee or gainshare payment.

3.7 Demonstrating value for money

Selection process based on 'non-price' criteria

The selection process which owners will adopt for a project alliance is quite different to that used for a traditional construction contract. In particular, owners typically select the other alliance participants based on *non-price* criteria, such as expertise of proposed team, ability to work within an alliance framework, ability to work with other alliance participants, ability to achieve project objectives, preliminary ideas on innovation and strategies to deliver exceptional results. Price, i.e. the expected outturn cost, is often not considered until after the preferred tenderer has been selected.

Establishing value for money

Establishing value for money is a challenge for both public and private sector owners even under traditional delivery models with price competition during the tender process. The tendered 'contract price' is rarely the sole indicator of value. Other factors which may affect the value for money proposition of a tender include:

- risks to be borne by owner (which if they materialise will affect the final outturn cost);
- expected quality and asset performance outcomes;
- expected whole-of-life costs;
- other benefits associated with the tender; and

- certainty of promised outcomes.

Accordingly, even with tenders for a traditional fixed price construction contract, the tender with the lowest tendered price will not necessarily be the tender which offers the best value for money.

The challenges associated with establishing value for money are exacerbated with an alliance contract where:

- the preferred tenderer is selected solely on non-price criteria (with the exception of the limb 2 fee); and
- the TOC, and other performance targets which will ultimately influence the final "price" paid to the NOPs are not determined until after the preferred tenderer has been selected.

Demonstrating the veracity of the TOC and other performance targets is central to establishing value for money on an alliance contract, given these are the factors which ultimately determine the profit and contribution to overheads derived by the NOPs. There have been some alliance projects which have been delivered for less than the TOC, or which have met or exceeded other performance targets, where it has been suggested this is due to the TOC and other performance targets being 'soft' because they were established in an uncompetitive environment, rather than due to better than usual performance by the alliance.

The level of the limb 2 fee is also central to establishing value for money on a project alliance.

Steps which can be taken to assist in demonstrating value for money where the TOC and other performance targets are set after the preferred tenderer is selected include⁴:

- the owner preparing a rigorous cost estimate for the project before deciding to proceed with an alliance;
- requiring tenderers to bid their limb 2 fee, or the percentages and methodology for establishing it, and locking this in prior to selection of the preferred tenderer;
- alternatively, requiring tenderers to provide their expectation for the limb 2 fee, evaluating this separately to the non-price criteria, but reserving the right to vary this fee during the commercial alignment process in light of the financial audit;
- engaging a financial auditor to audit the financial and cost accounts of each proposed NOP to establish a clear basis for the limb 1 reimbursement and the limb 2 fee;
- asking tenderers to critique the owner's cost estimate;
- asking tenderers to provide their proposed subcontracting and procurement strategy and explain how they will achieve best value for money outcomes for the alliance from subcontractors and suppliers. The alliance contract should require the alliance to comply with the agreed subcontracting and procurement strategy;
- conducting scope change benchmarking workshops with shortlisted tenderers, prior to the selection of the preferred tenderer, to ensure reasonable alignment of

⁴ See Victorian Department of Treasury and Finance *Project Alliancing Practitioners' Guide*, (April 2006) section 5 for more details.

understanding on what will and won't constitute a scope change justifying an adjustment to the TOC and other performance targets. This understanding should be recorded in 'interim scope change benchmarking guidelines', which should be validated with the preferred tenderer before the owner decides to proceed with the project.

- engaging an independent estimator to confirm that the TOC is a fair and reasonable estimate of the outturn cost;
- utilising a budget KRA, whereby a share of any underruns in the approved TOC against the owner's cost estimate is added to the pool to be paid for excellent performance in other KRAs.
- benchmarking the TOC to similar projects;
- reconciling the TOC with the owner's cost estimate;
- preparing a report which explains why the agreed KRA/KPI targets represent value for money, and having this independently verified;
- engaging a financial auditor to confirm that all payments made to the NOPs are in accordance with the terms of the alliance contract;
- preparing detailed value for money reports during the project delivery phase and following completion which reconcile the actual outturn cost (AOC) with the TOC and the owner's costs estimate.

Competitive bid processes for establishing TOCs?

Some owners have also sought to address the value for money concern by:

- deferring the selection of the successful participants until after the TOC has been developed and bid by the competing teams; and
- factoring the TOCs bid by each team into the evaluation process.

There is, however, some debate within the industry as to the potential downsides of this approach and whether it has the potential to undermine the very foundation of a successful alliance. If an owner imposes a competitive bid process with regard to the TOC, some NOPs may be tempted to underbid the TOC in order to win the job, knowing that the most they will lose is their fee. Gaming of this nature undermines the trust needed for a successful alliance.

As the owner will typically fund the development of each TOC, the competitive TOC process adds to the owner's project costs, although these costs may be offset by the reduced need for independent auditing of the TOC and increased (competition driven) innovation during the TOC development process.

Also, even with a competitive alliance process, the TOC is likely to be adjusted in a non-competitive environment before the alliance agreement is signed. This is because in working up the TOC, each competing tenderer is likely to develop innovative, but different solutions. The owner is likely to want to take advantage of at least some of the innovative solutions devised by the losing tenderer, which necessarily means a change to the scope of the winning tenderer, and hence its TOC. To the extent this change is significant - and where the project is such that real innovation is available it may well be significant - arguably this undermines the competitive nature of the TOC.

Establishing value for money of alliance model

Of course, even if the veracity of the TOC and performance benchmarks, and the value for money of limb 2 fee, can be established, this does not necessarily mean that the delivery of the project as a project alliance will necessarily result in a better value for money outcome than would have been achieved had the project been delivered under a traditional construction contract or some other project delivery model. Indeed, short of delivering an identical project in identical conditions under the alternative delivery model, it may never be possible to demonstrate with absolute certainty that the adoption of a project alliance has delivered the best value for money outcome possible.

That said, if:

- the project is suited to the project alliance delivery model and therefore capable of generating cost savings of the nature described in section 3.2; and
- the veracity of the TOC and performance benchmarks, and the value for money of the limb 2 fee, is established,

then it should be possible to justify the adoption of a project alliance delivery model on value for money grounds.

3.8 Projects suitable for project alliancing

The project alliance delivery model is best suited to projects with the following characteristics:

- projects which are complex in terms of risk, interfaces, stakeholder issues and the like;
- projects where the scope of work is not sufficiently defined to enable sensible pricing, or where the likelihood of scope changes is significant;
- projects with significant scope for value adding through innovation; or
- projects with tight timeframes which require scope definition, design and construction to occur concurrently.

It is not particularly well suited to projects where:

- the risks can be readily allocated and costed;
- the scale of the project and the benefits which can be derived from using the project alliance model do not justify the additional procurement and contract establishment costs associated with a project alliance; or
- there are significant potential whole of life efficiencies which will not be captured under a project alliance.

3.9 Bankability of project alliances

Project alliances have until recently been considered unsuitable forms of contract for projects where the owner wishes to raise finance on a project finance basis, i.e. where the financiers may only look to the cash flows and assets of the project to secure repayment, and not to the balance sheet of the owner. Traditionally, project financiers have required the special purpose vehicle established by the project owner(s) to largely pass the risk of cost overruns, delays to completion and quality to a creditworthy head contractor via a fixed price, fixed time construction contract.

However, fixed price, fixed time construction contracts are becoming increasingly scarce in today's tight construction market. As a consequence, some project financiers are now considering lending to projects where the delivery method is an alliance contract. To address the greater risks assumed by the owner under an alliance contract, project financiers are likely to require:⁵

- the owners to provide more equity upfront, together with binding commitments to provide additional equity in the event of delays or cost overruns. Completion guarantees from the owners/sponsors may also be required;
- the establishment of separate cost overrun facilities with higher margins;
- that the alliance contract itself include certain features such as a well structured gainshare/painshare regime, a prescriptive subcontracting regime, the reserve power and deadlock breaking mechanisms discussed in section 3.4 above;
- more extensive due diligence in relation to technical issues, project risks and the capabilities of the participants; and
- tailored insurance policies - see section 3.3 above.

3.10 Fiduciary obligations and duties of good faith

Given that the alliance model is a relatively recent innovation in contracting there is still considerable uncertainty as to the legal and contractual effect of giving the sorts of relationship contracting commitments typically found in a project alliance agreement or, for that matter, a partnering charter. Committing to concepts such as honesty, trust and sharing may fundamentally alter the parties' legal obligations to each other. Particular care is required in the areas of good faith and fiduciary relations.

It has been suggested by several commentators that the inclusion of such commitments can result in contractual rights being qualified by obligations to act reasonably or in *good faith*.

Moreover, it has also been suggested that project alliances may inadvertently impose fiduciary obligations on the alliance participants because alliance relationships rely upon each participant acting in the interests of the others. A fiduciary relationship arises when one person is able to take advantage of another, who places trust, reliance and confidence in him or her by reason of his or her experience, position or influence. If such relationship is held to exist, then the law will impose certain additional obligations on the alliance participants.

There is authority for the proposition that parties to a joint venture agreement may put themselves in a position where fiduciary obligations are imposed. Fiduciary relationships may certainly arise, for instance, in a partnership.

If the concept of fiduciary obligations is applicable to project alliances,⁶ then the obligations of the alliance participants will be significantly more onerous. In particular, participants would be obliged to, amongst other things, disclose all relevant facts and circumstances, act with utmost good faith, and not permit their own interests to conflict, or potentially conflict, with those of the other participants. Participants would also be precluded from using knowledge or

⁵ See Cornwell P, "*Bankable Alliances*", Project Finance International, Nov 2006 at 44.

⁶ It may not be the case: it may be that participants do not undertake to act in each other's interests so much as attempt to align their interests with those of other participants.

opportunities obtained as a result of their participation in the alliance for the advantage of themselves or a third party, or to the disadvantage of the other participants.

Unfortunately, the law in Australia relating to good faith and fiduciary obligations is far from settled in the context of relationship contracting generally and project alliances in particular. To avoid uncertainty in these areas, the best policy is to carefully consider these issues on a case-by-case basis and specifically address them when drafting the project alliance agreement.

3.11 Added potential for legal relationship to be affected

The creation of joint management panels such as the alliance board provide valuable opportunities for communication and joint problem solving. However, they also provide a forum in which statements can be made by one party which might affect its legal rights. For example, one party might say during a meeting of the alliance board that it won't insist on strict compliance with the contract. If the other party acts in reliance upon this statement the first party may be prevented from subsequently asserting its rights under the contract, as a result of the operation of the doctrine of promissory estoppel. Alternatively, the first mentioned party may be taken to have 'waived' its right to insist upon strict compliance with the contract.

Similarly, the parties may during such meetings reach an oral agreement which has the effect of amending their written contract, even if the contract contains a clause requiring all amendments to be in writing signed by all relevant parties.

Whilst these issues can arise in relation to any sort of contractual relationship (including conventional lump sum construction contracts), the dynamics of a project alliance relationship with its regular meetings and joint decision-making processes increases the likelihood of such events occurring.

Parties contemplating an alliance relationship need to be aware of these legal risks.

4. Strategic Alliances

4.1 Characteristics and rationale

In the alliancing context, a distinction is drawn between project alliances and strategic alliances. As the name suggests, strategic alliances⁷ share some fundamental characteristics with project alliances. They both make provision for performance risks and incentives, and are founded upon the parties' stated intention to work co-operatively on a non-adversarial, open book basis in order to achieve an agreed set of objectives. However, the strategic alliance is distinguishable from the project alliance in a fundamental respect, from which all other points of distinction flow: it is conceived as a *long-term relationship* between the participants, enduring beyond any single project.

As such, strategic alliances operate on a distinct rationale, and employ a rather different form of resource allocation. Essentially, the appeal of strategic alliancing is most apparent where the owner's requirements involve the performance of routine and ongoing work, or a series of similar or related projects, and where there is impetus for the owner to decrease its engineering and/or maintenance departments. In such circumstances, a strategic alliance is the outsourcing of work to a contractor on a continuing basis, and on terms where the participants agree to pursue mutual goals and share the benefits of the alliance. In particular, the reasons for instituting a long-term alliance structure include the following:

⁷ Also sometimes described as 'program alliances': see, for example, Victorian Department of Treasury & Finance, *Project Alliancing Practitioners' Guide* (April 2006).

- The longer term allows the contractor to train its staff and gear up in the confidence of a reasonable amortisation of its investments.
- The longer term facilitates a more complete fruition of the attitudinal aspects of alliancing: the development of trust, intimacy and co-operation between the participants, and the adoption by the contractor of a more 'owner-like' attitude.
- Where the work involved is, for instance, the construction and maintenance of infrastructure, the duration of the strategic alliance encourages the contractor to use foresight in its planning and provides an incentive for contractors to develop, in advance, solutions to problems which may arise during the life of the alliance.
- Subject to probity considerations, under a strategic alliance the costs of tendering and transition are significantly reduced.
- Any improvement in performance will be continuous across projects.

Given that the contractor under a strategic alliance will be committing resources on a long-term, and perhaps indefinite, basis, the owner will as compensation for this risk allocate or guarantee to the contractor a certain amount of work - a *core workload* - for the period of the alliance. The core workload is regarded as essential to a strategic alliance, and is normally estimated with reasonable certainty over a five to seven year period. In discussions of how much of a contractor's total resources should be committed to a strategic alliance it has been considered that "no single [strategic alliance] should utilise more than 30% of the contractor's office resources", and its "total commitment to [the alliance] should not utilise more than 50% of its total technical and managerial resources".⁸

4.2 Risks or disadvantages of strategic alliances

As should be clear from the foregoing explanation, a strategic alliance has more specialised applicability than does a project alliance. In particular, certain risks and disadvantages are faced by parties who enter a strategic alliance. From the perspective of the contractor the risks are that:

- There may be a possible loss of business from other clients because of a perceived special relationship with participating clients.
- Although the contractor is guaranteed a workload (the core work programme), the margins are lower.
- If the core work programme does not materialise, or is too variable, the commitment of resources by the contractor may prevent it obtaining adequate return on its personnel assets.
- A possible 'blurring' of contractual rights and obligations may give rise to the owner requiring work without documentation.

From the perspective of the owner the risks are that:

- The absence of competitive bidding may reduce the benefit to be gained in the event of any market turndown, and remove the market pressure upon contractors to keep costs down.

⁸ NECD, *Partnering: Contracting without conflict*, Report, June 1991, 56.

- There may be contractual uncertainty as to the contractor's obligations.

On the whole, a strategic alliance requires a higher degree of trust from all parties than that required under a project alliance. The invitation to form a strategic alliance is likely to come out of a situation where the parties have a history of working together harmoniously.

5. Case Study: Australian Rail Track Corporation Improvement Alliances

The Australian Rail Track Corporation (ARTC) rail network improvement alliances are prominent recent examples of the use of hybrid alliance structures for large-scale infrastructure programmes.

In late 2005, the ARTC (which is responsible for the management of over 10,000 kilometres of interstate rail track) entered into:

- the North Coast Improvement Alliance (indicative value \$220 million), for the upgrading of the North Coast rail corridor, with a joint venture between Barclay Mowlem and Balfour Beatty; and
- the Southern Improvement Alliance (indicative value \$560 million), for the upgrading of the Sydney-Melbourne freight rail line, with a consortium lead by John Holland, MVM Rail and O'Donnell Griffin.

Both alliances have an initial term of three years, with the possibility of extensions, and each covers a number of individual improvement projects of varying sizes. As such, they are probably better described as strategic alliances rather than project alliances, or perhaps as sitting somewhere between those two concepts.

In terms of remuneration, the North Coast and Southern Improvement Alliances adopt the basic form of the pure alliance model by requiring the ARTC to pay:

- the alliance participants' direct costs, other than those arising as a result of defects or a contractor's failure to comply with the contract;
- an amount (calculated as a percentage of the alliance participants' direct costs) for corporate overheads (as a percentage of the alliance participants' direct costs); and
- 50% of any net savings, to be shared between the other alliance participants in a proportion determined by their representatives on the alliance board, against the overall budget of each alliance programme.

However, the remuneration structure is also somewhat different from that of many other alliances, and that described at 3.2 above, in that:

- the alliance participants' fee payments are not a lump sum but rather a percentage of the direct costs; and
- only 10% of the alliance participants' fee payments are at risk, and this 10% is subject only to a limited number of KPIs (against which the alliance participants' are measured on a quarterly basis).

The reason that a relatively low percentage of the alliance participants' fees are at risk, and are assessed against a limited number of KPIs, is that these alliances also depart from the pure alliance model by omitting the no blame, no disputes clause (though the contracts do emphasise that disputes should be resolved on a non-adversarial and mutually beneficial basis).

The absence of the no blame, no disputes regime allows the ARTC to pursue claims against the alliance participants if they fail to meet the requirements of the contract - particularly those other than in respect of cost or time - so that it need not rely entirely on deductions from the fee payments in order to incentivise the alliance participants and align their interests with its own. This is a good example of the way in which, in a hybrid alliance, a change to or the removal of one of the 'core' pure alliance features may allow - or even necessitate - a change to another.

The decision making structures for the alliances hew closer to the pure alliance model. Under both contracts:

- for each alliance there is an alliance board (responsible for the high-level management of the alliance projects and the alliance as a whole) and an alliance management team (responsible for the specifics of project management), both comprised of representatives of the ARTC and of the alliance participants;
- decisions of the alliance boards require the unanimous agreement of the board members (though the ARTC may unilaterally amend individual projects or the works programme as a whole); and
- there is no contractual deadlock breaking mechanism.

Clayton Utz was legal adviser to the ARTC on both the North Coast and South Improvement Alliance contracts, as well as on a further alliance contract for signalling upgrades.

6. Conclusion

Alliance contracts now come in many shapes and sizes as alliance participants, especially owners, have sought to adapt the pure alliance model to better suit their particular requirements and objectives.

There is no 'one size fits all' when it comes to contracting strategies, including alliance contracts. The model which will best suit a particular project will depend upon the nature of the project and the particular objectives and requirements of the owner and the other alliance participants. Each project and contract needs to be considered on its merits.

The experience to date suggests that the alliancing model is particularly suited to projects which lack clear definition, or to complex projects which require significant flexibility for change during the delivery of the project or which offer considerable scope for innovation and clever work processes that may generate significant cost savings.

What is most important is that the parties clearly understand the nature of the relationship that is proposed and the risks and opportunities associated with it, so that the appropriate strategies can be put in place to maximise the opportunities and manage the risks. Parties should also appreciate that whilst it is possible to 'tone down' the pure alliance model in an effort to address some of its more controversial features, doing so can have the effect of negating some of the advantages and opportunities which the pure project alliance model is designed to provide.