Project alliancing: does it work?

By **Juliet Pratley**

It's easy to be cynical about the construction industry's latest buzz words such as 'project alliancing', 'relationship contracting', 'partnering'. After all, cynicism is as much a part of the building industry as low margins and adversarial behaviour, and the exploration of new methods of project delivery is often thrown in the too hard basket.

A recent half day seminar held by KPMG Legal, construction and infrastructure group, reviewed the concepts and practices behind project alliances in Australia. The seminar was attended by both sides of the fence; those who had been involved in projects successfully delivered under a project alliance as well as the cynics and government departments still struggling with probity issues potentially posed by alliancing.


Tony Abrahams

So just what is project alliancing? According to Tony Abrahams, director of the construction and infrastructure group of KPMG Legal, essentially alliancing is a collaborative, incentive-driven method of contracting where all the participants work co-operatively to the same end, sharing the risk and rewards of bringing in the project within time and under cost, whilst respecting principles of good faith and trust.

"The participants create between themselves an entity to carry out the project on behalf of the various alliance members," said Mr Abrahams.

"They agree on a target cost (the anticipated cost of completing a project) and may also agree on other targets or key performance indicators (KPIs)."

If the alliance reaches or improves on the KPIs, then all participants share in the gains on a pre-determined basis. Even where target costs are not met or where other KPIs are not conformed to, the participants will normally receive from the client a full reimbursement of the direct costs incurred by each of them in carrying out the project.

Mr Abrahams said critics may ask how can you have a contract where the parties undertake to get on with each other and legally bar themselves from almost any right to sue each other. This requires a massive change away from the adversarial nature of Australia's construction industry. He said other concerns include whether or not the individual team members will be able to act as a member of the alliance entity rather than as the traditional representatives of their company's interests.

"One of the more radical principles of project alliancing is the selection of participants on the basis of factors other than price," said Mr Abrahams.

"Because a project's direct costs need to be calculated with alliance participants, the winning tenderer is not chosen on the basis of price, but by 'soft dollar' factors such as expertise, safety and environmental record, current commitments and an ability to work cooperatively," he said.

Mr Abraham's opening remarks were followed by Michael Stokes, director, capital and asset management branch, NSW Health,(speaking on behalf of David Gates, general manager, information and asset services) who referred to the process undertaken in deciding the delivery method for the new Coffs Harbour Hospital being constructed on the north coast of NSW. According to Mr Stokes, a number of innovative procurement methods were investigated by the Department of Health, with project directors hired to review procurement options. Project alliancing was one such option 'on the table' and Mr Stokes said that it had the support as a delivery method of both the Public Works Department and the Department of Health.

Ultimately however the contracts of all design consultants were novated to the successful contractor, Lend Lease, and the project is being undertaken under a 'managing contractor' arrangement. Mr Stokes said the managing contractor delivery method is 'only one step away from a project alliance' but in this case provided greater certainty to all the players in terms of their role and risk allocation.

"Under a managing contractor delivery process, there is a clear delineation between the client and the contractor, although the latter still shares in the profits or additional costs," he said.

Michael Delaney, manager, central engineering, Leighton Contractors Pty Limited, had first hand experience of project alliancing on the Wandoo gas platform project in Western Australia. He believes any contract will succeed, regardless of the form of documentation, if its scope is clearly defined, if all parties are fully aware of the risks in the project and the risks are appropriately allocated.

He also believes an alliance contract is better able to cope with flexible scopes of work, difficult risk evaluation and fast tracked projects.

Mr Delaney defines alliancing as 'a virtual corporation with its own identity and culture, with a working relationship based on trust and cooperation which is focused on a common goal.' Alliancing, he says, 'is a way of doing business, not merely a means of avoiding disputes.'

"The difference with alliance contracts is there should be a total openness in dealings, a 'no blame' culture and a sharing of all risks," said Mr Delaney.

"It means getting away from the 'us and them' attitude; there is no servant-master relationship," he said.


Michael Delaney

He believes the concept should be attractive to clients in that they can expect cost and time savings and if such savings are not apparent at the outset alliancing is probably not the most suitable delivery method. He said common goals would include the expectation of no disputes, staff reductions and a united front if things go wrong (the 'no blame' principle).

"Furthermore, this leaves the clients free to focus on their core businesses.

He said the attractiveness of alliancing to contractors lies in the certainty of pre-agreed margins, increased influence on the final outcome (for example, if a client introduces a variation during the project, he will discuss the impact of the variation on the project with the contractor). Downside exposure is protected and the likelihood of a successful outcome should lead to repeat business.

To the 'perceived' and 'real' restraints of alliancing, Mr Delaney says the former includes the issue of probity with government departments, although it is believed the concept has been 'run past' the Independent Commission Against Corruption (ICAC) which has not raised any objectives to such a delivery method. The other perceived disadvantage is what Mr Delaney terms 'an entrenched dogma of following old customs.' Real restraints include lack of total commitment to the concept by the owner's CEO or staff and/or by other participants, the sense of a loss of control, the concept of carrying an unqualified element of risk and the diminution of lawyers' roles after project commencement.

As the most important element of his presentation, Mr Delaney presented a list of nine essential prerequisites on which a client must be satisfied before commiting to an alliance. These included that the advantages must be visible, that authority can be delegated to the board representative, bureaucratic subversion must be controllable (some people want project alliancing to fail) and that suitable staff are selected, trained and supported, according to Mr Delaney.

"The most important criteria is however that there is a champion involved, someone fully committed and able to guide the process," he said.

He said a champion has to 'emerge from the ruck' and that 'it is a self-generating thing, not hand picked or imposed by the team.'

Interestingly Mr Delaney said that as well as having the confidence that selected participants will play ball, there must be an ability to see that the 'best man may be in another team. He said without these conditions being satisfied, alliancing should not even be considered and it should never be used simply because it is 'trendy.'

"And a last word about head contractors, they can make better profits in conventional contracts; indeed the chance to make a bonanza is gone for the contractor as half of any windfall goes back to the client.

"Furthermore opening their books to competitors and asset owners may risk a takeover bid and contractors may also be unwilling to share inhouse systems, methods or proprietary technology with competitors."

Greg Klamus is Sydney Water's project director for the Northside Storage Tunnel in Sydney which is currently being delivered under a project alliance contract. Mr Klamus agreed with Mr Delaney that the emergence of a champion is fundamental to the success of project and that trying alliancing just because it is a fad is a recipe for disaster.

"It is important to know the outcomes you want to achieve from the outset and then to continue to focus on them throughout the process - what's best for the project, best for all parties," said Mr Klamus.

"You have to be prepared to put all ideas on the table, no matter how crazy or stupid they seem and you have to have an integrated team," he said.

The aligned outcomes must have risk/reward parameters, key performance indicators and a Target cost which includes contingencies.

For the Northside Storage Tunnel, the alliance delivery method was chosen due to the extremely tight construction schedule (the EPA requested its completion before the year 2000 Olympics) and the flexibility required in the design and delivery methodologies. Client issues, being a government department, included probity issues in the selection process and the establishment of commercial arrangements, its traditional attitude to risk allocation, a perception by the department of a loss of control over the project and whether it had an 'appropriate' role in the alliance team.

"The risk allocation on this project is very different.

"And instead of a perceived loss of control by the client, the client is actually involved in specifying the outcomes and driving the outcomes." said Mr Klamus.

The project alliance contract is a fairly simple document. It establishes principles and a target cost to be followed, provides a regime for sharing of gain/pain, sets an agreed level of profit for participants and the consequences in event of poor performance.

Key elements of the Tunnel's alliance agreement include open book accounting, where everyone can see all the costs, project variations being limited to changes in scope and those requested by the client. Conflict is dealt with by a project alliance leadership team with decisions unanimous and all profit and overheads are at risk.

"We looked very carefully at whether or not we would require any part of the direct costs to be borne by the project alliance partners in the event of poor performance," said Mr Klamus.

'Ultimately we decided that there was sufficient incentive in the threat of loss of profit and corporate overheads to make the alliance work without pushing direct costs as well."

Thus in the tunnel project, as with other alliances, direct costs, overheads and profit are separated with overhead rates independently assessed. Profit and overheads are set as fixed $ amounts (the rationale being that by locking these key elements in there is no incentive to drive costs up by any party) and direct cost estimates are jointly developed by the participants at about 70% of the design stage. This direct cost estimate is then independently validated.

According to Phil Armessen, project manager, NSW Department of Public Works & Services, whilst DPWS has not participated in a project alliance to date, its sees definite advantages in this form of contracting and is closely examining how the Department might manage such contracts, should appropriate projects arise.

For such government departments the issues of probity and transparency arise, as project alliancing may be perceived as a 'cosy' arrangement, lacking the contractual rigour many expect in government contracting.

"That perception, combined with the likelihood of the projects being of a high profile nature, behoves public sector parties to place special emphasis on transparency of process.

"Additionally, this close working relationship could result in lapses in standards normally expected in public sector procurement," said Mr Armessen.

The DPWS will be preparing guidelines incorporating government standards and expectations in project alliancing. It is envisaged that these guidelines will assist administrators in evaluating the suitability of project alliancing for government projects, and in selecting appropriate projects for alliancing. Mr Armessen said for example, all decisions will need to be fully documented and all matters available for public scrutiny unless parties can justify 'commercial-in-confidence.' Mr Armessen said the commercial-in-confidence issue is a complex issue for DPWS, with government agencies having to resolve the extent of information they intend disclosing and to determine what would justify commercial-in-confidence.

"For example, should all material be disclosed or should disclosure be decided on a case-by-case basis?," said Mr Armessen.

"The other question is what constitutes 'public' release, what may be readily released to one party, say government, auditor or ICAC, may not be so readily released to others such as the media or individuals.

Other considerations include ensuring transparency and, pre-contract, should proponents be provided with the selection criteria weightings (bound to be a contentious issue) and what role should a probity auditor have in the selection process? On awarding the contract, other areas of contention may arise, namely releasing contract details including profit and overhead margins, painshare/gainshare relationship and performance incentives.

Another obvious area of importance for government agencies is achieving 'value for money.' Mr Armessen said it can be argued that this is achieved through the selection process ensuring that the best consortium is chosen. In almost all cases, a facilitator, experienced in alliancing, will be engaged to focus the team, fully documenting the reasons for variations including decisions concerning quality.

It is obvious that much work has yet to be undertaken by government agencies in responding to the above issues in a project alliance.

Eric Kolatchew, project director for the $2.4 billion BHP Port Hedland HBI project, was brought into the project when it was suffering significant cost and time overruns. At that stage it was the project delivery method, project alliancing, which was blamed. A review undertaken by Mr Kolatchew established however that alliancing was not the primary cause of the problems but indeed a change was required in the way the project operated.

"I believe that the ultimate success of alliancing depends on the compatibility and commitment of the organisations and people involved; indeed the selection of participants is the most important decision to be made and should not be rushed, " said Mr Kolatchew.

He said an intensive review needs to be carried out of the prequalified organisations, taking into account the way they operate, previous jobs, the opinions of past and present clients and the compatibility of the key personnel proposed. He said another key to success was to avoid participants who naturally compete with each other as they will be reluctant to share techniques/knowledge.

Mr Kolatchew said that whilst it is highly admirable to make alliance agreements simple and concise, it is important to spell out how particular commercial issues need to be handled. Commercial pitfalls he nominates are issues such as how gain share is derived and if it is to be capped; what constitutes 'acceptable direct costs'; how off-site costs are to be handled, what is an overhead; and how internal plant hire and equipment, small tools and consumables are to be costed.

"Issues such as what constitutes a variation, who gets the benefit of corporate rebates/discounts when it comes to assessing direct costs, who pays what insurances and who pays for work done more than once all have to be dealt with consistently across all participants.

"However if you have the right players and commitment, a lot of the above issues won't even emerge," said Mr Kolatchew.

Similiar to the other speakers, Mr

Kolatchew said one organisation needs to be created with the individual team members being compatible, open minded about the alliance concept and able to accept change.

"Taking a traditional adversarial approach will not work; you have to get rid of the cynics upfront or else they will poison the entire team."

He believes the alliance should work around a 'tying in' approach whereby organisations are 'tied together' by an agreement. The alliance principles can be made to cascade to sub-contractors and then to the rest of the workforce.

"This involves looking at issues such as whether or not the alliance partners are prepared to treat their sub-contractors in the same way the alliance agreement treats them."

Steve Knisley is the managing director of JMJ Associates, Asia Pacific, and specialises in the facilitation of alliance contracting. He said principles of the alliance selection process must include those participants with the most potential to achieve outstanding results and be designed to go beyond 'traditional salesmanship' in a bid.

"Answering the probity issue also means that the selection process has to be able to be strenuously tested," said Mr Knisley.

"Selection must be based on proponents' ability to achieve client objectives based on the selection criteria and not on price."

He said contractors are shortlisted via interviews, with ultimately two contractors chosen to attend a two day workshop where alliance principles begin to be developed. This is followed by a two day 'risk/reward' workshop which concerns creating and clarifying the risk/reward components, resolving issues such as non-cost components.

"This is a fundamental step, as you move from the initial proposal to the risk/reward workshop, where you get to know the participants more and more.

"Of course they could be well coached, but the two day workshop will reveal the real person/company," said Mr Knisley.

An alliance board is then created (whose number shouldn't exceed ten) and a 90 day alliance creation plan with the risk/reward structure finalised.

"To build the alliance culture you have to create a culture which is committed to breakthroughs, has mutual respect and an integral approach."

Mr Knisley used the PT Peni Alliance project in Indonesia as a successful example of this approach, with the project cost 35% less on completion than the conceptual estimate and 13% less than the funding estimate. This was despite the project schedule intentionally being delayed six months due to political challenges.

Alan Cullen, senior lawyer, construction group of KPMG legal, said that traditional contracts are characterised by an adversarial culture, lots of claims and frequent price blowouts. In contrast, alliance contracts have been shown to be based on a cooperative approach, have a sharing of risk/rewards, incorporate open book accounting and are an incentive driven method of contracting.

From a legal viewpoint, Mr Cullen said objectives should be laid out clearly in the alliance charter, focusing on compliance with specifications, early completion, low cost, highest safety standards as well as environmental, industrial relations and local community issues all being dealt with. Principles should include value for money, fairness, trust, innovation, open book accounting, sharing of risks/rewards and no disputes.

In his experience, a variation will be outside the general scope of work if the variation gives rise to a substantial increase or decrease in the scope of work, constitutes a fundamental change to the design, involves a substantial alteration by the principal of technical outcomes or is ordered after practical completion of the work.

The exception to the 'no dispute' objectives in an alliance contract would be 'wilful default', being 'a deliberate or intentional failure by a party to perform a contractual or legal duty with reckless disregard as to the consequences but not including an honest mistake; or an accidental act or omission.'

The legal structure of an alliance contract must be carefully examined; for example, will it be an unincorporated joint venture (most common), separate company (Wandoo), or a partnership?

"If the alliance is indeed a partnership, what happens if one party becomes insolvent?, " said Mr Cullen.

"The other question is if all parties are actually authorised to enter into a partnership?- for example, in NSW, government agencies generally have no authority to enter into partnerships unless the matter is covered by statute," he said.

Other areas of concern include insurance - who takes out the policies, for what period and the amount of cover required - and indemnity - should there be a limit on liability and is it joint and several liability (which again will be dependent on whether or not it is a partnership)?

Termination must be addressed; should there be a general termination clause or will the parties rely on the common law? Public sector clients for example will require a clause in the contract concerning termination.

The issue of fitness-for-purpose has received much attention in recent times from all parties involved, even in 'standard' contracts. Mr Cullen believes that a clause should be written into an alliance agreement which articulates callback/fitness-for-purpose issues in the event they do arise.

"However all attempts should be made to address this issue in the spirit of alliance and if there is an additional cost to be borne arising from a fitness-for-purpose issue everyone should carry that cost."

Last and certainly not least was the NSW Auditor-General, Mr Tony Harris who remains sceptical of the value of alliance contracting. He said the issue of commercial-in-confidence is 'overblown' by government agencies, pointing to Sydney Water use of it 'as its mantra'. His second point was that alliancing is not a 'marriage' but a 'marriage with a divorce date in it.'

"Those who support project alliancing talk most avidly about how the parties come together with joint aims and goals and how they will collectively solve any problems which arise," said Mr Harris.

"However the individuals involved also have a duty to safeguard the interests of their employers and shareholders so it is not really a marriage.

"It is more than that, as at the end of the day one party is left with the project and the other parties walk away."

Mr Harris said that from the government's viewpoint, it has to justify projects on the basis of their costs.

"If, as in project alliancing, you enter into a project and don't know the cost or do not have the capacity to manage the risk of cost blowouts, it would be hard, as a government agency, to justify the decision to undertake the project on such a delivery method," said Mr Harris.

He also said that the idea that a job is awarded to the party the client liked best after sitting down and talking with them, rather than on price, 'simply won't wash.'

He commented that he doesn't believe it is adequate for the public sector to select the head contractor based on 'the colour of his or her eyes.'

"We don't have the same drivers as in the private sector, we have to fall back on competitive processes which includes competing on price," said Mr Harris.

"I also don't understand the rationale or economics on the allocation and sharing of risk; why is the downside capped and why indeed are all risks put in one basket and shared?

"Why cap the losses, I would have thought this reduces incentive."

Mr Harris posed the rhetorical question 'can project alliancing fail?'

"Yes, and then what do you do - life is all about failure and I see looming project alliancing failures which will be very interesting," he said.

He believes the selection of the right project under which to undertake an alliance contract is important and that target costs should be carefully examined.

"What do you do under an alliance contract when target prices deviate from the initial estimates?" said Mr Harris.

"Look at the Northside Tunnel project, the deviation there is huge and you have to ask the question would Sydney Water have been better off using conventional contracting methods (like D&C) if it had known of the cost blow-outs?"

He said the selection of the project team was equally important, pointing to the outcry from unsuccessful tenderers on the Walsh Bay project when the scope of the project was changed after tenders had closed.

"Walsh Bay changed significantly and that's not fair; how do you address that in an alliance contract?" he asked.

On an optimistic note, Mr Harris said it was fair to say, in some circumstances, that there were benefits of project alliances.

"For example if there is an urgent need to undertake a complicated task, project alliancing may have its place," said Mr Harris.

"There may be from time to time, for reasons governments can't control, the need to undertake an urgent project.

"And there may be other advantages of project alliancing, I just can't identify them at the current time."

"There is some sense for example in managing risk in a way which is of benefit to both parties; project alliancing does that.

"However there are disadvantages in not allowing the people best able to manage to do so; it's that trade-off which interests me," he said. ■

ElectraNet SA - The South Australian government-owned electricity transmission company has announced a unique approach to alliance-based contracting

The alliance is thought to be unique for three ways:

- first in SA Government;
- first in the Australian Electricity Industry;
- first to be undertaken as a series of projects under a master alliance agreement umbrella.

ElectraNet SA, Kilpatrick Green (KG) and Burns and Roe Worley (BRW) have established an alliancing contract with the following features:

- Master Alliance Agreement (MAA) governing the overall conduct and intent of the three alliance participants;
- Project Alliance Agreement(s) (PAA) which are developed on a per project basis and encompass the key commercial features of each project;
- Interim Project Alliance Agreement (IPAA) as a precursor to the PAA and a key check point after detailed scoping, initial design and costing - providing the opportunity to decide to continue or not with the PAA.

ElectraNet SA established the alliance arrangements after a competitive process (including assessments of gross margin percentages etc) and after shortlisting decided on KG and BRW because of the overall strength of their proposal and an assessment of their cultural and strategic fit with ElectraNet SA.

ElectraNet SA's decision-making process included an exhaustive probity exercise and stakeholder consultation process which was supported by KPMG (Auditors) and Mallesons (Legal). Stakeholders included the State's departments of Crown Law, Auditor General, Premier & Cabinet, Treasury and Finance, Electricity Reform and Sale Unit and the Prudential Management Group.

ElectraNet SA was very well supported in the establishment of the alliance by their specialist consultant Mr Jim Ross of Project Control International Pty Ltd (PCI). ElectraNet SA considered Jim's facilitation and expert advice as pivotal to the achievement of the alliance.

The first project alliance agreement is underway for the S3.8 million Penola West transmission works to connect Boral's new 80 MW power station in the South-East of South Australia.

The second project alliance agreement is being considered for the S18 million Pelican Point transmission works for National Power's S400 million, 500 MW power station located near Port Adelaide.