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think through the future

Alliancing Association of Australasia

Contract Selection & Risk

Sharing the risks through Relationship Contracting

10 Feb 2009

Context

- Best value-for-money is the truth and the light.
- Best value is not necessarily lowest cost.
- Convention says that value-for-money is achieved when risk is allocated to the party best able to manage the risk.
- What do the parties do in response to being allocated risk and does this lead to value-for-money?
- Is higher value-for-money *certainty* or higher *expected* value-for-money better?

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Risk Allocation

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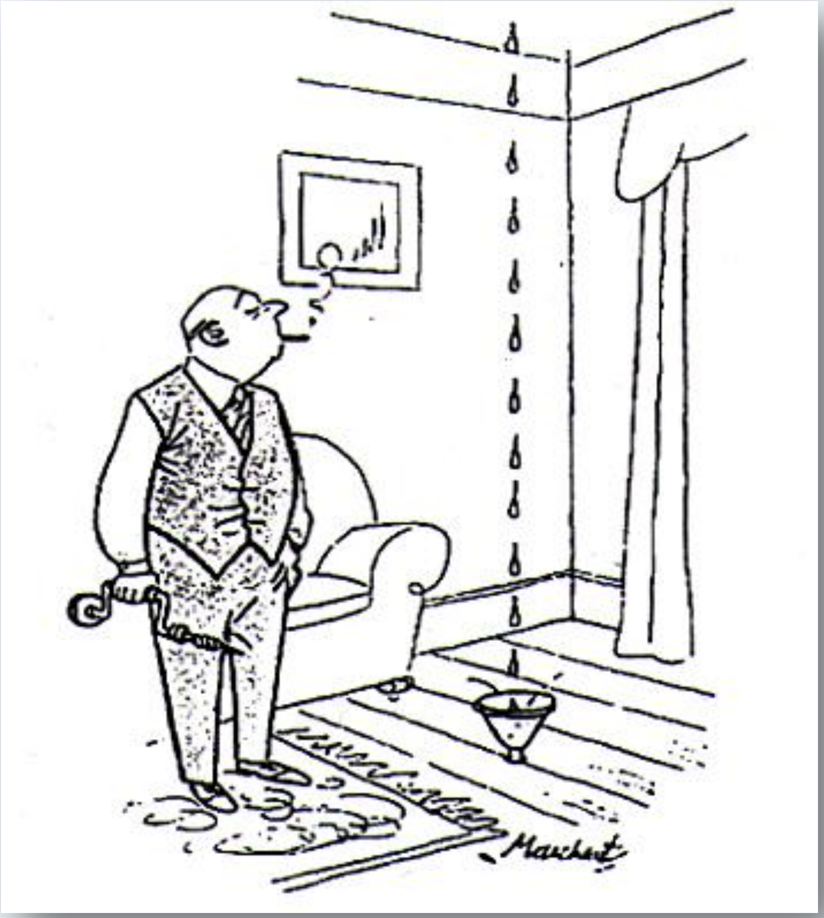


A “fix” to shift the burden

Value for Money Requires a Broader, Whole Systems View

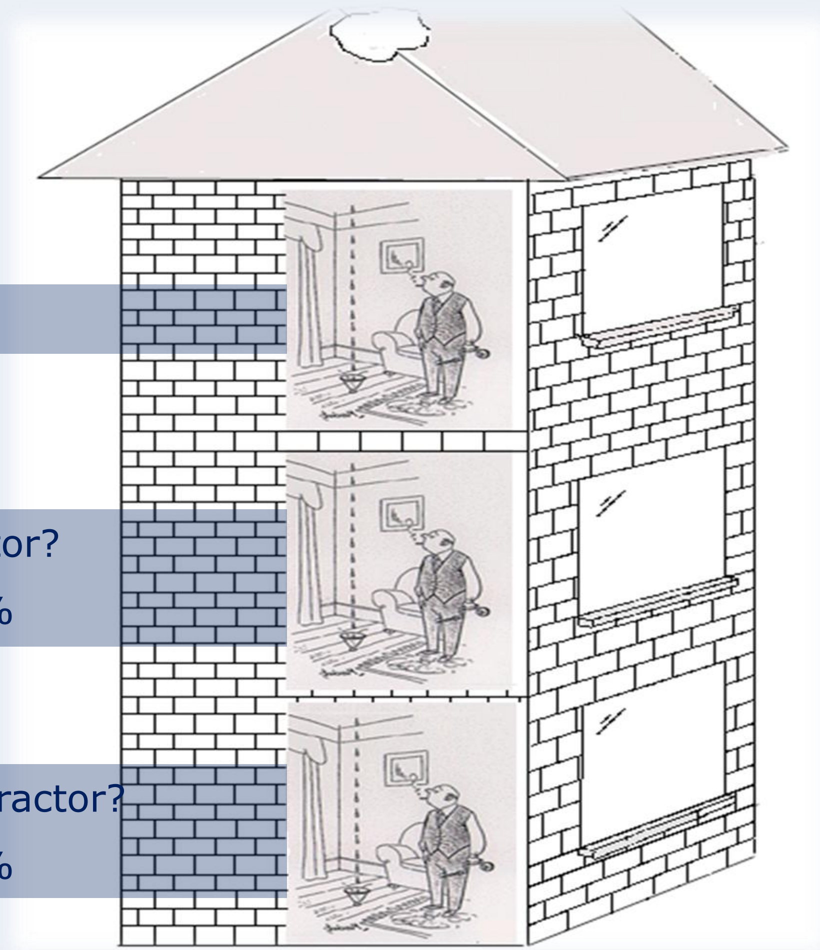
State?

Contractor?

Add 10%

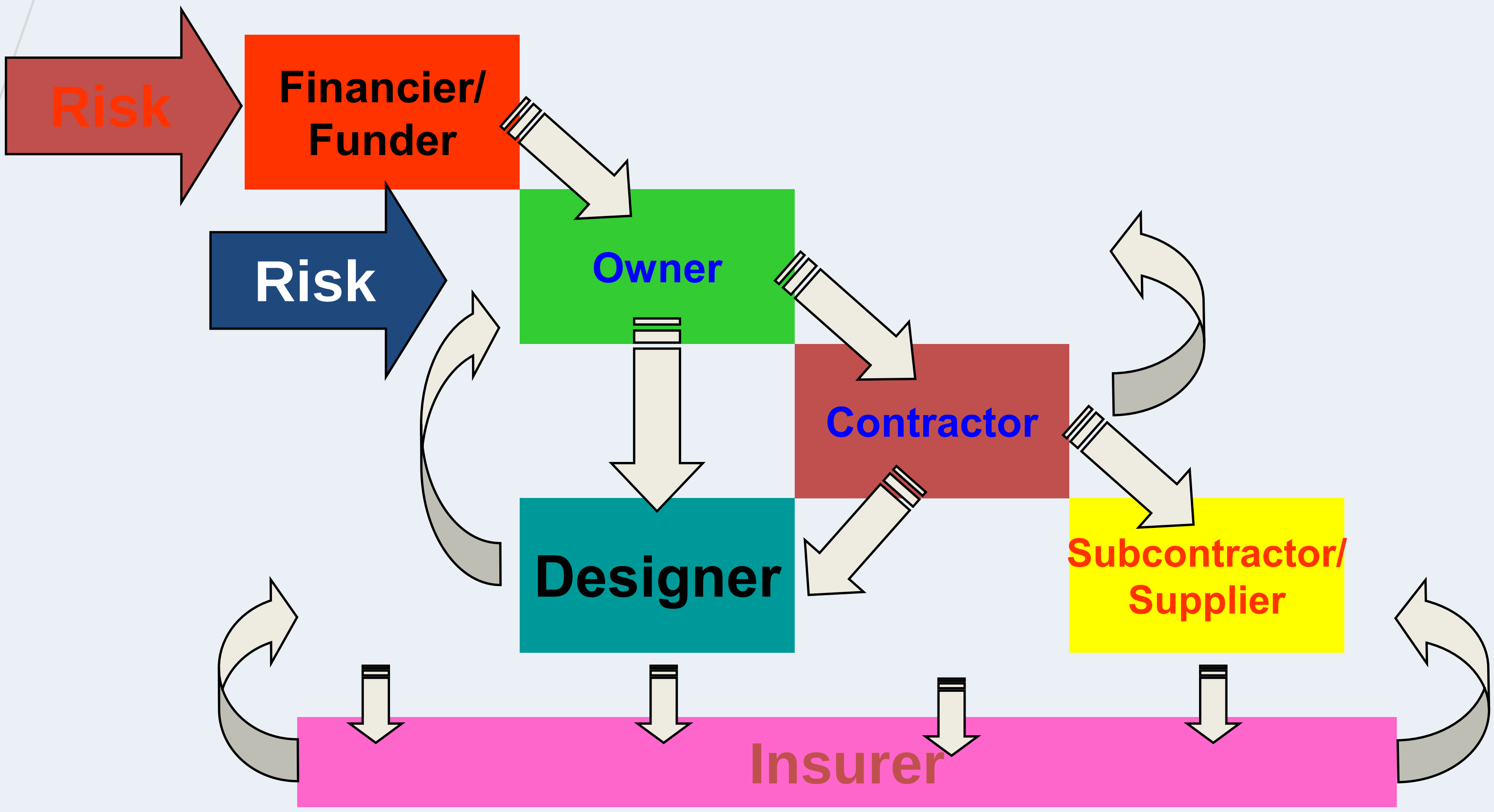
Subcontractor?

Add 10%

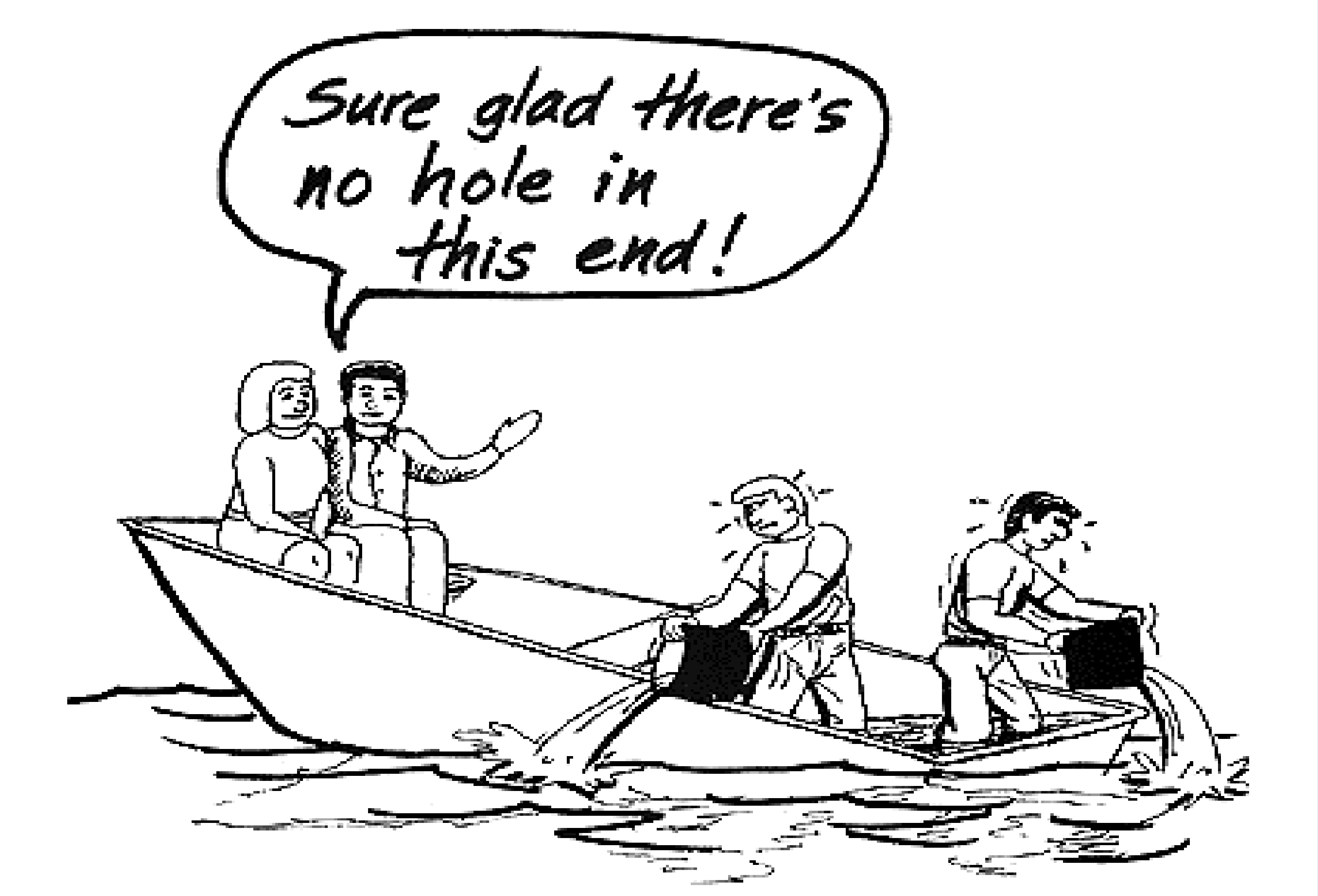


A problem “thrown over the wall” is not a problem solved

Risk Shedding – does risk allocation work?



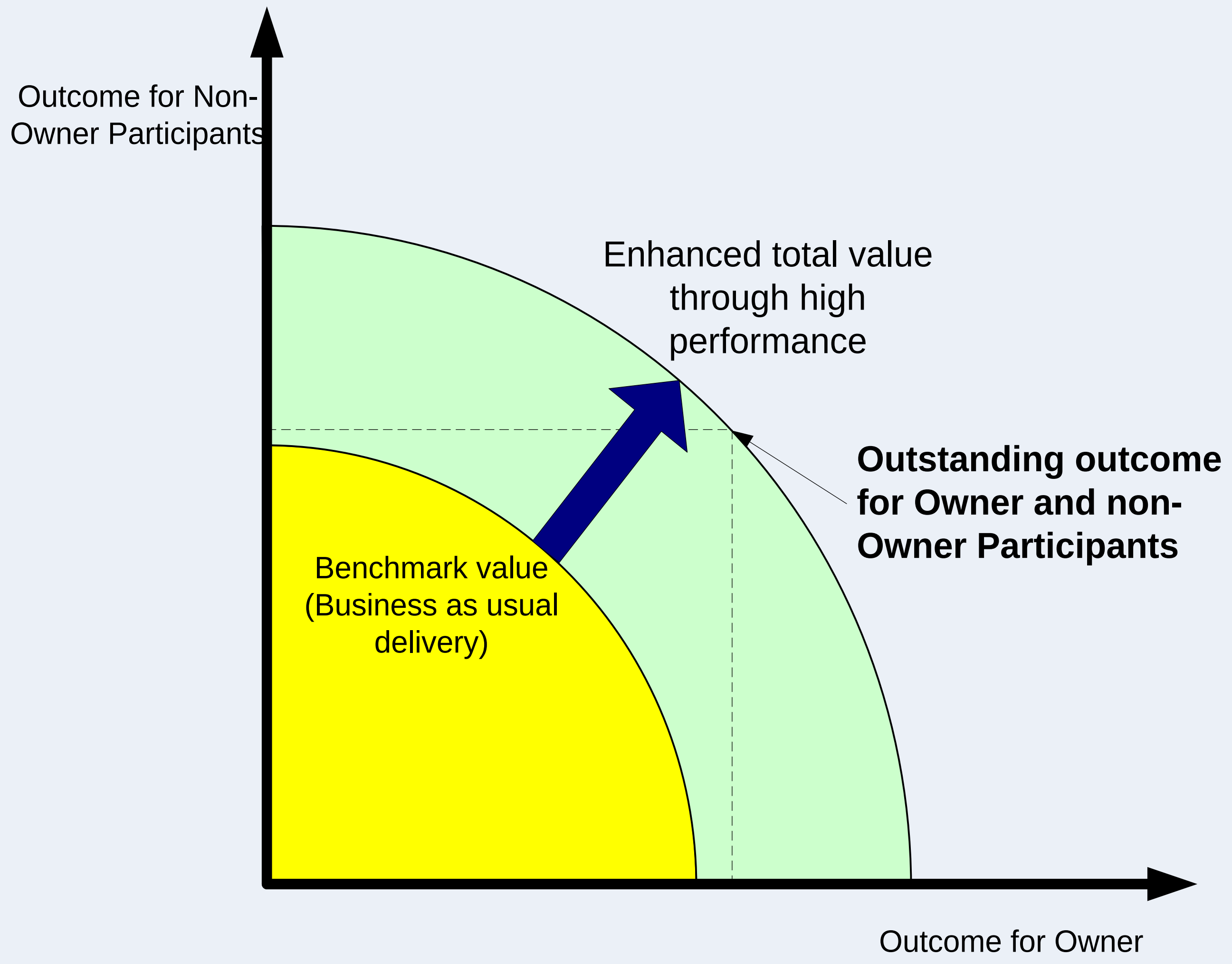
"We're all in this together"



Purpose of an Alliance

- To provide improved outcomes through:
  - The alignment of the parties commercially, culturally, and legally, to reflect common objectives (allowing win-win outcomes)
  - Collaborative, sharing working relationships
  - Sharing risks and removing barriers to innovation and collaboration
- The Alliance approach drives innovative thinking , collaboration and an outcome focus to optimise project outcomes

“Butter and Buns”



Why an Alliance?

- No master and no servant
- Risk sharing – it happens, so why not do it properly?
- No finger pointing and associated waste – if there's something wrong, fix it
- No unnecessary process, no duplication, no man-marking
- No barriers to collaboration and innovation
- Sharing of resources
- More effective cash flow
- A better basis for negotiation with technology providers

Project Alliances – Foundations

- All parties, including the Owner, enter the Alliance – a single, multi-party Contract
- Once established, the Alliance is governed by an Alliance Leadership Team (Alliance Board) – all decisions rest with the Alliance
- The Alliance does all of the work
- **All parties in the Alliance share in all of the risk and all of the opportunity – there is no risk allocation** (subject to defined exceptions)

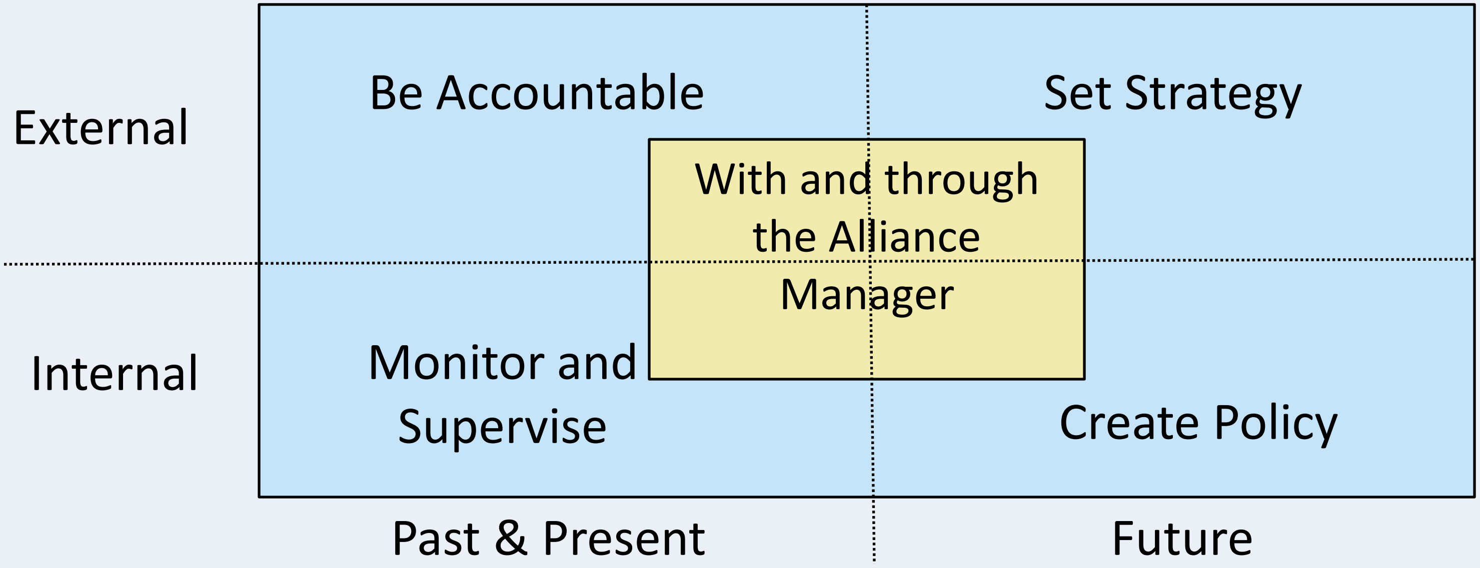
Alliance Principles

- Collective (not individual) ownership of all risks
- Objectives of all participants are aligned and all decisions are made on a “best-for-project” basis
- Collective responsibility for performance and outcomes
- All participants win or all participants lose together
- A “no-blame” and peer-to-peer culture
- Outstanding performance delivers outstanding reward (and vice versa) for all parties
- All transactions are fully open-book
- All issues must be resolved within the alliance

Governance – "Direction and control"

- Alliance Leadership Team:
  - Primary governance body of the alliance
  - Analogous to a company board except decisions by consensus, not majority

Robert Tricker Model for Board Responsibilities (adjusted for an Alliance)



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Legal Alignment

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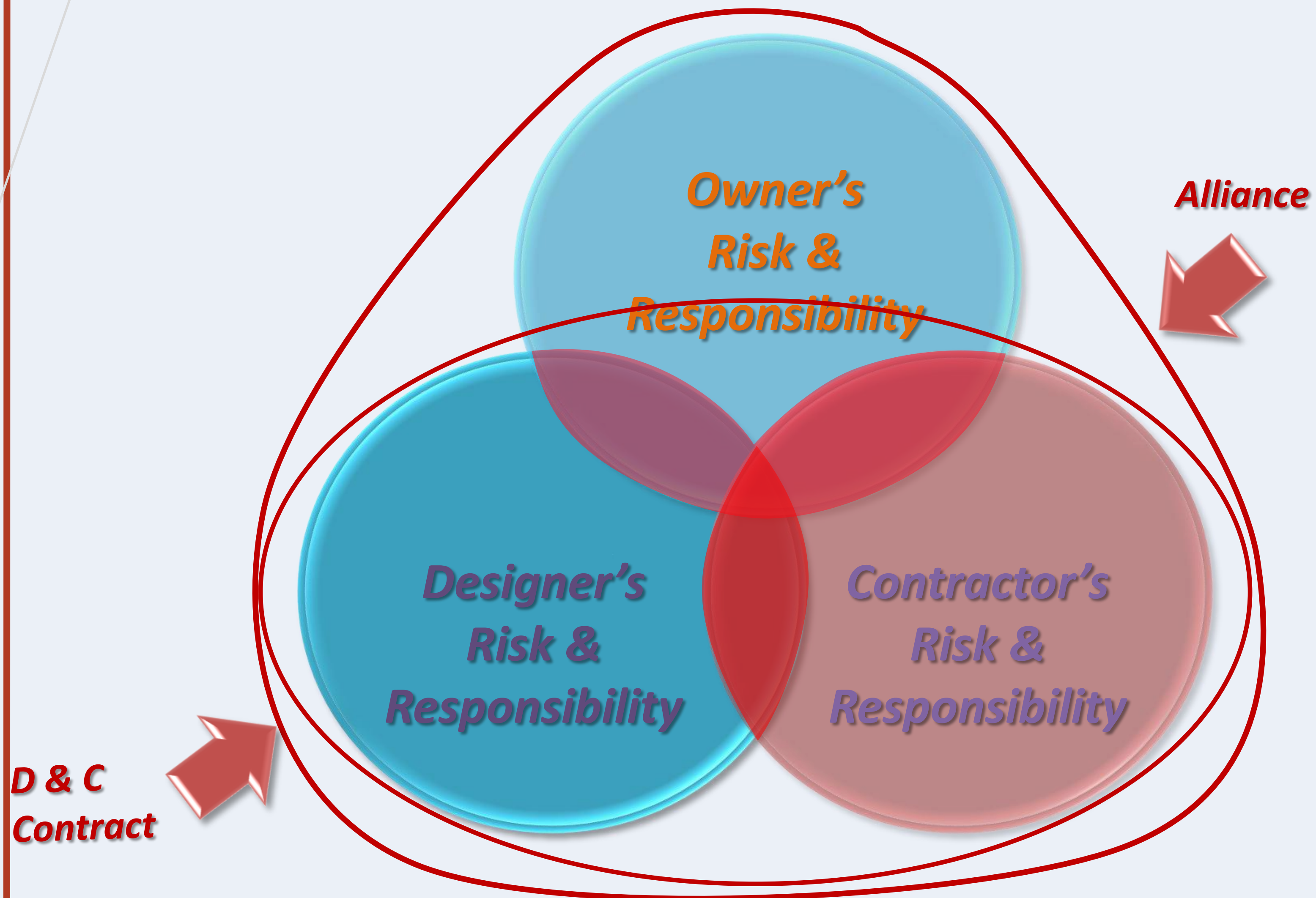
- A Contract that binds all parties to the:
  - Agreed principles
  - The problem to be solved, for which the Alliance is responsible
  - Alliance structure
  - Commercial framework
  - Alliance mechanics / processes
- Records risk allocated to non owner participants, owner retained risk and reserved powers.

Risk and Responsibility in Alliances



Risk in Alliances

- Generally the Alliance takes all risk except those specifically allocated
- Allocated risks include:
  – Wilful misconduct
  – Reserved Powers
  – Risk that cannot be shared under legislation (eg Principal Contractor obligations, some corporate governance obligations)
  – Other exceptions agreed to by the ALT

Risk in Alliances (continued)

- ALT will generally decide whether a risk is allocated using example scenarios that are explored prior to entering the Alliance ("Target Adjustment Guideline" sessions or similar)
- The ALT must agree on whether a risk is the Alliance's or not
- Cost consequences of risk are generally held by the Owner once the cost overrun is such that the NOP's cost risk limit has been reached (ie not fully shared)

Reserved Powers - Example

- Although we intend that decisions affecting the Work under the Alliance will be made collectively as required by clause 6.3(c), we acknowledge that the final decision on the following matters (**Reserved Powers**) ought to be, and is, reserved for unilateral determination by the Owner:
  - functional requirements, scope and fundamental design parameters for the Alliance Works;
  - media communications ;
  - urgent protection of the Alliance Works or the environment;
  - a suspension of the Alliance Works under clause 14.2;
  - site access arrangements and access restrictions made necessary because of operational requirements of the existing plant; and
  - the determination of a Separable Portion under clause 14.8.
- We will abide by and implement such Owner decisions /directions as though they were decisions of the ALT.
- We acknowledge that, where the Owner is exercising a Reserved Power, it may take into account the wider interests of the Owner and the State of Queensland.
- The decision on what impact, if any, the exercise of a Reserved Power has on compensation to Non Owner Participants under this Agreement will be made by the Participants collectively in accordance with the ALT decision-making protocols set out in clause 6.3(c), not unilaterally by the Owner.

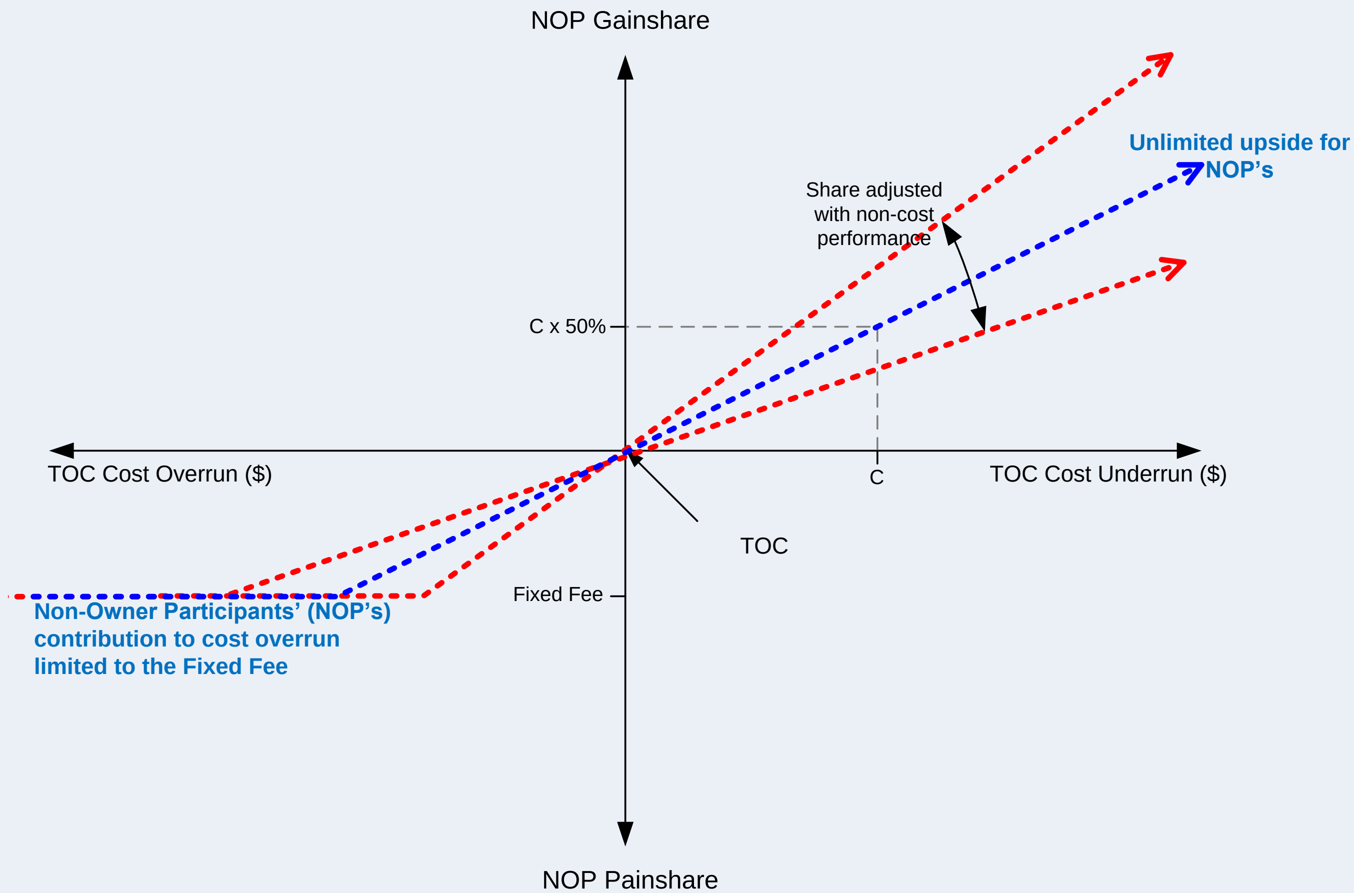
Insurances

- Alliance shares liability
- Alliance generally obtains All Risk Insurance in the name of all participants
- Alliance generally obtains no blame, first party P.I. Policy in lieu of individual Proponents' P.I.

Commercial Alignment

- All project costs are paid at cost
- Costs are fully transparent to all parties and auditable
- No hidden profit in costs
- Business-as-usual fee for business-as-usual performance, to cover corporate overhead and profit
- Profit and corporate overhead portions of fee are “at risk” based on performance
- Fee increases meaningfully with better performance (“gainshare”) and decreases with poor performance (“painshare”)

Commercial Alignment



Gainshare / Painshare – Consequences of Risk

- Cost overrun / underrun typically shared 50 / 50
- Non-cost objectives also incentivised by:
  - Additional bonus pool
  - Increased / decreased share of cost underrun / overrun for better / worse performance
  - Other financial mechanisms
- These mechanisms do not relieve the Alliance (all parties together) from its obligations to accept and manage risk

Commercial Alignment

- Commercial alignment relies on agreement of the calibration of cost and non-cost performance by agreement in advance
- Generally based on Minimum Conditions of Satisfaction (“MCOS”) being business-as-usual performance
- Should be objective and moral hazard free
- Generally determined without competition

Commercial Alignment – Calibration of Performance

- Target Outturn Cost
  - Usually determined by negotiation
  - Must reflect the risk that sits with the Alliance – ***outturn cost*** (cf tender price, which is not risk adjusted)
  - Can be benchmarked based on other projects
  - Usually independently verified as a "reasonable pre-estimate of the cost at completion" by an independent third party
- Other performance benchmarks agreed in a similar way

Cultural Alignment

- Shared understanding of what is “best-for-project”
- “Best-for-project” staff in all positions
- All personnel work together
- One team, wholly accountable through the Alliance Manager to the ALT (and not their employer organisation)
- Accountable and responsible with appropriate authority, but no blame
- Motivated, courageous, committed people supporting each other
- No man-marking
- One set of systems
- Recognise and capitalise on differences
- High Performance Team plan

Alliances have been of most benefit:

- For complex projects that are subject to significant internal and external change as they develop;
- where external factors such as government regulations and the physical environment are likely to constrain management;
- where size (physical, manpower, financial) exceeds a previously established threshold for the industry, technology or enterprise;
- where the project must interface and coexist with an existing, operating facility;
- where the project is aiming to set new benchmarks for early completion; and/or
- where technology is state-of-the-art and involves research and development.

Legal Issues Generally Avoided

- Disputes over risk allocation
- Negligence
- Trade Practices
- Disputes over payment amounts and timing
- Disputes over scope unless scope inappropriately defined:
  - Too much uncertainty; or
  - Too much detail
- Disputes with suppliers and subcontractors
- etc

Key Issues in Alliances

- Establishment of cost (TOC) and non-cost performance benchmarks in the absence of competition
- Subsequent “soft” performance or windfall reward - in many instances, cost is high relative to similar projects
- Lack of commitment to the Alliance – resources, leadership, risk
- Unlimited worst case exposure of Owner to risk (but is this really any different?)

Topics for Discussion

- Alliances are they watertight?
  - Contractual history of Alliances is very good – little litigation to date
  - Cost performance is of concern to some stakeholders, but cost performance reliability is high
  - How well they work depends on all of the above
  - Refer to key Alliance issues
- Breaches of the contract
  - Statistically, not an issue
  - Risk allocation is secondary in Alliance contracts
  - If ALT agree to a change, generally no breach
  - Remedy?

Topics for Discussion (Continued)

- "No litigation" provisions
  - "It is our intention not to litigate"
  - Little or no litigation to date
- Risk profile of Alliances from Owner's and Contractor's perspective
  - Almost no allocation
  - High degree of mutual satisfaction except with TOC – positive behaviours and culture because of risk sharing
  - Note Owner's unlimited cost exposure
- Risk in commercial terms
  - Discussed above

Risk Allocation & VFM

- Alliances avoid the issue by risk sharing
- Conventionally delivered projects may offer better value, provided that:
  - The objectives, costs and risks are properly thought through
  - The project is not burdened with commercial arrangements that attract:
    - *Additional layers of commercial resource, overhead and margin*
    - *Additional risk premiums that do no provide acceptable value*
- Competitive pricing may drive superior cost and performance outcomes in these types of circumstances.
- Conventional risk allocation is often simplistic, flawed and/or illusory

Summary

1. Alliances are formally structured, virtual organisations, set up to share risk and responsibility in achieving an outcome.
2. They have parallels with companies as well as projects.
3. Owners and Non-Owner participants continue to report high levels of satisfaction with Alliance outcomes.
4. Alliances have some issues, particularly the lack of competition in pricing and in the establishment of other performance benchmarks.
5. Risk allocation may be a better choice in some circumstances.

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