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## ALLIANCES - FRESH THINKING IN CONTRACTING STRATEGY

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*Western Canada has in the past experienced mixed success with alliance contracts. There is currently a resurgence in interest in this contracting strategy as contractors are tending to avoid fixed price contracts and as Owners seek paying an arm and a leg. Consequently, Revay and Associates Limited (RAL) is pleased to introduce Suzanne England and in particular her thoughts, based on actual experience and research on this contracting strategy. She holds a Post Graduate Diploma in Construction Law and Arbitration (awarded by King's College, London University, England) and a professional designation of the Chartered Institute of Arbitrators, London, England. Suzanne England is an active member of the Construction Owners Association of Alberta's contract drafting committee. She has 18 years of experience with construction disputes, and has mediated the settlement of claims in the sum of \$53,000,000. Suzanne joined RAL from Siemens Building Technologies in the UK where she was responsible for Siemens' commercial and contractual health. Her mandate included the drafting of a suite of customized contract forms and devising and delivering commercial training to project managers and engineers. Suzanne also has an abundance of experience in connection with partnering and alliancing. While working for BAA plc on its London Heathrow Airport expansion, she developed effective incentive schemes for constructors and control mechanisms for commercial matters.*

### Introduction

The alliance was first conceived in the UK in the early 80s – in the last 20 years it has proven itself to be a successful delivery method in many regions of the world. Several large Owners in Western Canada have recently approached RAL with a view to exploring as to how alliances could work for them. In this article, RAL will discuss the origins and uptake of alliances and the reasons for its success. RAL will identify the essential features and provide real-life examples of implementation.

While alliances are most closely associated with mega-projects, they are appropriate for all project sizes. Alliances improve upon traditional delivery methods because they:

- motivate all participants to fulfill the project objectives;
- harness the degree of collaboration necessary for the successful implementation of projects; and
- effectively manage conflict.

### The Difference between Partnering and Alliances

Broadly speaking, the version of partnering most often encountered in our industry is a 'gentlemen's agreement' realized through the attitudes and behaviors of individuals. Crucially in this situation, there is no contractual compulsion that constrains the actions of the parties and when things become difficult those until then amicable individuals tend to find themselves embroiled in posturing that militates against resolution.

Conversely, an alliance is a contractual, and therefore enforceable, agreement wherein undesirable behaviors have financial implications and conflict is actively managed. Proponents of alliances argue that these particular attributes are the key to its success.

### Alliances

#### What is an Alliance?

The project organization that flows from

an alliance is a co-located, cohesive team brought together for the duration of the project. The team includes the Owner and all key participants in the building process - specifically designers, constructors, principal service providers and major suppliers.

The alliance agreement is characterized by its treatment of risk allocation and compensation. Abraham and Cullen<sup>1</sup> define a project alliance as:

*'An agreement between entities which undertake to work cooperatively, on the basis of a sharing of project risk and reward, for the purpose of achieving agreed outcomes based on principles of good faith, trust and an open-book approach towards costs'.*

Unlike partnering, the focus of an alliance is not on relationships. That said, research from Australia suggests that alliances do engender a more convivial atmosphere in which to work<sup>2</sup>. Rather, the focus is on creating financial wealth for each and every participant.

Governance - in the sense of strategic direction and policy - is managed by a board drawn from all members of the alliance team; while daily business is conducted by a project management group with democratic membership that solves all issues (howsoever arising) in the best interests of the project.

Selection of the participants takes place on the basis of expertise alone. The team develops a target cost for the project when design is sufficiently well defined; the team is collectively motivated to achieve the project goals by means of risk share and reward.

Without a doubt, BP (formerly British Petroleum) and BAA (formerly British Airport Authority) blazed the trail. These corporations first began experimenting with new forms of contract in the mid 1980s. The drivers for new contracting strategies differed as between the two corporations but they both sought the same ends – namely cost reduction. The formal agreements that emerged from those experiments have now become known as alliances.

### BP and BAA – the Alliancing Approach

In the 1990s, BP was faced with a threatening prospect – oil reserves in the North Sea had become uneconomical to exploit. BP figured that exploitation would be viable only if the significant development costs could be reduced. Initially, BP's efforts to save money centered on attempts to engineer a cheaper project through the latest technology.

Crucially, BP procured the project through competitive tendering using traditional contracts. This strategy worked to a fashion – while it provided cost savings, the savings failed to make the project economically viable. So BP was forced to change track and the contract style that has become known as an 'alliance' was conceived. BP was so persuaded of the prospect for success under this new form of contract that it chose a notoriously problematic reserve – the Andrew field – to showcase its pilot project.

Thankfully, the pilot project was an unmitigated success. By changing track and entering into an intense six month period of collaboration, the project team was able to shave off \$154 million from the original estimate.

Further, as a result of extraordinary teamwork, a further saving of \$100 million was

incorporated into the estimate before work on site began and the schedule was truncated by three months. During the construction phase, the team was relentless in its attempts to secure cost savings by minimizing the incidence of rework, by ensuring that work packages were let to subcontractors and suppliers on full particulars. As a consequence, the outturn cost was reduced to a little under \$580 million and production started nine months ahead of the original schedule.

Similarly, in the mid 1980s BAA committed itself to an alliance in order to build its \$8.2 billion expansion of Heathrow Airport.

By the late 1970s, cost overruns and delays in the UK construction sector had become routine; the order of magnitude of overspend in big projects hovered around 15%. The prospect of forking out 15% over and above budget was unacceptable to BAA and prompted it to seek alternative procurement strategies for its largest capital projects. This ultimately led to experiments with performance incentives and risk sharing. The learning from these experiments gave rise to the contract that governs its expansion of Heathrow Airport, the so-called T5 Project.

The T5 Project is not due to complete until March next year but current cost forecasts predict an outturn cost at circa 10% below budget.

### Uptake of Alliances in Other Jurisdictions

While alliancing has its origins in BP, it has been refined and used successfully in several jurisdictions. Australia has embraced it with open arms – the first two alliancing projects in Australia were 'The Woo Project', an oil field project that began in 1994 and 'The East Spar Project' gas field project, which also started in 1994. As it transpired, these projects were resounding successes and good press led to experiments by other Australian public clients along with contractors in the heavy engineering sector. Today, numerous large, complex private and municipal works have been constructed by alliances. The popularity of alliancing has spilled over into the commercial world – the first alliance in the commercial sector was the construction of the National Museum of Australia. This was completed on time, under budget and to the complete satisfaction of the Owner<sup>3</sup>.

### What Marks an Alliance?

The common denominators that distinguish alliances are:

- sharing of all uninsurable risk;
- an effective compensation mechanism that aligns the interests of the parties;
- a culture where the fingers of blame are never [openly] pointed;
- absolute buy-in to the cultural shift;
- internal handling of conflict.

Partnering, on the contrary, makes no attempt to share uninsurable risk, align the parties' interests or create a culture of no blame.

### Risk Sharing

Traditional contracts attempt to shed risk to the contractor, who, in turn, passes risk down the contractual chain. Rubin<sup>4</sup> describes the consequences of this approach in most eloquent way. He says *'the scenario for contract claims is invariably written right into the contract documents. Long before men and machines reach the jobsite, conditions for claims and disputes have often been signed by both parties'*.

The fact is, it is impossible to pre-empt all the possible disasters that might arise. The only sensible responses to this vicissitude are to either:

- defer discussions as to how the impact of unforeseen events should be apportioned should they actually occur; obviously, this requires a process written into the contract for dealing with unforeseen events and an extreme leap of faith or
- share the risk.

The second option is the one adopted by alliancing. The idea is: risk share leads to collective responsibility. The mechanism that gives life to this idea is the compensation structure.

### Compensation Model

In short, successful alliances create collective responsibility through hard money. Typically, the compensation model is a three-limb, open book arrangement.

The three components are:

- Limb 1 is the aggregate of all direct project costs (including rework) and project overhead incurred by team

members - these figures are transparent to the entire team and are payable whatever the project outcome;

- Limb 2 is the corporate overhead and profit; generally, these are lump sums generated as a percentage of the target cost and sometimes are ring fenced. In my own model these amounts are payable irrespective of the project outcome unless the contractor abandons his works;
- Limb 3 is the contractor's share of a potential pot of money available in the event that the outturn cost is lower than the target cost. Commonly the share is a predetermined percentage based on the contribution of the party either in terms of the value of his works or the complexity or the criticality.

As previously discussed, the target cost is developed by the team. Once the target cost is agreed, it becomes the benchmark against which limb 1 is measured.

Typically, where the team outperforms on cost, the savings are shared according to the predetermined amounts; where the outturn cost exceeds the target, the parties bear the over run in the same predetermined percentages to the extent that limb 3 allows. Any overruns are funded by the accumulating pot and any shortfall is picked up by the Owner. Always provided – in the author's model at least – that particular prerequisites concerning schedule, quality and safety are met. She calls these 'trigger conditions' and, in her model, they must be satisfied before payout of limb 3 is made. Her trigger conditions are:

- completion to schedule;
- quality at or better than contemplated by the scope documents;
- minimal safety incidents.

These criteria were also of interest to BP - although BP's treatment of them differs from the author's. As extra incentive, essentially BP creates a limb 4, a fund that represents a percentage of the target cost. Concomitantly, BP creates key performance indicators around the criteria and, depending on performance, pays out additional money such that each team member potentially earns a bonus even if the target cost is exceeded.

Normally in alliance contracts, profit is ring fenced. In other words, the only risk to which a team member is exposed is the erosion of his profit margin. However,

BP takes a more draconian approach. In BP's model, the contractor runs the risk of actually losing his profit and his corporate overhead.

Several models that the author has first hand experience with divide limb 3 into three separate funds. This separation enables the incentive to operate at two levels: specifically, the incentive applies to the contracting entities at the project level and also at the level of the project as a whole.

In the author's model, limb 3 works at three levels. In addition to the above, it applies to the individuals performing operations and managing the projects. The requirement for the contractor to cascade the incentive to his workforce is made a condition of the contract.

By means of Limb 3 (in whatever form it takes), all models create, as between all participants in the project, an interdependence that engenders collective commitment and focus on the Owner's goals.

The Limb 3 funds are handled as follows:

1. 1/3 of the savings is paid to the contracting entity on completion of his works;
2. a further 1/3 is transferred to a fund held in trust for all contracting entities engaged on the projects; the entity earns the opportunity to benefit from this fund by means of 'reward shares'
3. 1/3 is retained by the Owner for use as it sees fit; the Owner is at liberty to award discretionary bonuses or – at the other end of the spectrum – it can retain the cash.

As far as the author's model is concerned, in the event that either or both of the trigger conditions are not met, any savings are transferred to the trust fund, in other words the second pot.

Invariably, the trust fund is controlled and managed by the Owner; crucially, the Owner has a contractual right to recoup from the trust fund any losses made on the project (to the extent that funds allow). The trust fund is never permitted to be in deficit and no contracting entity or individual is pursued for a remedy (excepting that in the event of latent defects appearing, the Owner ordinarily reserves the right to recover from any payouts made from the trust fund to the contracting entity whose works are affected).

In the author's model, reward shares enable the party to benefit from the fund generated by all entities working on the project. The shares are allocated to it in accordance with the magnitude of its saving. At project completion the fund is divided up and each entity receives a proportion of the fund that corresponds to the numbers of reward shares it holds. Payout from the trust fund occurs after all reckoning pertaining to the project is completed. In this way, team members have a vested interest in their impact on others. Other models have analogous mechanisms.

### Creation of a Culture of 'No Blame'

The benefits of a no blame culture are palpable – the potential for protectionist behavior is minimized; problems are not concealed; in the event of a mishap the project does not get stalled by posturing or intervention by in house counsel.

To underpin this culture alliances tend to require all participants to waive rights of redress against other participants. Also, Owners typically obtain an insurance program that is not fault based and pays out irrespective of whether actual physical damage has occurred.

In the case of one alliance with which the author was involved, the contract was set up so that in the event of an insurance incident, the participants were liable only for the policy deductibles, irrespective of any shortfall between payout and cost of rectification. The Owner self-insured any shortfall. The contract was designed to use peer pressure to ameliorate any wanton underperformance rather than financial penalties - the liability for the insurance deductible attached strictly to all members of the team.

Where any member of the team caused an insurance incident, the entire team was liable for a contribution (which they were forbidden to insure). The evidence is that this regime is working – those on the inside advise that performance is genuinely exceptional.

### Internal Handling of Conflict

Characteristically, alliance contracts make the management team the ultimate tribunal for dispute resolution. This unanimity is the attribute of alliances that will likely cause most discomfort for lawyers and funders; their fundamental misgivings will concern unpredictability of outcome, application of clandestine and possibly arbitrary procedures.

Notwithstanding, unanimity does circumvent the rigmarole often associated with the established dispute resolution tools.

For those who would shrink from unanimity, the following regime is suggested as an alternative.

An alternate solution would be to pursue different resolution paths dependant on the nature of the dispute in question, always provided that either party may resort to the courts once the prescribed paths are exhausted. For example:

- (a) where a dispute turns largely on a question of law, the parties ask an eminent construction lawyer for his/her view on a non-binding basis; additionally either party is entitled to forward the decision to any subsequent tribunal dealing with the matter;
- (b) where the dispute turns solely on a question of specialist technical fact, the matter is remitted to an expert for determination on a non-binding basis; the parties further agree that the expert's decision is admissible in the event of subsequent proceedings;
- (c) where the dispute either turns on a mixture of fact and law or on a complex series of facts, mediation may be appropriate<sup>5</sup>.

Alternatively, the resolution path could be dictated by the value of the dispute or a mixture of both. Such a hybrid solution was adopted by one alliance the author has experience with.

In that instance, the contract incorporated the following resolution ladder:

Negotiation occurs at site level for differences of opinion or grievances of aggregate value < \$40,000. This level is bypassed where differences of opinion /or grievances are of aggregate value > \$40,000. In these circumstances, the

next tier of management is tasked with the negotiations. Immediate management escalation is mandatory also where negotiation at site level has not within 8 weeks brought about a mutually acceptable resolution or where issues affect public relations or are expected to have serious ramifications for the schedule. Where no solution emerges from either the site level or its immediate management, the differences of opinion /or grievances are referred to a panel consisting of one principal representative from each of the respective parties. The panel makes its decision based on written and oral submissions by the respective parties, advice from counsel, or independent experts as required.

Superimposed on this regime is the opportunity for mediation. Mediation is mandatory where management or the panel is unable to find a resolution, but it may be supplanted at any time at any point on the ladder. Under the contract, the parties agree that any settlement brought about by mediation is recorded and made binding as a contractual term. Should mediation be unsuccessful, the contract provides that either party may commence litigation. However, the parties are contractually bound to tread the entire ladder before litigation may be started.

## Conclusion

The discussion above draws on a small sample of successful alliance projects but nevertheless illustrates the tangible benefits that are commensurate with alliances.

The alliance is a form of collaborative contract that provides:

- contractual compulsion to perform and
- hard cash incentives that create a vested interest in how others in the team perform. In the current market

conditions that we face, having a vested interest in how one's activities affect others in the team can only help curb the incessant poaching of staff.

The experience of BP and BAA recorded in this article demonstrates that an alliance can be instrumental in reducing costs and shortening schedules, in addition to improving working relationships. If these are your objectives perhaps you should seriously consider an alliance as your next procurement strategy.

If you would like to know more please contact Suzanne England at [sengland@revay.com](mailto:sengland@revay.com).

<sup>1</sup> Abrahams, A Cullen, C 'Project Alliances in the Construction Industry' Australian Construction Law Newsletter Issue No 62 Oct/Nov (1998)

<sup>2</sup> Keniger, M, Hampson, K and Peters, R 'Case Study of the National Museum (Acton Peninsula) Project' Proceedings of the Fifth Annual Conference: Innovation in Construction 11 October (2000)

The above research suggests that negotiation styles do alter in an alliance environment. A research team pooled from Queensland University, the Construction Research Alliance and the Royal Melbourne Institute of Technology surveyed a wide cross-section of project participants involved in the construction of the National Museum of Australia in Canberra and asked respondents to compare their experience of negotiation on the Museum project with, amongst other things, their ordinary experience of projects outside the alliance.

The results indicate that 30% of participants had abandoned their normal proclivity for hanging tough and 29% had embraced principled negotiation i.e. deciding issues on their merits rather than pursuing a haggling process.

Coincidentally, it seems that no individual perceived his or her relationships as having been damaged by the negotiation process.

Tactics also changed – significantly, the proportion of individuals who confessed to making an opening demand far greater than hoped for dropped by 18%; only 8% had succumbed to the temptation of conveying a false impression that they were in no hurry to settle.

It must be said that the survey size was small and therefore it is not possible to conclude with confidence that negotiation in an alliance context is less of a charade. However, I hope that the findings of the CII indicate a potential trend.

<sup>3</sup> Hauck et al 'Project Alliancing at the National Museum of Australia – Collaborative Process' Journal of Construction Engineering Management Jan/Feb (2004)

<sup>4</sup> Rubin 1999

<sup>5</sup> I gratefully acknowledge the help of Dr Robert Gaitskill, Q.C. to formulate these ideas

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