

PROCUREMENT AND RISK SHARING

Practice / Case Study

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1. INTRODUCTION

A pre-condition to effective contract management is an effective contract.

An effective contract is one in which there is a fair and sensible allocation of risk and responsibilities. Of particular importance to principals and contractors alike is the management of time, cost and quality.

The construction field is a fertile area for disputes, a product of the myriad of issues and interests at stake, the amount of money and effort invested in a construction project, the high level of complexity of projects and the climate of inherent risk and uncertainty in which projects are performed.

This paper will examine the traditional models of contract delivery vis-à-vis more recent developments in contract delivery, particularly alliance contracting. Each will be evaluated as to their effectiveness for principals and contractors, with an emphasis on their method of allocation of risk, to determine the best method of contract delivery for particular projects.

2. TRADITIONAL MODELS OF CONTRACT DELIVERY

Traditional models of contract delivery denote a theme of imbalanced risk allocation and concentration on the end dollar. Methods such as 'construct', 'design and construct' and 'project management', generally allocate a great proportion of the project's risks to the designer and contractor. This inevitably creates a dispute-riddled environment, with each party seeking to attribute liability to the other. In this climate, issues such as buildability of designers' designs and the quality of contractors' work were high on the agenda.

2.1 DESIGN AND CONSTRUCT CONTRACTS

2.1.1 *Adequacy of the Design Brief*

Failure on the part of the principal to provide an adequate design brief for the contractor will inevitably result in delays and increased costs. The principal will be required to clarify the design brief, usually by way of variations to the contract works.

Initial design brief deficiencies will have adverse time and cost implications. If changes or clarification to design are effected by way of principal-directed variations, many contracts will provide that the principal is liable for any delays caused by those variations, in terms of dollars and time lost on the

project. The contractor may have prolongation claims against the principal in this regard. Moreover, principals may find that a deficient design brief results in a reduced quality of the end product. In any case, adverse implications for time, cost and/or quality are likely results of a deficient design brief.

These issues should therefore be considered by the principal at the outset, by ensuring an adequate design brief is delivered at first instance and ensuring any time limitations on delivery of variations by the principal, delivery of variation proposals by the contractor and action on variations by the contractor, are complied with.

2.1.2 Risk Allocation

Allocation of design responsibility is an important issue in design and construct contracts. Although design and construct contracts place the responsibility for design and construction of the project in the hands of one player, these contracts have high potential to create new risks for the principal.

Contracts should specify the extent of the responsibility of the principal and the contractor as regards design. Issues to be considered may include:

- the extent of the contractor's duty to inspect and verify any of the principal's consultants' plans prior to commencement of construction; and
- the principal's obligations as regards time and costs arising from a need to rectify design briefs after commencement of construction.

2.1.3 Conclusion

As with all traditional models of contract delivery, the design and construct contract has the benefit of its familiarity, the parties' general understanding of its delivery and administration and well-established contract documentation.

2.2 GUARANTEED MAXIMUM PRICE (GMP) CONTRACTS

The GMP contract is applicable to contracts both in traditional models and in alliance contracting. Its distinguishing feature, to be examined here, is its allocation of a high proportion of risk on the contractor, which would usually be apportioned as between the contractor and the principal on the contractor. Of particular significance is the apportionment of risk as regards time and cost.

As discussed earlier, a construction site is a fertile area for disputes. This is also true of cost fluctuations. In a GMP contract, a contractor's bottom line is subject to a range of external and internal factors, many of which are out of the contractor's control. The contractor is required to accept the risk of increased costs arising due to industrial actions, subcontractors' defaults, environmental conditions, variations and deficiencies in the principal's design brief.

Therefore, the GMP contract's allocation of risk favours the principal and provides the principal with greater certainty at the expense of the contractor. This risk allocation means that GMP contracts are more common in competitive marketplaces. Contractors are often rewarded for the additional risks by higher tender prices.

2.2.1 Conclusions: Traditional Models of Contract Delivery

Often the casualties in traditional delivery models are time, cost and the quality of the works. However, the benefits of traditional contracting methods are clear: they are 'tried and true' methods of contract delivery, in that they have been the subject of judicial review, parties are well-versed in their operation and administration and there is a bank of appropriate documentation available for their effective delivery.

2.3 ALLIANCE CONTRACTING

The concept of alliance or relationship contracting has developed in answer to the problems posed by traditional contracting models. Alliance contracting acknowledges the inherent risks involved in construction and project delivery and provides mechanisms to deal with disputes as they arise. Alliance contracting aims to ensure effective project delivery and resolve any disputes which arise, with a focus on the collaborative relationships between the alliance participants.

Large scale capital works projects are exposed to inherent risks, including political, economic, environmental and industrial factors arising from within the project and externally. Project alliancing has been employed as a means of dealing with an uncertain construction environment in which conventional contractual models may fail to offer the best outcomes for the parties.

Project alliancing is characterised by pro-active collaboration whereby all parties work together to achieve optimum outcome, whilst minimising inefficiencies associated with adversarial conduct. The enhanced ability of alliance participants to work together, embrace risk and uncertainty and deal with these factors in an innovative and collaborative fashion is the key to optimising outcomes for all participants.

Alliance contracting adopts a 'no blame' approach to contracting. On completion, the alliance participants share pain or gain collectively, effectively creating a situation whereby all participants "win" or "lose" at the end of the day. Thus, the risks and benefits associated with the project are shared between the alliance participants.

Furthermore, the alliance agreement usually provides that any failure by alliance participants to perform an obligation to or discharge a duty under the agreement will not give rise to an enforceable obligation at law or in equity, except to the extent that the failure also constitutes 'wilful default'. Alliance agreements will generally define 'wilful default' to mean intentional acts or omissions by alliance participants carried out without regard for the harmful consequences for other alliance participants, but not any acts or omissions performed in good faith, whether negligent or not.

In furtherance of the objectives of trust and dispute avoidance, alliance agreements commonly contain clauses which provide that the parties will not have recourse to arbitration or litigation in the event of a dispute. This emphasises the collective rather than individual accountability which alliance contracting seeks to establish.

The relationship of dependence created by the alliance agreement demonstrates effective risk sharing and illustrates the need for trust between the alliance partners in completing their contractual obligations.

Alliance contracting may be used to deliver a project which has been riddled with disputes. Adopting an alliance contract will assist in getting the project 'back on its feet' by re-distributing risk and responsibilities, motivating the parties to work in an environment where they know they will share the benefits and losses of the project. The parties will be required to undertake a significant change in thought process as to how they fit into the project, under an alliance agreement. A shift to an alliance agreement is also likely to preserve the parties' business relations by shifting from an relationship focussed on apportionment of liability to one where liabilities are shared.

2.3.1 Problems with the Alliancing Contract Model

The new contract structure of an alliance project inevitably has some teething problems. The success of an alliance contract is dependent on a number of factors.

Firstly, the nature of the project will have significant bearing on the success of an alliance contract. An alliance contract is generally best suited to large-scale projects which involve many parties which are required to work together on the project. Its use in smaller-scale projects may prove more difficult to manage in terms of the parties' "gainshare - painshare".

Secondly, as it is a developing area, there does not exist a body of contractual documentation as to alliance contracting and the administration of such contracts. Traditional standards may be used as a starting point, however careful and clever drafting will be required to adapt the alliance agreement to the particular project and alliance partners.

2.4 PROJECT REALIGNMENT AND ALLIANCE CONTRACTING

Project realignment is required where a project is required to be 'resuscitated' - where the project is not meeting required time, cost and/or quality indicators, where the parties are in dispute, or when changed circumstances dictate that there is a need to do a new deal.

Often, the parties will best succeed where the traditional 'hard-money', commercially-driven contract is abandoned in favour of an alliance agreement. An alliance agreement avoids the issue of apportioning blame between the parties, as any pain or gain is shared between the alliance partners, the alliance relationship is inclusive, rather than exclusive of any particular party or interest, and the alliance agreement forbids recourse to litigation in the event of a dispute. The alliance relationship also means that no particular party will be bearing the risk of the continuation of the project, in contrast to the situation under a traditional contract arrangement.

Breaking from the traditional contract to an alliance agreement will re-focus the parties on the end result and provide a new motivation for completion of the project.

2.5 FINDING THE BEST METHOD OF CONTRACT DELIVERY

Parties should take into consideration the advantages and disadvantages of the traditional methods and alliance contracting in determining which style of contract will govern their relationship for the construction of a project.

It should be remembered that traditional methods can be adapted to suit the parties' needs. This maintains the benefit of certainty which attaches to the traditional method, whilst ensuring that the parties' needs are met.

In other circumstances, particularly large-scale developments which involve numerous parties, alliance contracting may be the best method of contract delivery.

Parties should consider the range and levels of risks involved in each delivery method and ensure that their contractual obligations and responsibilities are well documented and understood. Furthermore, parties should attempt to project-specific information, such as design and liability issues, prior to commencement of the project.

In essence, risks should be allocated to the party who can best bear that risk. Whether it is the contractor or principal in any individual circumstance, the risks borne by each party should be realistic from the outset.

3. CASE STUDY

PROJECT ALLIANCE - CONSTRUCTION OF THE NOWRANIE CREEK SECTION, BARKLY HIGHWAY (MOUNT ISA TO CAMOOWEAL), QUEENSLAND, AUSTRALIA.

An example of the successful strategic use of an alliance agreement for major construction works is the Project Alliance Agreement made between the State of Queensland (acting through the Department of Main Roads), Leighton Contractors Pty Ltd and Myuma Pty Ltd (a subsidiary of the Dugalunji Aboriginal Corporation), for the construction of the Nowranie Creek Section of the Barkly Highway (Mount Isa to Camooweal) in north-west Queensland ("the Project").

The Project comprises an upgrade of the Barkly Highway and construction of several new bridges on the highway.

The Project is unique as the land on which the Project is to be constructed is the subject of native title claims, the region has a large indigenous population and is cultural significance to the Indjilandji and Dithanoo peoples. The Alliance Agreement therefore aims to address the significant cultural and environmental issues in the planning, construction and administration of the Project, in addition to the time, cost and quality parameters usually the subject of traditional contracts. The Alliance Agreement requires that the parties develop, implement and maintain policies and procedures relating to the construction of the Project which take into account the cultural and environmental interests.

In planning the Project, the Department of Main Roads consulted with the

local communities and particularly with the Indigenous Traditional Owners (ITO) groups. The Department entered into an agreement with the Dugalunji Aboriginal Corporation, as representative of the Indjilandji and Dithanoo peoples, to enhance the employment and training opportunities for ITO groups from the region and to provide opportunities for ITO groups to tender for the supply of products (particularly locally produced products) and provision of labour and services required for the Project. Myuma Pty Ltd will represent the interests of the ITO groups throughout the duration of the Project.

The alliance therefore addresses not only the commercial drivers for the project, such as the time, cost and quality parameters, but it also makes provision for the inclusion and representation of the indigenous peoples of the region, as well as cultural and employment considerations. This is exemplified by the requirement in the Alliance Agreement that the Department of Main Roads and Leighton act with full liaison and consultation with Myuma. Just as the Department of Main Roads is required under the Alliance Agreement to pay Leighton, Leighton is required to pay Myuma, and Myuma is required to provide labour and services, supply materials and perform a consultative role in the construction of the Project. Furthermore, the Alliance Agreement provides for an environmental management plan, a cultural heritage management plan, community liaison and ITO groups employment management plan.

Given the unique characteristics of the Project, the Alliance Agreement is the most appropriate method for project delivery, not only for the benefits of risk sharing, technical and financial output and savings generally associated with an alliance, but also because the alliance bridges the parallel between the private sector focus on commercial delivery on the one hand, and cultural, environmental and social demands and considerations on the other. The alliance agreement is a practical and legally binding method of bringing the two opposing interest bases together, to achieve set standards and outcomes effectively and efficiently.