# PAYING THE PRICE UNDER PROJECT ALLIANCES

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Most readers will be familiar with the concept of alliance contracting, and more particularly the spin which its advocates use sell the concept: non-adversarial and co-operative relationships based on respect, trust and integrity, working together towards mutual goals to achieve win-win outcomes, etc. But the crucial characteristics of a typical project alliance contract—the ways in which the contractor's remuneration is calculated, key risks are allocated and any cost overruns funded—are often not as well understood, especially by parties contemplating a project alliance contract for the first time.

The project alliance model of contracting has evolved out of a desire to get away from the inherently adversarial nature of traditional lump sum construction contracts. In conventional contracts the financial interests of owners and contractors are fundamentally opposed. The contractor's interest, having agreed on the lump sum, is to minimise its costs in order to maximise its profit, often at the expense of project performance. Design work, for example, becomes not so much a matter of exploring the best solution, but more a matter of inflexibility prompted by cost constraints. The owner's interest, having agreed on the lump sum, is in direct conflict with this: to maximise project performance, regardless of the impact on the contractor's profit margin. In this framework, disputes are almost inevitable.

There are two core features of most project alliance contracts: they discard the traditional lump-sum price model of remuneration in favour of a radical performance-based remuneration regime which aims to align the commercial interests of owners and contractors, and usually, but not always, they include a no blame, no disputes clause. The idea is attractive, but it is also worth sounding a general note of caution.

In short, while the project alliance model of contracting offers several advantages to both owners and contractors over traditional lump-sum construction contracts, potentially resulting in cost savings for owners and greater profits for contractors, these benefits do not come without risks, especially if there are cost overruns or defective work.

## A NEW APPROACH TO REMUNERATION

Remuneration is a fundamental part of any contract. So it is paradoxical that it receives very little attention in most discussions of project alliancing. Under the typical Australian project alliance, the contractor's remuneration essentially comprises two discrete components. First, the owner agrees to pay all the costs incurred by the contractor—and the other alliance participants, if there are more than one—on the project, even if they are greater than expected and even if the project fails to perform as expected. These direct costs exclude any profit or margin. Second, the owner agrees to pay what is known as a gainshare or gross margin payment to the contractor, provided certain agreed key performance indicators (KPIs) are met.

The maximum possible amount of the gainshare payment is a fixed lump sum, not a percentage of the final project cost, and is agreed upfront. This amount is generally set at the level the contractor would receive to cover its normal profit margin and make a contribution to its overheads under a traditional lump sum contract.

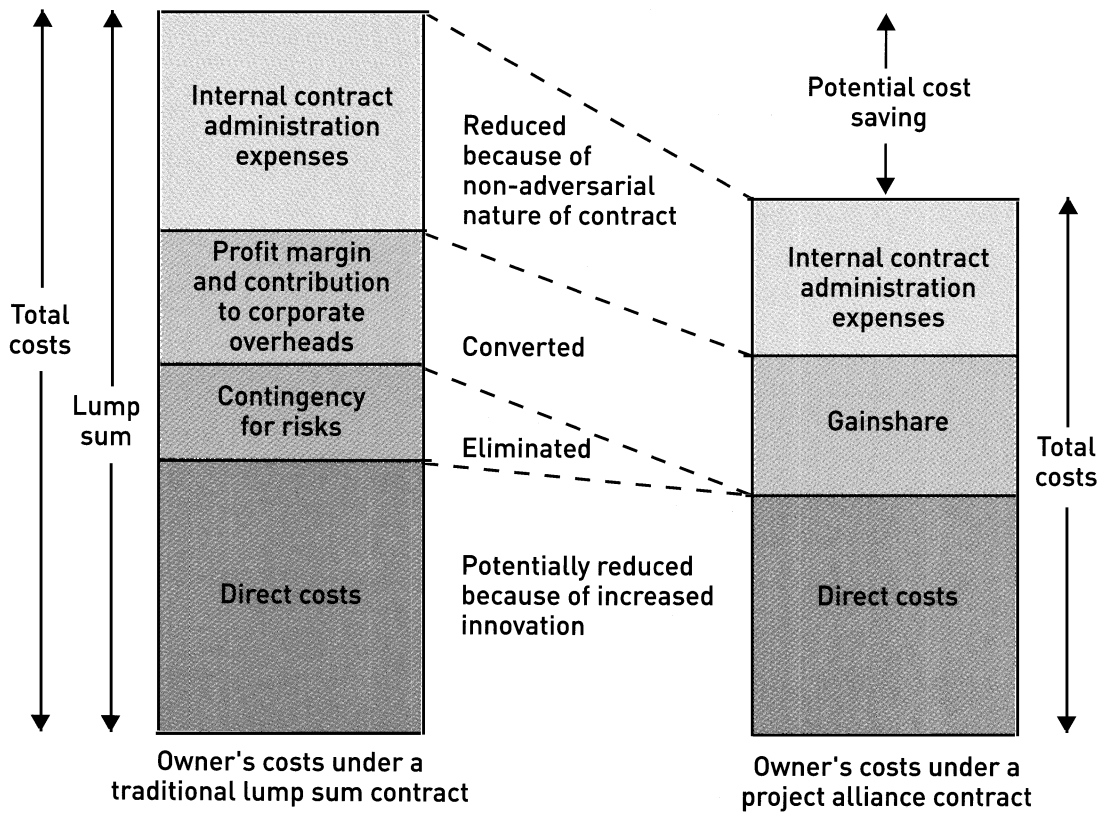
The KPIs against which the contractor's performance will be assessed are also agreed upfront. At their simplest they include a target cost and time for completion, but other KPIs may be added, depending on the owner's other objectives. In Australian examples other KPIs have dealt with safety, environment, industrial relations, community relations and even the operating performance of the project.

If all the KPIs are achieved the owner must make the full gainshare payment if one or more of the KPIs is not satisfied the gainshare payment, and hence the profit derived by the other alliance participants, is reduced. In this way, the non-owner participants put their profit at risk, dependent upon their performance.

Sometimes the owner also agrees to share any cost savings—that is, the difference between the final cost of the project and the agreed target cost with the other participants by adding a proportion (say 50%) of the cost savings to the gainshare payment provided all other KPIs are met. In this way, extraordinary performance by the other alliance participants can be rewarded with extraordinary profits.

At first sight the requirement for the owner to pay all the costs incurred by the other alliance participants might seem to suggest the owner bears all the risk of increased or unforeseen costs. But this risk is in fact shared between the owner and the other participants, because any increased or unforeseen costs may cause the final cost of the project to exceed the target cost, thereby reducing the gainshare payment, and hence the profits, of the other participants.

The potential cost savings for owners are shown in the diagram below.



**But the ramifications when things go wrong can be far-reaching. For example, because the entitlement of each non-owner participant to its gainshare payment depends on the performance of the other alliance participants, if any one of them fails to perform adequately all of them will suffer—but none of them will have any claims against the non-performing participant.**

As shown in the left-hand column, under a traditional lump sum contract the price has three components: an amount the contractor charges to cover the direct costs it expects to incur in completing the work, an additional amount, or contingency, to cover the contractor's additional costs if risks for which it is responsible under the traditional contract materialise, and the contractor's profit margin and contribution to overheads.

The owner also has to meet its own internal contract administration expenses in checking the contractor's work, processing payment claims and managing and defending any disputes.

Under a project alliance contract, as shown in the right-hand column:

- there is a potential for, but no guarantee of a reduction in the direct costs, through the combined effects of the gainshare KPI incentives to contain costs and meet other performance targets and the no blame, no disputes clause, which essentially 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;
- the contingency cost is eliminated, because the owner has already committed to pay all the costs incurred by the contractor even if they exceed the target cost;
- the contractor's normal profit margin and contribution to overheads are converted to the gainshare payment, with the maximum possible payment being agreed upfront;
- the owner's internal contract administration expenses are generally reduced, because the non-adversarial nature of the relationship reduces the resources required for managing and defending claims and disputes.

There is thus a significant potential for overall cost savings to the owner. But there is no guarantee. Indeed, because the owner is obliged to pay all the direct costs of the other alliance participants, even if they exceed the agreed target cost, the owner's cost exposure is potentially unlimited. Further, the owner is required to pay the costs of the other participants even if they fail to do the work properly. Indeed, if rectification work is required to fix mistakes made by the other participants, the cost of this must also be paid by the owner. All that the contractor puts at risk is its gainshare payment. So the adoption of a project alliance structure requires something of a leap of faith by the owner, confident that the potential efficiencies will be realised and will result in a lower overall project cost.

Not all owners are willing to go so far, and many are exploring variations to the standard project alliance structure to reflect other allocations of the risks. They argue there is no reason why a performance-based contractor should not still be liable, under a project alliance contract, for those risks clearly within its own control.

No blame and no disputes—but unexpected consequences. Under the no blame, no disputes clauses found in many project alliance contracts, each alliance participant agrees it will have no legal claims against any of the other participants, except in the case of narrowly defined wilful defaults. The purpose of this clause is to encourage the participants to take risks and accept stretch targets in the pursuit of extraordinary results.

But the ramifications when things go wrong can be far-reaching. For example, because the entitlement of each non-owner participant to its gainshare payment depends on the performance of the other alliance participants, if any one of them fails to perform adequately all of them will suffer—but none of them will have any claims against the non-performing participant.

Similarly, the owner will have no remedy against the other alliance participants for losses suffered as a result of their negligence or inefficient or defective work practices. And there are likely to be problems with design insurance. Under most policies the insurer won't pay unless the designer is liable, and the designer is liable only for wilful defaults, which most policies specifically refuse to cover. So some owners are now considering project alliance structures without a no blame, no disputes clause, or clauses with a much broader exception than just wilful default.

True believers often argue that the no blame, no disputes concept is an essential ingredient of project alliancing. However, there is no reason why many of the other benefits of the standard project alliance model, including the efficiencies associated with the novel remuneration structure, cannot be obtained, at least in part, without such a clause.

## BREAKING DEADLOCKS

Most Australian project alliances establish alliance boards with representatives of all the participants and require all decisions made by these bodies to be unanimous. This arrangement is considered by many to be crucial to the success of the project alliance approach, as it forces the parties towards mutually acceptable solutions. But what if unanimity simply can't be achieved, and there is no mechanism for breaking the deadlock?

An inability to resolve such a dispute can bring the whole ongoing legal basis of the alliance into doubt. The absence of an ability to quickly resolve deadlocks at the alliance board level can also result in significant delays to the progress of a project. In addition, some owners feel the requirement for unanimity has resulted in a loss of ownership and control over their projects.

Possible variations to the standard project alliance model to address these concerns include:

- an ability to resort to an alternative dispute resolution process outside the alliance when disputes cannot be resolved within the alliance, and
- in other cases, a casting vote for the owner on certain types of decisions, but on the basis that any knock-on effects of the decision on, say, the remuneration regime will be determined by the normal decision-making process.

One of the alternative dispute resolution processes being explored is the so called swing man process. Under this process, disputes which cannot be resolved unanimously by the alliance board are referred to an independent third party, and each alliance participant makes a submission on how the dispute should be resolved. The independent third party must then choose which of these competing positions it prefers, having regard to the terms of the alliance agreement. It is not entitled to impose its own, separate solution. The theory is that each party will be discouraged from making an extreme submission, for fear that the third party will prefer the other's position, and this will assist in achieving a resolution which all the participants can live with, minimising any ongoing damage to the alliance relationship.

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