

FACTS ABOUT

An Information Update from the IADC



ALLIANCE CONTRACTS

WHAT IS AN ALLIANCE CONTRACT?

An alliance contract is, legally speaking, a contract like any other. The essence of an alliance contract is more in the process than in the formal contract. The foundation lies in the different approach to co-operation between clients and contractors. Trust instead of distrust is the basis of an alliance contract, although a clear and transparent contract is still needed to support this spirit of trust. An alliance contract seeks to move away from the traditional “adversarial” approach in which parties are first of all competitors. Alliance contracts involve a collaborative process which aims to promote openness, trust, risk- and responsibility-sharing and the alignment of interests between clients and contractors. The focus is on the best arrangement for project delivery rather than on self-interests, typical of traditional contracts.

WHAT IS AN ALLIANCE CONTRACT STRATEGY?

An alliance contract requires a different strategy from traditional contracting. Parties will in an early stage of the project seek to align their (commercial) interests and avoid win-lose scenarios. They will accept a collective responsibility for risk, performance and outcome (gain-sharing / pain-sharing) and avoid a blame culture. Parties will at the soonest possible stage start forming integrated teams to work out strategies from which both parties, and the progress of the project, will benefit.

HOW DOES AN ALLIANCE CONTRACT DIFFER FROM A TRADITIONAL CONTRACT?

First and foremost the difference between alliance contracts and traditional “adversarial” contracts lies in the underlying premise of the contract. The dredging industry, and the same is true for the construction industry as a whole, has to care for its commercial interests in order to survive and prosper. Protection of these interests absorbs a huge proportion of intellectual and professional energy. The commercial

imperatives can divert dredging industry capability away from dredging. This diversion of capability, intellect, attention and energy away from project construction is a major inefficiency. This win-lose attitude leads to inefficient allocation of intellectual and professional resources. Traditional forms of contracting cause parties to adopt defensive behaviour, which leads to adversarial relationships and therefore to misdirected efforts. Alliance contracting removes the necessity for diversion of effort into protection of commercial interests by seeking an alignment of commercial imperatives. This alignment makes possible joint management of the risks and the project as a whole, resulting in a more effective process. An example of how the alignment of interests works: Normally a contractor profits from a longer-lasting project, while the client profits from the earliest possible delivery. In an alliance contract parties may agree to share an early delivery bonus, so that both parties have the same interest: A speedy delivery of the project.

HOW DOES AN ALLIANCE CONTRACT DIFFER FROM PARTNERING?

Partnering is in itself not a contract. A partnering charter may run parallel to a traditional contract providing guidelines to the relationship amongst the various partners. Alliancing is sometimes seen as an outgrowth of a partnering relationship which results in a legally enforced contract.

WHAT DOES THE ALLIANCE ESTABLISHMENT PROCESS LOOK LIKE?

The procurement process for an alliance contract is quite similar to a traditional procurement process. In a typical procurement process, pre-qualification of four to six alliance partners is awarded based on the responses to the Expression of Interest (EOI) documents. Interviews then take place with these parties, after which two contractors are shortlisted. After further and more detailed interviews, questionnaires, on-location visits and/or third-party references, the final selection is made and an Interim Project Alliance Agreement

Images used in this document are taken from the New Suez Canal project, which was a titanic effort in logistics. Six global dredging contractors completed the works within one year. The contractors disposed of more than 245 million m3 of sand in just nine months.

(IPAA) is signed. On the basis of the IPAA project planning, design and investigation commences. This will result in a Target Cost Estimate (TCE). As soon as parties agree on the TCE, the contract can be signed and the alliance is official.

WHAT DOES AN ALLIANCE CONTRACT LOOK LIKE?

Especially the first part of an alliance contract will clearly differ from a traditional “adversarial” contract, as the contracting parties set out the alliance principles, good faith commitments, an alliance board is established and no-dispute provisions are adopted. An alliance contract will as much as possible consist of contract arrangements that drive parties together, rather than apart. If a major change of scope or direction in the dredging project occurs, the alliance board may decide to adjust the TCE, which is the basis for gain-sharing / pain-sharing. Notably lacking in an alliance contract are firm time and cost obligations and liability is limited to wilful default. A model alliance contract may include the following categories of documents:

- a deed of agreement that defines the terms and conditions of the agreement,
- annexes containing the client’s project requirements,
- schedules in which the tenderers placed their replies to the client’s project requirements,
- General Conditions of Contract and
- technical specifications.

In the contract the non-financial components such as administration and plans for the environment, communication and workplace health and safety may be modified to suit the particular needs of the project. The commercial arrangement can be modified to reflect gain share and pain-share provisions and key performance indicators.

The author of the model contract will determine how the project design and construction risks are to be distributed between the contractor and the client. This distribution can be revisited during the tender assessment and modification phase to reflect the contractor’s preferred distribution of risks. All the basic elements of a traditional contract can also be found in an alliance contract, only often less detailed, with a different way of risk allocation.

WHAT ARE SOME OF THE CHARACTERISTICS OF AN ALLIANCE CONTRACT?

An alliance contract is not a formal form of contract and as yet it is not a very common form. Still, its essence can easily be grasped. An alliance contract does not solely rest on legal clauses; non-legal considerations such as trust, openness and a collaborative and constructive mentality also play an important role.

In fact, the choice of form of contract is less important than it might seem. If parties share a constructive and collaborative attitude from the beginning, then the best form of contract should automatically follow from that approach.

DOES AN ALLIANCE CONTRACT POSE THE DANGER OF LEADING TO CONFLICT?

Working in an alliance contract does not lead to conflict or

confusion, even though in the contract far less emphasis is on legal considerations and on time and cost obligations than might traditionally be expected. Conflict is avoided by defining the nature and the extent of the co-operation at an early stage of the project and by establishing an effective alliance board which, if and when necessary, can intervene as a deadlock breaker.

IS AN ALLIANCE CONTRACT MORE COMPLEX AND TIME-CONSUMING?

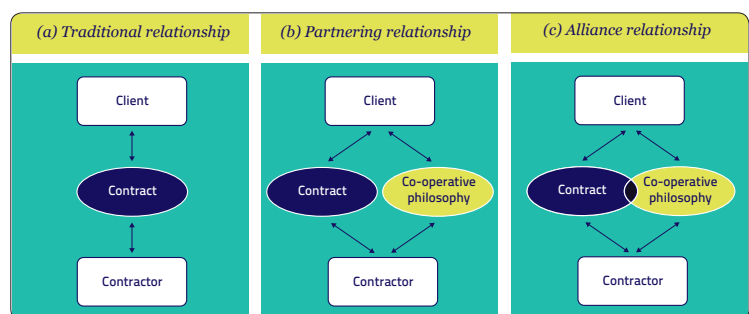
An alliance contract cannot function without a true spirit of co-operation. This means that parties have to invest in better and more frequent communication which might seem to be a negative. On the contrary, however, this investment in frequent communication means that time is often saved in other areas. For instance, the client and contractor work much more closely as a team and are far less competitive, especially since these teams are created early on in the project. In addition, the alliance board plays an important role in mitigating conflicts and increasing efficiency.

WHAT IS THE ROLE OF THE ALLIANCE BOARD?

Traditionally all the eventualities of a dredging project are dealt with in the contract. Contracts are therefore often very detailed and do not allow much room for flexibility. The traditional contract is often the product of long and difficult negotiations and parties are therefore reluctant to open the contract again.

In contrast, a good alliance contract has a major instrument to promote the spirit of co-operation necessary to making an alliance contract a success: The alliance board. The alliance board has a mandate to deliver the project in accordance with the agreed goals. Many of the decisions of this board will be taken in the planning phase, but some will be taken during execution.

The alliance contract is much less detailed and leaves many of the decisions to the alliance board. Decisions are therefore often taken at a more appropriate moment when additional information is available, information that may not have been available at the time the contract was signed. Traditional contracts often contain provisions which prove to be unrealistic as a project progresses. It takes time to the correct these false assumptions and thus time is saved when decisions are taken at the right moment. The alliance contract will have enough provisions and checks and balances to prevent the spirit of co-operation from turning into tunnel vision.



Graphic representation of the differences between traditional, partnering and alliance relationships. Based on a drawing from Tang, Duffield and Young.



HOW ARE DISPUTES RESOLVED?

In an alliance client and contractor release each other from all liability except in the case of “wilful default”. Disputes have to be amicably resolved in the alliance board, although sometimes (not in a “pure” alliance contract) an ultimate deadlock breaker has been appointed. The philosophy here is that rather than spending time and energy on apportioning blame, the better approach is for the parties to work co-operatively to overcome the problem on a cost-effective basis. Similarly the design process, unconstrained by liability apportionment issues, is intended to be more innovative, iterative and co-operative.

DO ALLIANCE CONTRACTS LEAD TO A DIFFERENT WAY OF RISK ALLOCATION?

Traditional contracts recognise different ways to allocate (the responsibilities for) risks and the same is true for alliance contracts. Still, it can be said that alliance contracts tend more toward risk sharing and less toward allocating the risk to one party. This is the logical consequence of co-operating in the early stages of a project. Early co-operation also provides the possibility of an early risk analysis. An early analysis is a condition for the attribution of the risks to one of the parties, preferably the party that can steer the risk.

WHAT ARE THE MAJOR ADVANTAGES OF ALLIANCE CONTRACTS?

Alliance contracts can diminish the threat of disputes through a more co-operative approach between principals and contractors, which leads to several advantages:

- Most risks remain within the alliance which has included a provision about this in the TCE. The contractor is entitled to be reimbursed for all direct costs even in the case of delay, negligence, cost overruns or defective design.
- More contractors are likely to bid on projects because of the shared liability exposures and a greater ability to prevent and pass through cost increases and delay risks.
- The design process can in principle be more innovative and co-operative when unconstrained by liability apportionment issues.

WHAT ARE THE DISADVANTAGES?

In most alliance contracts time and cost obligations are notably lacking; the emphasis is on the result, e.g. delivery of the project, and less on the road that leads to the result. This brings with it a degree of uncertainty about budgets and

delivery dates. If a project has an inflexible completion deadline or inflexible budget, then an alliance contract could lead to major problems. Unfortunately, but understandably, the dredging industry is more often than not confronted with inflexible deadlines or budgets. Government agencies, which are often the client, do not in general have the liberty to engage in projects with open deadlines or budgets.

The organisation of an alliance contract can also be much more difficult as soon as more than two parties are involved. With three or more parties, an alliance board may easily become unmanageable. Parties may therefore prefer a traditional contract with all the usual certainties. Also, third parties confronted with an existing alliance contract may wish to deal only with either the contractor or the client, not with both. In an alliance contract three can seriously be a crowd.

Third-party involvement may even lead to a conflict of interests. Nowadays the willingness to work in an alliance can be one of the selection criteria for a construction contract. But, because of obligations deriving from relationships with third parties, forming an alliance contract may turn out to be difficult.

CAN ALLIANCE CONTRACTS BE FINANCED?

At first sight, the shortcomings of an alliance contract on traditional bankability issues, such as certainty of time and cost, appear critical. Still, banks are more and more coming to terms with the concept of alliance contracts. For this they rely on:

- Enhanced due diligence: not just on technical and engineering issues, but also, and perhaps most importantly, on the alliance track record of the participants. Have they got the right background, people and systems, and a genuine commitment, to make it work?
- Financing structure: This will need to be prepared for reasonably foreseeable overruns by various means, including:
 - more equity, or contingent equity, in the form of sponsor standby commitments triggered by delays or cost overruns, or even sponsor completion guarantees; and
 - cost overrun debt facilities, typically attracting a higher margin and repayable by a cash sweep.
- The alliance contract itself will contain such mitigants as:
 - a gain-share / pain-share mechanism which seeks to achieve an alignment of commercial interests;

- a reasonably prescriptive process for subcontracting and direct procurement;
- a “reserved powers” provision under which particular topics of concern (e.g. functional or output specifications, emergencies) are taken out of the jurisdiction of the alliance board and placed under the exclusive control of the client; and - banks will generally prefer to see a deadlock breaker to cover any prolonged failure of the alliance board to agree on a material issue.
- Insurance: Professional indemnity insurance in particular will need special wording to make it effective despite the exoneration of the contractor for negligence and defective design.

IS AN ALLIANCE CONTRACT ALWAYS THE BEST OPTION?

Alliance contracts are by no means the only form of contract for the future. Traditional contracts probably remain the most appropriate form of contract for small scale, straightforward, short-term jobs. In such cases alliance contracts may be overkill, because they need time, energy and devotion to succeed.

Furthermore, not all parties can easily adopt the spirit of trust and co-operation that is essential for an alliance contract to succeed. A client or contractor, who feels more secure with a clearly defined legal contract, without too many non-legal considerations (“I prefer a good and sound contract, just in case things go wrong”) is well advised to work according to a traditional form of contract. Still for large-scale, complex projects which require long-term planning and execution, an alliance contract offers a unique opportunity to work in a cost-efficient manner that can result in a win-win situation for contractor and client.

FOR FURTHER READING AND INFORMATION

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Facts About is presented by the International Association of Dredging Companies whose members offer the highest quality and professionalism in dredging and maritime construction. The information presented here is part of an on-going effort to support clients and others in understanding the fundamental principles of dredging and maritime construction.

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