

# Relationship Contracting

- **Australian Constructors Association.**

The Australian Constructors Association (“ACA”) has developed the concept of “Relationship Contracting”, has published an A4 booklet called “Relationship Contracting – Optimising Project Outcomes” which explains and illustrates the concept, and on 29-30 June 1999 will conduct a seminar in Sydney entitled “Relationship Contracting In Construction”.

The ACA believes that successful relationship contracting is based on common sense, open mindedness, adaptability, inventiveness, prudent risk-taking, fairness and commitment.

Set out below with the kind permission of the Australian Constructors Association are some extracts from Relationship Contracting – Optimising Project Outcomes.

**EXECUTIVE SUMMARY**

The ACA is a national organisation formed in 1994 to represent major contractors. The ACA Board members are the chief executives of each of its eighteen member companies. ACA member companies have a combined annual turnover of \$15 billion, employ 49,000 people and account for around 30% of construction activity in Australia.

ACA is dedicated to making the construction industry more efficient, competitive and better able to contribute to the development of Australia, through positive leadership, open communication, and a commitment to infrastructure.

**Industry Survey**

A key objective of ACA is to improve the industry’s commercial and contractual practices with the goal of optimising project outcomes for clients and contractors.

In 1998, the ACA undertook a survey of the industry’s major private and public sector clients through a programme of interviews with their chief/senior executives to understand their:

- experience of contractors;
- expectations of contractors; and
- views on how project outcomes could be improved.

The ACA survey findings, with respect to clients’ experience and expectations of contractors, included:

- project outcomes were sub-optimum on too many projects;

- clients continue to utilise traditional delivery systems which they acknowledge have shortcomings and that often lead to adversarial relationships and overruns in cost and time; and
- clients believe the following factors contribute to successful project outcomes:
  - clear project goals;
  - clear definition and understanding of the project scope;
  - clear understanding and appropriate allocation of risks;
  - agreed risk/reward arrangement;
  - appropriately skilled project staff; and.
  - well defined communications through all levels of the contracting parties with proper empowerment for decision making.

The ACA survey also sought clients’ views on the way forward, towards the development of what we have termed relationship contracting, utilising delivery strategies based on closer alignment of client and contractor goals and a better understanding of risk sharing – a win-win outcome.

**Relationship Contracting**

Relationship contracting is based on achieving successful project outcomes, which include:

- completion within cost;
- completion on time;

- strong people relationships between the parties resulting from mutual trust and cooperation, open and honest communication and free sharing of information;
- optimum project life cycle cost; and
- achieving optimum standards, during execution and in service for safety, quality, industrial relations, environment, and community relations.

We have defined relationship contracting as a process to establish and manage the relationships between the parties that aims to: remove barriers, encourage maximum contribution; and allow all parties to achieve success.

ACA believes that:

- successful relationship contracting is based on commonsense, open mindedness, adaptability, inventiveness, prudent risk-taking, fairness, commitment, and the reflection of these values in behaviour by the contracting parties; and
- proven delivery strategies and techniques exist which optimise project outcomes and deliver optimum commercial benefits to all parties involved.

It is important to note that these proposals apply principally to major projects and are based on the views of clients associated with major projects.

**Key Messages Identified**

A number of key messages emerge from our work:

- Clients and contractors are best served when the delivery strategy utilised suits the project requirements.
- Many clients still utilise project delivery systems structured to alter the allocation of risk and neglect the opportunities to be gained through improving the relationship between the contracting parties.
- For larger projects, where there are many unknowns and uncertainties, the client can better manage its risks through a more cooperative approach where the risk is embraced rather than transferred.
- Where an examination of the risk allocation indicates that a risk embrace approach will be more suitable, relationship contracting offers the parties a variety of techniques to ensure that the goals of the client and contractor are closely aligned within a gainsharing/painsharing framework that balances risk and reward and focuses both parties on an optimum project outcome.
- Relationship contracting requires the parties to become result focused and willing to challenge conventional standards. The focus

is on a cooperative endeavour to improve project outcomes rather than establishing a legal regime to penalise non-conformance.

In the latter parts of this publication, we have set out some of the fundamentals of relationship contracting and discuss the practices, processes and techniques to guide clients and contractors.

We have included case studies of projects where the contracting parties utilised the practices and techniques of relationship contracting, resulting in very successful project outcomes.

It is ACA's view that a commitment by clients and contractors to work towards relationship contracting will result in a more efficient and effective Australian construction industry, and that the factors that result in a successful project should be understood and adopted as a benchmark.

**The Way Forward**

ACA's key objectives are to promote and develop with their clients contractual relationships and project delivery systems which will:

- raise the standard of contract arrangements towards the development of a more efficient, equitable and globally competitive industry; and
- foster the development of relationship contracting within a competitively robust industry,

thereby delivering projects with significant price advantages and efficiencies, both in capital and operating cost terms, and other successful project outcomes for clients and contractors.

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**NEED FOR CHANGE**

**Feedback on the Way Forward**

The comments below apply principally to major projects and come from clients associated with major projects.

- The majority of clients are supportive of the concept that, prior to detailed documentation, clients and their short-listed tenderers meet and, as a result of these meetings, the following documents would be prepared by the clients:
  - a Terms Sheet which sets out in plain English the respective obligations of each party to the fundamental issues in the contract; and
  - a Risk Allocation Matrix in which all risks envisaged in the contract are identified and the responsibility for managing these risks is allocated.

It was generally agreed that this approach should add an additional degree of commercialisation to the project outcomes, a degree missing when documents are prepared by clients and their advisers without reference to the construction industry.

In the interviews, there were a number of varying approaches taken but the above comments are representative of the discussions.

- Clients generally agreed that they should devote more resources to improving their definition of the Scope of the Contract.
- With the outcomes of the Terms Sheet and Risk Allocation Matrix, the contract documentation can be produced with results in superior project outcomes and a reduction in adversarial behaviour of the parties.
- Clients were, generally, open minded as to the form the contract could take, such as traditional, some form of relationship contracting or another form. They do see that prior to entering into some form of relationship contracting both parties will need to commit resources to ensure the chemistry of the contracting parties is compatible and appropriate for the contract form and scope.
- Clients, in general, are supportive of sharing risks and rewards/losses. However, some remain cynical about the contractors' willingness to share in any losses. Contractors tend to become adversarial in such circumstances.

Relationship contracting focuses on finding solutions to problems, rather than adversity and litigation.

MANAGEMENT OF RISKS

Traditional Risk Transfer

All major projects involve inherent risks. At the onset of the project these risks are "owned" and managed by the client.

The traditional risk management strategy adopted by clients has been to transfer as much of this risk as possible to others. This approach is typically evidenced by lump sum, schedule of rates and turnkey projects. It is a strategy that has served clients well for many years, although it is not always the most appropriate strategy.

Clients often try to transfer risks to designers and contractors that are more within the control of the client. This strategy is often pursued on the assumption that the extremely competitive nature of the Australian construction market will allow these risks to be transferred without paying any premium. However, this strategy often fails, creating an adversarial climate, a high level of commercial disputation, time and cost overruns and overall poor performance.

Poorly defined objectives, inadequate documentation, inadequate time and cost planning, unreasonable risk allocation and inadequate project staff contribute to the failure of these strategies.

Faced with a risk transfer strategy, it is often not in the contractor's interest to be flexible. However, given the adversarial nature of relationships, it may be in the contractor's interest to allow a problem to unfold rather than to deal with it positively. At its worst, the contractor's interests may be best served by pursuing strategies aimed at increasing the overall cost to the client.

Contracts fail if clients attempt to transfer all project risk to the contractor, or if the contractor seeks higher returns without accepting a greater proportion of project risk.

Risk Embrace Approach

The fundamental rationale for the client to utilise relationship contracting is that, in certain circumstances, the owner can better manage its risks by embracing them (rather than trying to transfer them) and then managing them within a flexible project delivery environment.

This requires a clear understanding of the principles of risk management within a project environment. A properly informed client will be able to recognise whether the circumstances suit a risk transfer or a risk embrace approach.

RELATIONSHIP CONTRACTING: DEFINED

Core Values/Guiding Principles

The relationship between client and contractor cannot be taken for granted. Even where the parties have established a close business relationship on previous projects, it is still important to build the relationship for each specific project.

The relationship must be founded on a set of strong, mutually held core values and guiding principles.

Core Values	Guiding Principles
Commitment	Total commitment to achievement of the project goals – actively promoted by the chief executives of all parties.
Trust	To work together in a spirit of good faith, openness, cooperation and no blame.
Respect	The interests of the project take priority over the interests of any of the parties.
Innovation	To couple breakthrough thinking with intelligent risk taking to achieve exceptionally good project outcomes.
Fairness	To integrate staff from all parties on a "best for job" basis.
Enthusiasm	To engender enthusiasm for professional duties and the project's social activities.



## RELATIONSHIP CONTRACTING: THE FUNDAMENTALS

The success of relationship contracting depends on the willingness of both clients and contractors to commit to change at an individual and project level.

### Alignment of Goals

Relationship contracting requires that all parties to the contract agree to align their individual goals, thereby establishing common or aligned goals for the project.

Agreement to these project aligned goals and the establishment of an effective Integrated Project Team will facilitate achieving total commitment from the parties and their staff to successfully complete the project. The proven technique of workshopping is critical to achieving agreement between the parties.

Parties work in a cooperative environment with common goals as opposed to the traditional “*conflict*” environment.

Alignment of goals is best achieved by the client taking a share of the project’s risk. Even taking a 10% share of the project’s risk produces a complete change to the attitude of the client at all levels. They cooperate to reduce costs rather than to increase costs. Contracts become enjoyable and productive rather than adversarial and negative. Under an adversarial contract, inspectors often insist on the contractor spending \$100,000 to give the client a \$1,000 benefit.

Under relationship contracting, if the client is carrying 10% of the risk, the inspector will only insist on the contractor spending \$10,000 for a \$1,000 benefit for the client – a massive improvement.

One of the common project goals will be the agreed Project Target Cost. The gainshare/painshare mechanism is structured so that the parties (client, designer and contractor) will either win or lose together. There can be no blame – success or failure is a joint responsibility. This is a significant departure from traditional project practice.

### Risk Allocation

As highlighted [above], equitable risk allocation is at the core of successful relationship contracting, with the various project risks assumed by the party best suited to manage them. To ensure appropriate risk allocation, a risk management analysis should be carried out.

The nature and scope of the project risks must be evaluated. Requests for tender documents should include either a risk allocation schedule or require tenderers to complete their own risk allocation schedule as part of the tender. The relationship contracting agreement is then structured to reflect the agreed risk allocation.

The relationship contracting agreement relies on realistic and sensible expectations on both sides. The agreement will fail if clients attempt to transfer all project risk to the contractor, or if the contractor seeks higher returns without accepting a greater proportion of project risk.

### Clearly Defined Project Scope

The importance of complete and unambiguous project goals and a project scope cannot be over emphasised – it sets the direction for all subsequent work.

When the outcomes of a project are less than satisfactory, it is often due more to unclear goals and scope, rather than poor design or management.

The work required to achieve the goals and scope of the project is carried out by a number of parties. It is critical to define completely and unambiguously the extent of the work to be carried out. This serves as a basis for the agreement/contract carried out by each party to identify all interfaces.

### Form of Contract

#### Australian Practice

Currently, Australian construction clients use unamended or modified versions of the traditional Standard Forms of Contract, e.g. AS4000-1997, or forms of contract developed by the clients’ legal advisers. These latter forms and modified versions of Standard Forms of Contract tend to be adversarial in nature and, as such, do not facilitate optimum project outcomes. Whilst the tendency is recognised in Australia, little has been done to improve the contract form.

#### International Practice – “Improved” Construction Contracts

This is in contrast to the UK where the Institution of Civil Engineers has produced an alternative form of contract, the New Engineering Contract, a contract form that is gaining industry support. This contract form incorporates a number of recommendations relevant to the development of relationship contracting. These recommendations include:

- fair dealings between all stakeholders to the project;
- firm duties of teamwork, shared financial motivation to achieve goals and win-win solutions to projects;
- clear roles and duties definitions for the parties. Defined project manager, contract administrator and arbiter roles and clearly nominated client’s representative;
- appropriate risk allocation amongst the parties;
- minimal changes to pre-planned works and a mechanism to evaluate such changes, including an independent adjudication where required;
- agreed methods and times for progress payments. Not solely by monthly valuations, i.e. upon achieving milestones;
- providing for speedy dispute resolution if any conflict arises; and
- incentives for exceptional performance.

The underlying philosophy of the New Engineering Contract is to encourage efficient and effective project management on construction contracts, and it particularly encourages trust and effective communication between the parties. The style is plain English and it is markedly different to the standard Australian forms.

## Integrated Project Team

The Integrated Project Team is comprised of senior member(s) from each of the parties involved in a project. The client is a member of this team.

This Integrated Project Team approach eliminates the traditional client/client representative/designer/contractor hierarchies.

The team has the responsibility and accountability to make all key decisions and to drive the project to achieve the aligned goals. It is, therefore, important that there is a clear understanding of the individual and collective responsibilities and accountabilities.

The selection of parties to relationship contracting is crucial to achieving successful project outcomes. The selection needs to be based on criteria including, but not limited to, commercial and technical competence.

The criteria must include less tangible factors associated with attitudes and receptiveness to cooperation, such as:

- appropriate behaviour as members of a team;
- establishing relationships with suppliers and subcontractors;
- making available key personnel and their personal commitment to achieving project goals;
- integrating staff from one party into another where it best suits project needs;
- continuous performance improvement programme; and
- eliminating inefficiencies at all interfaces.

The Integrated Project Team must be committed to achieving the project goals. It must operate on mutual trust that puts the best interests of the project ahead of purely self-centred gains, achieving a single and unified team.

Training and guidance by an experienced consultant “*facilitator*” is essential to achieve and maintain an effective Integrated Project Team.

## Gainshare/Painshare

The parties (client, designer and contractor) to an agreement should be aligned not only through common goals, but also through shared business interests in the project’s success, firmly linking profitability to performance. This approach, to be successful, must operate at all levels of the project, not just at the top.

By aligning parties to the project’s goals, they can be motivated to question costs, pursue best value and to innovate. It is possible to provide an environment that both effects behavioural change and fosters technical excellence.

This behavioural change requires the parties to operate with “*open books*” and the mutual review of all parties’ costings.

This methodology is used to establish the Project Target Cost and continues throughout the life of the project.

Under a reward and risk approach – a gainshare/painshare mechanism – the profit of the parties would be

reduced in the case that the Project Target Cost is exceeded and increased in the case where the actual costs are less than Project Target Cost, in accordance with agreed formulae.

The gainshare/painshare split between the parties is generally based on a 50% allocation to the client and 50% divided in proportion to the other parties’ contribution in the Project Target Cost.

The gainshare/painshare mechanism is structured so that the parties will either win or lose together.

This mechanism can also:

- incorporate other key performance indicators and a performance guarantee for the completed project/facility; and
- provide a key motivator and opportunity for the relationship contracting parties to achieve exceptional performance.

## Open Honest Communications/Behaviour/Change of Attitude

For relationship contracting to be successful, all parties need a positive change in habits, behaviour and attitudes towards project outcomes and towards one another.

This is achieved by formulation and agreement of project aligned goals, establishment of the Integrated Project Team and implementation of training techniques and skills development to sustain a team building environment and performance. This includes:

- comprehensive induction of all new members joining the team;
- external coaching and guidance to assist and reinforce the team approach; and
- workshop sessions to identify concerns and pinpoint key issues which need resolution, and setting stretch targets.

Open, honest communication between all individuals is effected by their belief that they are members of the team and that the entire team is focused on achieving the project aligned goals.

## Public Sector Issues

The issue of “*value for money*” is central to the probity concerns of government. For example, where a project is assessed against a number of criteria which provide benefits when assessed against cost, represents value for money.

This outcome is relevant to project delivery systems, such as project management, managing contractor and project alliancing, due to the fact that assessment of tenders on these delivery systems is not based on “*hard dollar*” tendering.

These delivery systems do provide a significant assurance of value for money. They are based on a cooperative approach, a philosophy of no disputes and no blame, and a containment of costs within Guaranteed Maximum Price or estimated Target Cost of the project.

This can provide a more effective guarantee of value for money than “*traditional*” projects with a propensity for conflict, claims and general price blowouts.

In government contracts, a probity auditor can be appointed as an independent observer of the decision making process in the evaluation of expressions of interest or tenders.

The public sector should ensure that the selection criteria and selection process is clearly communicated and transparent to all involved parties and monitored by a probity auditor.

### Facilitators

Relationship contracting requires a substantial change in behaviour by the client, designers, suppliers and contractors.

Facilitators have been valuable contributors to the successful establishment and ongoing performance of the Integrated Project Team.

The facilitator should assist and work with the Integrated Project Team to:

- build best practice behaviours;
- develop an environment of trust, cooperation and open communication;
- develop the goal of achieving excellent results; and
- maintain a focus on common project goals and the team.

### Legal Advisers

The traditional role of lawyers in drafting construction contracts has been to advise the client (whether it be owner or contractor) as to the relevant allocation of risks in any given project, and to ensure that the client’s objectives are reflected properly in the contract documentation. The very nature of that role has often led to a one sided perspective in the drafting and negotiation of contract documentation. Client’s and contractor’s attitudes in the contracting process have also driven this approach.

The challenge to legal advisers to clients and contractors in the implementation of relationship contracting will be to fully embrace the new approach to the relationships between contractors and clients.

Lawyers must recognise that the type of documentation and language used can assist in the development of open and honest relationships between clients and contractors and optimise project outcomes. This will involve a substantial shift in perspective in advising clients and contractors. Lawyers have an important role to play in educating their clients as to the benefits of relationship contracting.

With the commitment of their clients to the objectives of relationship contracting, lawyers will then be able to assist the process by drafting more appropriate documentation to reflect the common goals of the client and contractor with an equitable risk allocation.

The key to successful relationship contracting will be to ensure that the form of contract documentation is

appropriate to the business relationship between the clients and the contractors and which assists in administration of the contract and achievement of project outcomes.

Those documents will also need to provide adequate forums for discussion, teamwork and open and honest communications which lie at the core of a successful project.

Clients and contractors must direct lawyers to prepare contract documentation which operates as a management tool designed to facilitate the business relationship.

### Third Party Advisers

The most valuable input from third party advisers typically occurs at the outset of discussions between the parties about a proposed relationship contracting project delivery strategy, during project formation and definition, and during the development of formal contractual and commercial arrangements.

There is also a useful role for independent reporting on performance and progress.

The specific role of third party advisers typically includes:

- reviewing the operation of proposed commercial arrangements between parties to the relationship contracting project delivery strategy;
- advising on suitable contractual and commercial arrangements including allocation of responsibilities and the structure of risk/reward sharing mechanisms;
- implementing workshop approaches for developing a group approach to identification of goals and objectives, stakeholder interests, functional performance requirements, and risk and constraints; and
- reviewing and reporting on progress and achievement of outputs during the project.

Third party advisers must be able to effectively communicate suggestions and opinions to all parties and to achieve a high level of confidence by the group in the result of its activities.

For more information about Relationship Contracting, to obtain details of ACA’s forthcoming seminar on the concept or to obtain a copy of “Relationship Contracting – Optimising Project Outcomes”, contact:

Mr Jim Barrett  
Secretary  
Australian Constructors Association  
Level 4, 51 Walker Street  
North Sydney NSW 2060

Phone: (02) 9466 5566  
Fax: (02) 9466 5599