



PCI response to DTF's Practitioners' Guide to Alliance Contracting (Exposure Draft)

1. In November 2009 the Department of Treasury and Finance, Victoria (DTF) published a report entitled *In Pursuit of Additional Value - A benchmarking study into alliancing in the Australian Public Sector*.¹ The study was co-sponsored by the state Treasuries of Queensland, New South Wales and Western Australia.
2. The Benchmarking Study addressed (among other things) a widespread concern over the inability of alliancing to demonstrate value-for-money in the absence of price competition. The study was widely perceived as controversial,² nevertheless has become the foundation for a significant change in the policy and practices associated with public sector alliances. Central to this change is a new *Practitioners' Guide to Alliance Contracting* (the Guide), with an Exposure Draft released for comment in July 2010.
3. This document summarises feedback from PCI Alliance Services (PCI) in response to DTF's invitation to comment on the Guide. Elements of PCI's response have also been incorporated into the Alliancing Association of Australasia (AAA)'s feedback to DTF (including all of our comments on the model PAA). Whilst we touch on some of the positive aspects of the Guide, this review is necessarily focused on opportunities to improve the draft, so the balance between positive and negative comments in this document is unrepresentative of PCI's overall view of the Guide.

The Guide contains some very helpful advice and information

4. The Guide contains some excellent information and commentary that will be helpful to Owners and others engaging in alliancing. This includes:
 - Codification of the key features of alliancing, including endorsement of the foundational principles such as collective responsibility and joint management of risks;
 - An unambiguous obligation to drive the project in a manner which is consistent with the Owner's Business Case and Value-for-Money (VfM) Statement;
 - Clear endorsement of the importance of establishing an effective team culture; and
 - A clear exposition of the various roles in establishing and delivering an alliance, including distinction between legal and commercial roles (which in PCI's experience are rarely available in a single individual or firm).
5. We also acknowledge the complexity of the subject and that the Guide seeks to enable Owners to reap the benefits of competition where practical, whilst retaining the benefits of the alliance approach. For example we applaud the recognition that the quantum of the NOP's fee "has a marginal impact on VfM outcomes... compared to other VfM elements such as the Project Solution" (page 53).

There are key gaps in the understanding of alliancing presented in the Guide

6. The picture of alliancing presented in the Guide contains some critical gaps or misunderstandings which could mislead the reader or limit the benefits obtained through alliancing. We believe that the Guide would provide better guidance to users if improvements were made in the following aspects.

¹ The Benchmarking study is available from the DTF website via www.dtf.vic.gov.au/project-alliancing

² For example see *PCI comments on DTF Alliancing Benchmarking Study* via <http://www.pci-aus.com/article.asp?id=8&cid=1>



7. The 'Introduction to alliancing' (Section 2) outlines the theory and background to alliance contracting, and the critical success factors. We believe there is a need for greater emphasis on the role of leadership (including why an 'Alliance Leadership Team' is so titled). In our experience the quality of leadership is central to the success of an alliance, hence should be included in the discussion of alliance success dynamics (Figure 2.2 et al.) There is a helpful discussion on the importance of leadership at the end of Section 2.5 but this is somewhat out of place and does not reflect the importance of this subject to achieving VfM.
8. The various statements in Section 2 and elsewhere about increased risks to the Owner under an alliance are not balanced by any commentary about the limitations of conventional contracts. Under a 'risk-transfer' contract the behaviour of the parties in protecting their interests often amplifies any problems that arise, so for highly complex or risky projects it is unrealistic to assume that the Owner can in practice transfer all risks (whether economic or political) to other parties. The Guide should explain the experience that the alliance approach of collective assumption of risks actually minimises their impact, which is why alliances are so widely used for complex public infrastructure projects.
9. The Guide discusses the merits of a downside cap on NOP painshare and promotes the idea (on multiple occasions) that this may be undesirable, without describing the key reason why the cap is used so often. The Guide should explain that while the downside cap creates a sense of asymmetry, most Owners prefer this to the likelihood of far more damaging consequences if NOPs find themselves bearing significant losses. Without this understanding any decision by an Owner regarding the downside cap would be ill-informed, hence this is a critical omission – particularly as the price-competitive establishment approach may lead to TOCs being exceeded more frequently.
10. The brief commentary on program alliancing (Section 2.6) describes a program alliance as “effectively a prequalified panel of potential alliancing parties that an Owner establishes so it can expeditiously and conveniently select from the panel to form an alliance for a specific project”. This is quite unlike any program alliance that PCI is aware of, and whilst consistent with the price-competitive philosophy it will nullify the objective of a program alliance – to tackle a series of work elements without the overhead of multiple procurement transactions. For example PCI is currently involved in seven operations and maintenance (O&M) program alliances – four in the private sector and three in the public sector – and whilst some of these involve initial elements of price competition, none feature an annual competitive budget process because this would be inconsistent with the owners' long-term objectives.
11. The role of Behavioural Coach in assisting the Owner to establish an alliance is described as one of assessing Proponent behaviours. This omits the critical task of preparing the Owner to participate in the selection process (and the subsequent alliance) in a manner that provides positive behavioural leadership, which is a pre-requisite for optimum performance and VfM. This is a particularly important aspect of advice for an Owner with limited alliance experience and 'adversarial' expectations acquired from traditional purchasing transactions.
12. The table comparing the three selection methods (page 85) is significantly misaligned with contemporary non-price alliance establishment processes. In terms of the four quadrants:
 - Integrated Collaborative Team: Rather than a single “selection interview” proponents are likely to be engaged in a series of workshops and commercial sessions, enabling a significant degree of team building to occur in conjunction with the assessment process;
 - Commercial arrangements: For a number of years non-price selection processes have established full commercial arrangements with both final Proponents, in an environment of competitive tension, with the ability to revert to the next-most preferred Proponent if satisfactory agreements cannot be reached with both finalists. It is inappropriate for the Guide to indicate that this practice is not or should not be followed in non-price-competitive alliance establishment processes;



- TOC / Project solution: A contemporary non-price selection method will draw out most key solution and VfM elements during the establishment process, for example by enabling the two final Proponents to quantify the benefits of their proposed approaches by reference to savings against the Owner's reference design.

Further guidance is required on selecting the alliance establishment route appropriate to various circumstances

13. The Guide presents three approaches to establishing an alliance – full price competition, partial price competition, and non-price competition (Section 2.7) – and makes it clear that the preferred method is full price competition. However, the guidance as to when the other methods are in the public interest is limited to the statement that “Certain ‘exemptions’ are traditionally recognised where full contestability (e.g. a sole supplier situation) and/or full competition may not actually be possible or a more limited approach will better satisfy the public interest”. On such a critical issue we believe the Guide should provide more practical guidance, particularly since the approach used in the past by most successful alliances now requires the Owners to justify an exemption.
14. The sole example given that might constitute grounds for an exemption to the price-competitive policy is “works of an urgent nature”. However:
 - This is inconsistent with the discussion associated with Figure 5.2 (indicating that the authors believe full price competition is the quickest method of establishing an alliance);
 - There is a need for further guidance in relation to the category of projects that originally gave rise to the alliance approach – i.e. projects where risks and unknowns are so great that price competition is likely to undermine the collaboration and collective assumption of risks necessary to deal with any eventuality and deliver the Owner's objectives efficiently.
15. We believe that Figure 2.3 correctively identifies the extent of risk (i.e. unknown or unquantifiable inputs required to achieve the desired outcome) as the prime determinant of the appropriate contracting method. We believe that this should be the prime factor under consideration when determining the appropriate extent of competition involved in establishing an alliance.

The commercial guidance and examples should be improved

16. The premise that an Owner should “define what is included in the Corporate Overhead component and specify this in the proposed PAA” (page 52) is unfounded. Whilst the PAA should precisely define the categories of cost which are reimbursable, it is not necessary to define the costs covered by the NOP's Fee. NOPs simply need to know what will be reimbursed in order to determine the level of fee required to cover any other costs and meet shareholder's expectations.
17. The comments on Adjustment Events (Section 6.4) include some confusing and potentially damaging advice. In particular “The NOPs' entitlement to any gainshare payment should follow demonstration to the Owner of how the relevant cost savings against the TOC have been achieved. If the Owner determines that innovation is not demonstrated, the NOPs' gainshare entitlement should be reduced to the extent that the relevant cost saving innovation / approach should have been identified during the TOC development” (page 97). This statement:
 - Implies that the Owner should circumvent ALT recommendations on Adjustment Events and impose a downward TOC adjustment where savings “should have been identified during the TOC development”; and
 - Introduces an untested concept of the Owner assessing how savings have been achieved, and making a (necessarily subjective) decision to withhold Gainshare against TOC, despite having previously accepted that TOC. Such a provision seems certain to undermine trust and alliance performance, and lead to unnecessary delays or disputes. If there is a legitimate fear of ‘super-



profit' the Owner would be better advised to seek a Gainshare regime which progressively reduces the NOP's share of savings above various thresholds.

18. The Guide encourages Owners to develop project-specific commercial frameworks, and to seek and consider suggestions for "innovative commercial arrangements" from Proponents. We believe that this is dangerous advice, as in our experience the effects of novel frameworks are often misunderstood and sometimes quite detrimental. Further, it is misleading to say that "Applying a generic Commercial Framework to a project is unlikely to assist Owners to achieve the Owner's VfM Statement..." (page 60); some generic frameworks are inherently better than others at aligning the parties' interests, so this statement is open to misinterpretation.
19. The range of commercial models illustrated in Appendix E is confusing and could be dangerous for inexperienced Owners. Several of the models have serious logical flaws or misleading explanations, for example:
 - Models 1-3 do not provide incentives for KRAs;
 - The diagram used to illustrate Model 4 (caped Owner pain/gain) is mathematically infeasible, and it is difficult to conceive of any beneficial behaviours that would eventuate if either cap was exceeded, so we do not think Owners should be encouraged to consider this model;
 - Model 5a (self-funded KRA pool) does not provide KRA incentives if actual cost is close to TOC, as acknowledged by the statement "self-funding can align price and non-price performance where savings are likely [but] can render the KRAs ineffective if overruns are possible" (page 56). Given the price-competitive approach promoted by the Guide, reliance on "likely" savings against TOC seems unwise, hence this model should not be presented for consideration;
 - Model 5b (owner-funded KRA pool) is probably the most common or 'generic' commercial framework seen in alliance contracts, yet carries a caveat that "this should only be used where the Owner requires the NOPs to achieve exceptional performance in those KRAs." We believe this is misleading since the Owner should set MCOS as required by the business case (whether ordinary or 'exceptional') and incentivise above-MCOS performance when this will deliver further value;
 - The significant drawbacks of the 'flat spot' featured in Model 6 are correctly described (pages 60 and 148) so we do not think Owners should be encouraged to consider this model.
20. Overall we believe that Appendix E should be replaced by a clear set of principles that can guide the development of a effective commercial framework, with advice on the approach required to ensure a proposed framework achieves its intended effects. This could be enhanced by worked examples to illustrate how various approaches will support – or fail to support – achievement of the Owner's objectives under various circumstances.

Further guidance is required on the challenges associated with a price-competitive process

21. If we include Proponent preparations prior to issue of the Owner's initial EOI, some price-competitive alliances are now taking well over 12 months to establish. Proponents are reporting that bid costs far exceed those seen on equivalent D&C contracts, even when the Owner's contribution towards Development-phase costs is taken into consideration (which in PCI's experience is typically 20-30% of actual costs). If this trend continues it will reduce the number and/or quality of Proponents engaging in competitive alliances, which will diminish VfM and run counter to the public interest. The Guide should offer advice to Owners on means to reduce this time and cost, to prevent an inadvertent diminution of the intended benefits of competition.



22. There is an emerging practice for Owners to schedule a wide range of evaluation activities during the Proposal Development phase, which can be very disruptive to the TOC development process. It would be helpful if the Guide provided more advice on this subject.
23. Experience of price-competitive selection processes in both alliance and non-alliance contracts suggest that competition tends to engender cost- or risk-shifting behaviours at the expense of the Owner, since the Proponent 'wins' by quoting the lowest price (or TOC) and thereafter maximising additional revenue from 'extras'. Since experience of price-competitive alliancing is more limited than other forms of alliancing the Guide should provide more advice managing these types of risk, including (for example) any particular approaches that should be taken when developing or applying the Adjustment Event Guidelines.
24. The most challenging aspect of price competition in alliancing is the competitive pricing stage itself, and the Guide should provide more assistance on key aspects of this process. For example:
 - Since Proponents are motivated to minimise the TOC they will push the boundaries of innovation, and history shows that the lowest TOC may not be acceptable to the Owner. Guidance is required re the extent to which the Owner can steer Proponents during Proposal development – in matters which are necessarily Proponent-specific – to ensure that Proposals will be acceptable. The footnotes to the flowchart D1 (page 126) say “[the] evaluation process must balance Probity requirements with need for effective interaction by Owner” and “Ensure two fully developed Final Proposals are delivered – each capable of acceptance by Owner with no material outstanding issues” but there is a need for more practical advice to Owners and Probity Auditors re how this can be achieved.
 - In this context it would be helpful if the Guide gave further advice on the interaction between Owner and Proponents during the Development phase. The Guide states “It is expected that the Owner will establish processes to ensure that as each Proponent’s Final Project Proposal is developing, there is adequate separation of Owner Participants to assure a robust competitive process between the Proponents that satisfies Probity requirements, while maximising owner interaction” (page 124). This implies making an equal number of Owner staff available to each Proponent during the Development phase. This approach will satisfy Probity concerns but is unlikely to provide an optimal level of guidance for Proponents (e.g. articulating the acceptable boundaries of innovation) as this guidance would involve equal access to (senior) decision-makers rather than equal availability of (junior) staff.
 - Since two competitive Project Proposals can diverge considerably –in commercial, technical, and other non-price aspects – it can be complex for the Owner to achieve like-for-like comparison. The Guide briefly mentions the need to calculate “a risk adjusted price for each Proponent’s TOC (or partial TOC) that will provide the Selection Panel with a better understanding of the commercial offering from each Proponent” (page 68). In PCI’s experience this task can become extremely complex, and if too complex can become opaque to decision-makers. The extent of complexity is directly related to the extent to which the Owner has been able to guide the Proponents during the Development phase to minimise unresolved issues in the Final Proposals. There is a real need for the Guide to provide further advice on this process.
 - It is inevitable that in some cases (as seen in the past) the Proponent which offers the lowest TOC will not be successful. This will be difficult to explain and potentially opens the door to various challenges. It would be very helpful if the Guide provided more advice on the processes surrounding this issue – for example the extent to which the Owner can open its risk-adjustment process to Proponents during the Development phase, so that Proponents understand which aspects of the Proposal (other than ‘headline’ TOC) will be advantageous or disadvantageous, hence improve perceived VfM in their Proposals, and simplify the task of risk-adjustment.



- In this context the Guide outlines an Owner's Comparative TOC ('OCT') which is "the Owner's best estimate of the Actual Out-turn Cost (AOC) of the project... In particular, the OCT will be adjusted to reflect the Proponents' design solution and construction methodology together with their risk assessment and TOC estimate" (page 91). Since the finalists will develop separate design solutions and construction methodologies it would be helpful if the Guide provided advice on developing the OCT when the two Project Proposals diverge significantly.