Partners please

Incorporating alliance contracting

Kevin McGuinness

Stephen Bauld

ALLIANCE CONTRACTING, STRATEGIC alliances, industry alliance programs – terms all buyers hear that essentially mean the same thing, cooperative schemes aimed at achieving a significant amount of economic value by spreading production, procurement and distribution costs.

Alliances may be formed between suppliers in related fields, between those who produce distinct yet linkable products, or those who operate at different stages of a production cycle. For example, different software developers may collaborate to develop a technical interface that allows their software to inter-operate and exchange data, enhancing the marketability of each separate product. They may also exploit the interface technology as a method of certifying products produced by other suppliers (e.g., by certifying that it works with a common interface such as the Microsoft Windows computer operating systemmaking it "Windows compatible.") They may create joint training service centres to increase the availability of trained consultants to support end-users implementing their software. To improve overall product delivery, alliances are often formed in all aspects of sales, service and finance.

A strategic marketing alliance may be created by separate entities planning to enter the same market. If their respective products are not in direct competition, this arrangement helps them to plan for the higher costs associated with a start-up activity.

In each case, the goal is to achieve an economy of scale, capitalizing on the efficiencies attainable through cooperation.

Alliances can also substitute for vertical integration within the supply chain. The parties may wish to spread the cost of product development, with the "buyer" being sure of a source of supply that meets a high level product specification, and the "seller" being sure of a market for a good product. For instance, a computer manufacturer bringing out a new high speed processor may strategically ally himself with a manufacturer of high resolution display screens, to ensure that the final product takes best advantage of the higher processing capability. Another form of this type of alliance is described by the term, "OEM," which refers to manufacturers reselling other company's products under their own name.

Buyers need to be aware of available supplier alliances and ensure that purchase orders, tenders or RFPs are organized to take advantage of the benefits, possibly better prices and efficiencies.

Supplier-customer alliances are emerging in the construction industry as a means of spreading the risks associated with complex projects. Studies consistently show that most construction disputes arise from a narrow band of causes, particularly architect/engineer error and omission and excessive change orders. Traditional contracting (e.g., design-bid-build or turnkey construction) allocates most of the risk of project completion cost and performance onto the contractor, leading to an adversarial relationship that can undermine the project. Problems can be worsened when such methods of contracting are combined with a tender approach, where the contract is awarded to the lowest bid, lump-sum price.

To protect themselves, contractors often incorporate a price premium into their bid. Responding to escalating prices and growing contractor resistance, evidenced in a lower number of bids received, some owners have begun to share project risks. Alliance contracting aligns the interests of the owner and the contractor in a collaborative way, hopefully reducing disputes. British Petroleum, one of the first to use alliance contracting when building an offshore North Sea oil and gas platform in 1996, completed the project six months early and at 22 percent less than its target price, but generally savings range from 7-15 percent depending upon the extent of risk assumed.

Alliance contracting and other methods of risk sharing are not for everyone. They require a sophisticated owner able to appreciate the magnitude of the risks that a given project entails, and one with sufficient worker resources to allow it to manage the construction program aggressively. Ideally, each party assumes only the risks that it can manage. A typical project will incorporate financial incentives (e.g. bonus and penalty provisions) to achieve designated project goals, based on pre-determined project target costs agreed to by all members of the alliance team.

Public sector buyers considering alliance contracting must consider the extent to which their governing purchasing rules permit them to do so. Selection of the bidder is critical to success and is not based upon bid price, but rather the bidder's demonstrated ability to work within the alliance-contracting environment and to deliver products on time and on budget when doing so. Given the sophisticated balancing of risks that such a process requires, it must be carefully documented – often a custom-tailored, legal document – typically including an alliance charter, terms of payment with cost overrun and gain share rights, project management structure and a comprehensive dispute avoidance and resolution mechanism.

The contract is usually supported by a formal "partnering" arrangement, where both parties designate senior representatives to be responsible, overseeing the project, meeting regularly and jointly making all critical decisions relating to the project. The selection process of the alliance team should take into account teamwork capability, availability and commitment to the partnering arrangement, as well as technical expertise.

Although alliance contracting as a procurement strategy is beginning to come into its own in the construction field, *in our opinion* it deserves serious attention in other supply arrangements and is a practice with which all purchasing professionals should become familiar.

Steve Bauld is purchasing manager at the City of Hamilton, and Kevin McGuinness is a lawyer with Ontario's Attorney General.