

THE RETURN OF HONOURABLE CONTRACTING

Defence is moving from a transactional to a relationship based approach to contracting.
What are the opportunities and risks in this transition?
How do these opportunities and risks vary between large and small companies
in the Defence Industry Sector?

DEB MINCHAM - FRANK PERRONE – AMANDA WRIGHT



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Executive Summary

Defence is moving from a transactional to relationship based approach to contracting which has been heralded by some as a return to “honourable contract relationships”. This concept paper discusses what relationship based contracting is, and how it can be applied to Defence Industry; citing successful examples and experiences.

It is recognized that there are opportunities and risks in this transition, and that these opportunities and risks may vary between large and small companies in the Defence Industry Sector. An assessment of the risks and potential opportunities, using effective risk mitigation strategies can result in effective contracting in a relationship based environment for the right project in the right circumstances.

Crucially, this concept paper culminates with recommendations on how the Defence Industry sector can be best supported to successfully harness the benefits and optimize the opportunities that relationship based contracting can offer.

The Return of Honourable Contract Relationships

It is no secret that many believe that the relationship between Defence and Industry in Australia degraded between 1990 through to 2015. The consequence was low trust levels, high risk margins, low investment, a stifled level of innovation; representing a poor value proposition for the Australian taxpayer. Contract management had become overly risk adverse and governed, both Defence and industry had become disillusioned with one another and foreign sales increased with a corresponding reduction in Australian industry investment. The unfortunate consequence was a lack of Australian business opportunities, poor commercial relations and less indigenous innovative capability for Defence.

Internationally, post The Cold War and the fall of the Berlin Wall, Defence spending declined and the defence industry worldwide changed. By 1998, nearly one quarter of the top 100 largest defence companies had left the defence industry and many of the others had merged. More locally, in Australia, a turnaround commenced as the defence industry sector recognized that Australian Industry policy needed to change, and parties started to embrace a contract management style that captured the collaborative nature of the Australian spirit, the foundation of trust and mateship.

Relationship Based Contracting

Enter relationship based contracting; the deliberate pursuit and systematic management of post-signature contract value; the relational investment in the long-term opportunity.

Relationship based contracting is a relatively new concept in Australian Defence Sector contracting. What it sounds like is: *“let’s all be friends and see how it goes...”*- what it really is, is something far more sophisticated, challenging and rewarding for the contracting parties and Defence as an industry.

What IS Relationship Based Contracting?

Relationship based contracting is simply developing and executing a contract between two parties: in a way that grows and develops trust, delivers shared and mutually beneficial outcomes in a collaborative manner and fosters a longer term relationship whilst retaining the key fundamental legal requirements of an effective contract.

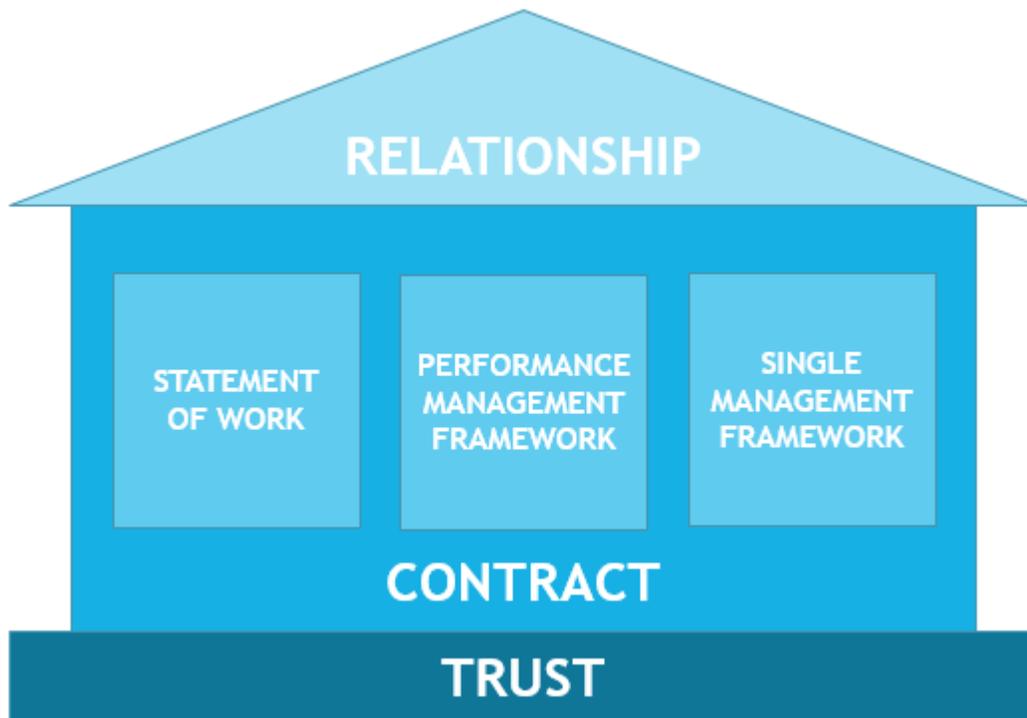
“Relationship based contracting is based on a recognition of and striving for mutual benefits and win-win scenarios through more cooperative arrangements between parties. Relationship contracting embraces and underpins various approaches, such as partnering, alliancing, joint venturing, and other collaborative working arrangements and better risk sharing mechanisms. Relationship contracts are usually long-term, develop and change over time and involve substantial relations between the parties and development of trust.”

(Rawlinson and Cheung (2002))

Relationship based contracting takes the required elements of more traditional transactional contracting and adds the flexibility to collaborate, innovate and deliver outcomes that are in the best interests of the Capability that is being acquired or supported for Defence. By doing so, the fundamental legal protections of Best Practice contracting are maintained, but the constraints and prescriptiveness of transactional based contracting are reduced or eliminated where possible.

Relationship Based Contracting as a “house” – the concept

To explain the concept and components of relationship based contracting, consider relationship based contracting as a “house”.



Trust – the Foundation

The fundamental principle of relationship based contracting is trust: which sounds counter-intuitive to seasoned contracting professionals whose traditional approach is adversarial and transactional: “us vs them”.

Trust in contracting is a challenging principle; as both a precondition to collaboration, but also a byproduct of the relationship; and there are competing philosophies on how it is earned and fostered, as there is in the literature on interpersonal relationships. But in a corporate environment, the vulnerability that is implicit in trusting another party can have real, material consequences – but also real, material benefits. For this reason, trust is the foundation of relationship based contracts. Underneath it is the history between the participants which affects the foundation’s structural integrity – the integrity of the people; their behavior directly affects trust levels in the relationship. The strength of their trust is the foundation supports the entire contracting enterprise.

When parties in a contracting relationship have high trust in each other, an environment of collaboration, innovation and efficiency can be created. The Journal of Construction Procurement 11 (2), 2005 concludes that relationship based contracts exhibiting a high level of trust give rise to *“free and frank exchange(s) of information and a significant reduction in transaction costs”*. The prospect of increased cost efficiency through “better” approaches to contracting should be embraced.

Trust in Defence Contracting

Like many industries, the Australian Defence Sector is comprised of a set of known participants who have long-standing relationships with each other, the Commonwealth of Australia and the Department of Defence. These Defence sector participants have proven histories of delivering quality Defence outcomes for their customers, and maintain the necessary approvals and accreditations to operate in the Defence sector. It is therefore a reasonable conclusion that there is sufficient base-level trust in the industry to support relationship based contracting and collaboration in the Australian Defence Sector.

The Contract - The Building Structure

Conditions of Contract

The formal instrument of agreement containing all of the required commercial terms and conditions such as performance and delivery, delay, warranties, insurances etc. to have a legally enforceable contract in Australia. The Conditions of Contract are the same for transactional and relationship based contracts, but their development journey can be very different depending on the relationship between the parties.

Statement of Work

The Statement of Work is where some of the magic of a relationship based contract can happen. The SOW should clearly articulate required outcomes and be prescriptive enough to provide clarity on Defence’s requirements whilst providing sufficient flexibility for the “how” to evolve to suit the efficient delivery of the goods or services over time. This gives smart defence industry companies the opportunity to deliver best for defence outcomes, efficiently and effectively, in collaboration with the Commonwealth and other members of Defence Industry.

Performance Management Framework

Closely tied to the Statement of Work, the Performance Management Framework (PMF) should be clear and precise on the required performance measures and include meaningful measurement of the behavior of the Contractor (and its subcontractors where applicable) in support of the relationship. Strategic Performance Measures (SPM’s) and System Health Indicators (SHI’s) are closely aligned with the operation and intent of the Single Management Framework (below) and should be aligned to Defence’s desired outcomes, reinforcing a one team, collaborative relationship to support best for Defence behaviour.

Single Management Framework

The remaining fundamental component of this support structure that really enables the relationship to function is a Single Management Framework (SMF) that operates effectively; creating a multi-tiered structure to support collaborative decision making that is empowered, responsible and accountable.

The SMF is the crucial enabling structure for the relationship based contract, as it gives responsibility and accountability for outcomes to the right level of decision makers in each organization. It is within this framework that the “how” of the contract may be decided, in support of the overall requirements of the Statement of Work. It is also within this structure, that the dispute resolution process lives, with disputes to be resolved at the lowest level possible.

The Relationship – the “roof”

So to complete the analogy, the house needs a roof – which is the relationship. It’s something that must be constantly maintained and supported, reinforced and strengthened, it requires skill, maturity and the right people with the right mindset.

Relationship-based Contracting Fundamentals

The author group agrees that relationship based contracts, in the right environment and for the right project can give both Defence and industry significant benefits (which are further discussed later in this paper). In order to achieve the potential benefits and capitalize on the opportunity, the following fundamental principles must be respected:

Mindset

All parties in the relationship must adopt a partnership mindset from the start. Trust needs to be laid into the foundations of the contract and be protected through any bidding or negotiation activity to preserve the relationship to prevent erosion.

The right mindset must promote a collaborative, one team (no blame) approach between all parties to promote the right behaviours and culture. Aligning stakeholders to this, whilst not always a simple exercise is critical to success.

This mindset must foster a spirit of collaboration but also continuous improvement.

Shared Vision

In order to effectively collaborate as a team, a shared vision is essential. Creating a team charter with mutually agreed guiding principles can be an approach for achieving this. In creating a shared vision, there should be created a collective purpose; which will be firmly grounded in best for defence and capability outcomes.

Shared Pain and Gain

The development of an agreed risk sharing framework that enables risk to be shared appropriately in the spirit of collaboration, and the establishment of a sensible performance measurement framework that focuses on measuring what really matters, and supports the collaborative approach.

Communicate: honestly, openly and often

Communication is critically important to every relationship. If done well, it strengthens the trust and alignment between the parties.

Respect

Aligned with the deep need for trust in the relationship, mutual respect is required. Defence must recognise that industry is an asset that needs stability, security, predictability and profitability in order to be effective and efficient. Industry must recognise that Defence must meet its outcomes in the most effective and efficient way.

The Opportunities and the Risks of Relationship Based Contracting

As with all things in business, there is a risk and a reward to adopting a relationship based contract in the Australian defence sector. The depth of the risk and the magnitude of the reward are highly subjective, dependent on the organization (or section of the organization) and the people involved.

The Risks

As with anything, there are a multitude of risks associated with relationship based contracting in Defence. With guidance and support, these may be mitigated to support success.

Mindset – The Human Factor

Defence on both the part of Commonwealth and of industry can be conservative in their mindset. Within the Defence sector, behavior and process maintain a conservative, risk adverse position. Relationship based contracting requires organisations and individuals to adopt a more open mindset that some may find challenging, and others can outright resist.

It is not difficult to contemplate that the larger Defence Prime Contractors and, the Department of Defence themselves could be slower to adopt this cultural shift than the small to medium defence industry organisations. The adoption of this collaborative mindset is critical to success, and must be championed by key members of the parties as successful relationship based contracting requires everyone involved, regardless of which role they perform, to be completely on board with the collaborative nature of the relationship.

Lack of experience or expertise in managing the relationships, or a lack of priority for doing so, can exacerbate this risk. The entire model only works if all parties to the contract actively manage the relationship in the spirit of collaboration. It can take only 1 person to degrade the relationship and erode the high level of trust required to support the contract. Everyone must have the right mindset, understand the “why” and have a long term viewpoint, especially when making decisions.

Balance

Not striking the right balance between Governance/Legal requirements and the relationship based model of operation i.e. being too “restrictive” or too “loose” in contracting is the second risk identified by the author group. Finding the balance between rigid structure and lack of clarity can be challenging. Failure to find this balance may result in disaster; terminated contracts, irreparable relationships, financial losses and lack of capability/vulnerability of systems and capabilities.

Failing to achieve the required balance may detrimentally affect quality and decrease Defence’s capability. The result may be increased cost to address the quality and performance shortfalls.

Finding the right balance would most likely need to consider and be influenced by, the contracted companies level of expertise, technology leadership, delivery track record and reputation.

The Opportunities

Relationship based contracting can present the Defence sector with significant opportunity, for those who successfully mitigate the risks. The potential opportunities are:

Efficiency

Reduced cost associated with administering contracts: less effort is required to handle contract correspondence as the level of formal correspondence required under the contract is reduced. The effort expended in the SMF and the more open communication between parties generally, reduces the overall administrative burden of the contract.

Effective Risk and Opportunity Sharing

Pain and Gain is 'shared': the entire enterprise shares in the success and the pain of any failure (through the relationship, not necessarily financially) – this more open collaborative behavior strengthens the trust and builds the relationship further with a shared sense of comraderie and transparency. By creating a more collaborative, 'win-win' environment, the parties can best share risk and work more effectively.

Future Opportunity

The ease with which new opportunities can be discussed and developed increases the ability for the parties to expand the work scope (subject to formal approvals). The ability for the Contractor organization to support Defence in right-sizing its requirements and refining their expectations in partnership with industry leverages the skills, knowledge and experience of the collective enterprise resulting in more effective outcomes for Defence.

Industry Relations

By participating in relationship based contracts there are opportunities to create better organisations or improve existing ones. Engagement in more collaborative, open, honest contracts built on trust and common core values encourages increasingly ethical and honorable relationships and raises the bar for behavior across the entire industry.

The overall environment within the contract delivery team can be much higher due to the open and collaborative working engagement that the relationship based contract supports.

Does Size Matter (of the organization)?

The Defence sector is comprised of organisations of varying sizes; the large multinational "Primes", the medium-sized growing companies and the smaller, niche organisations who's skill and ability to deliver specialty products has developed over time; and all the companies in between. The size of the organization will affect how the impact of the risks and the benefit of the opportunities from relationship based contract will be felt, but they remain fundamentally the same, regardless of the organization.

It is generally established that the larger an organization is, the stricter its own internal controls are and the less flexible they can be to adapt to a relationship based contract. They are organisations that have long histories in the industry and their governance is largely developed around transactional or traditional styles of contracting. However, under the right sets of conditions and with the sufficient support from senior leadership it is possible to see how the promise of a long-term, relationship based contract could be handled by one of the large Defence Primes: with a breadth of experienced resources to dedicate to the contract.

Alternatively, smaller Defence Contractors may, due to their size and agility be more able to quickly adapt contracting style. They are generally less encumbered with complex governance structures. The contracting teams within these organisation will have greater freedoms to consider relationship contracts relative to their counterparts the larger defence companies. The approval chains within these organisation are lean and contract outcomes have a more direct line to owners and shareholders.

So in summary; does organizational size have a bearing on whether it can perform in a relationship based contracting scenario? The answer is no. The determining factor is not size – it is willingness and ability:

- Large organisations will tend to have governance structures developed over time in transactional contracting frame works which can create higher burden and make them less reactive, but also contain highly experienced personnel with extensive experience with defence, and high levels of mature relationships and trust.
- Smaller organisations are generally less encumbered with complex governance structures making them nimbler and more cost effective, and are also likely to contain highly experienced personnel with extensive experience with Defence, and high levels of mature relationships and trust.
- Smaller companies may have unique proprietary technologies that may be more suited to being incorporated into a large prime company program under a relationship based contract, as a subcontractor.
- Large Sustainment programs with long terms may be well suited to a relationship based contract as the evolution of the program can be well supported in this environment.
- Higher financial risks for smaller companies that don't have the large capital support guarantees of the larger multinational primes
- Large complex programs still require structured contracting frameworks to ensure delivery to meet capability requirements
- Smaller projects may be well suited to relationship based contracts
 - They carry less risk – financial and schedule
 - Develop new and emerging technologies in collaborative frameworks
 - Provides opportunities to develop new suppliers and broaden the local supply base from the non-traditional defence industry supply base.
- Costs can be reduced by tailoring the magnitude of ASDEFCON requirements to the scope of the work and its criticality and risk.

People are people, no matter the size of the business – the culture of the organization affects how they behave. For a relationship based contract to be successful, the quality of the people and the strength of the relationship is key. Developing mutual respect and trust that enables transparency and information sharing is critical for successful outcomes.

Learning from others' successes

Whilst relationship based contracting is not commonplace in the Australian Defence Industry sector, recent developments and reform indicate a Commonwealth-led trend towards this style of contracting. Actions such as reforms of the Centre for Defence Industry Capability (CIDC), and recently announced activities by the Minister for Defence Industry (September 2020) to strengthen how Defence does business with Australian Industry, all have the opportunity to support the wider-spread adoption of more relationship based, and less transactional based contracting. The ASDEFCON contracting suite review proposed by the Minister, could be a powerful enabler for relationship based contracting.

Relationship based contracts can make sense for some contracts – if the organizational conditions and the subject matter are suitable and can support them. This isn't a style of contracting that is unique to the Defence sector, there are significant volumes of exemplar contracts in other industries such as construction and the energy sector. There are however some examples of successful relationship based contracts where the benefits of collaboration have been clearly demonstrated in the Australian Defence sector including:

Warship Asset Management Agreement (WAMA) Alliance a strategic partnership between the Commonwealth of Australia, BAE Systems, SAAB and Naval Ship Management for the through life support of the ANZAC Frigates. This partnership has a strong focus on continuous improvement and capability enhancement including a Life of Type Assurance Program for the fleet.



P3 Orion Master Accord between the Commonwealth of Australia, Tenix Defence and Australian Aerospace (now Airbus Australia Pacific) providing capability upgrades and Through Life Support for the RAAF AP-3C Orion aircraft. This Accord, signed in 2005, utilized a Joint Management Office to coordinate all Accord activities under an agreed risk sharing contractual arrangement, to foster better coordination, greater efficiencies and results.



These existing industry examples are sustainment/support contracts, which are more naturally suited to relationship based contracting than acquisition contracts. Whilst these examples are also Prime Defence Contracts, the potential to contract in a relationship-based manner with subcontractors in the supply chain should not be overlooked as the potential for collaboration and efficiency throughout the entire contracting chain should not be underestimated.

Recommendations

Strong, ongoing and trusting relationships take time to develop, and they need constant attention for them to flourish. In order for the Defence Industry Sector to make the step-change to relationship based contracting, we firmly believe that the Commonwealth needs to lead this transition to set the tone industry-wide.

The recently announced Defence Contracting Reforms must include relationship contracting as part of its reform agenda.

The recommendations are as follows:

1. Include relationship based contracting in the ASDEFCON review: the ASDEFCON suite of contracting templates and user materials must provide guidance and support to assist contract developers to contract in a relationship-based manner, considering both Acquisition and Support projects.
2. Develop a relationship based contract body of knowledge. In developing the body of knowledge the Commonwealth needs to review existing relationship based contracts and should investigate other industry sectors such as oil and gas who are already successfully using relationship based contracts. This body of knowledge should consolidate the learnings from historical examples to ultimately develop formal ASDEFCON guidance drafting notes within the available templates to assist with the development of future contracts.
3. Establish a Centre of Excellence to consolidate existing Defence Sector knowledge of relationship based contracts through developing the body of knowledge outlined in paragraph 2 above, and provide support, guidance and training and ongoing education to the sector contract development community to establish best practices. This Centre of Excellence should operate similarly to the Performance Based Contracting Centre of Excellence and provide specialist advice and support to users of ASDEFCON templates.

This Centre of Excellence should then, through involvement in emerging contracts continue the evolution of the ASDEFCON contracting suite through participation in the regular continuous improvement of the ASDEFCON suite of documents.

To Conclude

In conclusion, an increased adoption of relationship based contracting in the Australian Defence Sector, both with the Commonwealth and within industry, has the potential to herald a return to more honourable contracting in the Defence sector. The potential opportunities to Australia as a nation are immense and worthy of further research and development, in the best interests of Australian Industry Capability and Best for Defence and Best for Australia outcomes.

To capitalise on the incredible opportunities that can emerge from harnessing the collective ingenuity and creativity of Australian Industry, The Commonwealth of Australia must take a leadership role in an industry-wide development and support effort towards smarter, relationship based contracting.

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