Breaking mega projects into smaller contract packages – a fraught response to a fraught market

24 April 2020
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In brief

Article above detailed various strategies that project owners and contractors are adopting to respond to Australia's fraught construction market for major civil construction works. The most common response by project owners has been to break major projects into a number of separate contract packages that can be separately tendered.

Smaller contract packages – or packages involving fewer disparate activities – enable smaller or more specialized contractors to compete in their own right rather than as part of a joint venture, thereby expanding the pool of potential bidders. It also reduces the level of risk borne by any one contractor.

This strategy can also have a number of other benefits. For example:

- separate early works contracts can help to de-risk the primary contract packages, and deliver overall program benefits;
- the contract model for each package can be tailored to the characteristics of the works included in the package. For example, an incentivized target cost model can be used for risky works that can't be efficiently priced via a lump sum;
- if a PPP contract is proposed for the project, a separate design and construct contract for some of the civil works will generally take less time to award than the PPP contract, thereby allowing work to commence on those civil works earlier than would be the case if they were bundled into the PPP perhaps before the next election; and
- fewer civil works within the PPP package can also result in a more owner or operator led consortium, and a more manageable financing task for the PPP company.

Recent examples of projects that have employed this strategy include Sydney Metro Northwest, WestConnex, Melbourne Metro and Cross River Rail. It's been taken to new levels with Sydney Metro City and Southwest, where the project has been separated into no less than 15 contract packages.

But watch the interface risks

This strategy brings with it new risks that must be carefully managed. Most significantly, the project owner needs to carefully manage the contract interface risks associated with multiple interfacing contracts.

The project owner will need to make promises to each contractor regarding the scope and timing of the interfacing works that will be performed under the interfacing contracts, some of which may be yet to be tendered. If these promises aren't met, the project owner will be liable to the contractor(s) to whom the promises are made, and left to recover from the defaulting contractor.

Any gaps between the promises made by the project owner and those received from the defaulting contractor are borne by the project owner. Likewise, any liability which the owner has in excess of the cap on the defaulting contractor's liability remains with the owner. This can be a significant risk for a project owner if the value of the defaulting contract (and the resulting cap on the defaulting contractor's liability) is small relative to the value of the contract under which the owner is liable.

The sequence in which packages are tendered needs to be carefully planned to minimize the risk of the project owner having to guess what tenderers for subsequent packages will require or prefer regarding interfacing scope and activities. The project owner will also achieve better terms if it can consult with tenderers for subsequent packages on the scope of earlier packages before the earlier packages are awarded.

Each contractor bears the risk of "permitted" design development that occurs under the other interfacing contracts (i.e. design development that doesn't require a variation to the technical specifications). Each contractor will need to allow for this risk in its price, which will ultimately increase the total cost of the project for the project owner.

Other risks

Other risks with this strategy that need to be carefully managed include:

- **Systems integration risk**, on projects that involve the integration of multiple new systems, or where legacy systems and new systems interact. Is there a single organization with clear accountability for managing and mitigating system integration risks? Does that organization have the technical and contractual rights to make trade-off decisions and direct the system suppliers and other contractors in relation to the integration task? These decisions can conflict with the interests of individual suppliers and contractors, but are often necessary for the overall success of the project.
- **Bigger government project teams** to provide the resources needed to manage the contract interface risks, and the different forms of contract. The cost of this team is borne by taxpayers. Once created, the team has a vested interest in advocating for disaggregated contract models for future project phases, to retain the need for their positions in the organization, perpetuating the cost.
- **Silos emerging within the government project team** as the contract managers for each contract focus on the time, cost and quality results under *their* contract, rather than for the project as a whole.
- **Reduced cost certainty** at the point at which the project owner commits to the expenditure associated with the first contract package – any inadequacies in cost estimates for contract packages remaining to be tendered will not be revealed until after the project owner has passed this point of no return.
- **Scope creep** on contract packages remaining to be tendered.
- **Project benefits not being fully realized** if packages are deferred, abandoned or adjusted to bring costs back within available budget.

The WestConnex project can be seen as an example of the last three risks. The total projected cost of WestConnex has increased considerably since the time the NSW government committed itself to the first construction works package. This is due, in part, to scope creep on packages tendered subsequently (including improved connections at Rozelle Interchange). And some have suggested that the Sydney Gateway connection between WestConnex, the Airport and Port Botany has been excised from the WestConnex project, and its timing deferred, in an effort to reduce the cost overrun on WestConnex. Calls for stage 3 of WestConnex to be cancelled have also been rejected by a Parliamentary Committee "because without stage 3 the benefits of the WestConnex project as a whole would not be realized."

Take away

Project owners should think carefully before separating interfacing civil works into separate, smaller contract packages in an effort to expand the pool of bidding contractors. Failure to do so, or to carefully manage the new risks that this strategy creates, could result in a fraught response to the fraught market.