THE IMPACT OF RELATIONAL CONTRACTING ON THE CONSTRUCTION INDUSTRY

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Relational contracting (RC) is a generic term for collaborative approaches to procurement, such as partnering, strategic and project alliances, supply chain management, joint ventures and lean construction. These approaches are based on trust, cooperation and commitment. Since the 1980s, various forms of relational contracts have been advocated as an alternative to traditional arm’s length relationships. RC is based on the proposition that economic exchanges contain a significant social component, which is reflected in the behaviour and social relationships of the parties to the exchange. In such circumstances, the need to maintain the relationship overrides the gains achieved by enforcing the appropriate legal contractual obligations. While these attitudinal and behavioural norms are typically considered to be essential to the success or failure of RC, the manner in which they are understood, communicated and acted out is less clear. The practice and usage of RC is explored as an alternative to formal contracting. A case study approach is proposed for the in-depth analysis necessary to explore and capture the potentially diverse practices, attitudes and extent of usage of RC. The way RC agreements are practically understood, communicated and acted out; and their impact on exchange performance will be explored. Understanding of the realities of RC in practice can help researchers and practitioners choose the most appropriate business relationship to adopt and the practical ways forward.

Keywords: communication, contracting, procurement, negotiation, tendering.

INTRODUCTION

The modern UK construction industry is characterized by increasing competition, rapidly evolving client preference, rising client expectations, continually changing competitor actions and uncertain and changing conditions leading to high levels of uncertainty. Such high levels of uncertainty are bound to affect the contractual relationship that exists in the buyer-seller relationship. The considerable amount of literature relating to uncertainty in the building construction industry suggests that this has long been a problem. For example, Crichton’s (1966: 57) report concluded that “nothing contributes more to the industry’s inefficiencies than uncertainty”.

The industry has generally been described as being contested, fragmented and highly adversarial with inherent problems (Latham 1994, Egan 1998, Cox and Ireland 2002). These inherent problems include adversarial relationships between clients and contractors; inadequate information exchanges and inappropriate contracting styles.

In an attempt to mitigate these inherent problems, the industry has responded in various ways, including the formation of long-term contracts and collaborative

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working relationships. These include partnering, project and strategic alliances, joint ventures, supply chain management, lean construction and others. Such initiatives are supported and embraced by the concept of ‘relational contracting’ (RC). However, there is some evidence that there are problems with the implementation of these initiatives and that traditional methods of procuring construction works are still the preferred choice (Akintoye et al. 2000, Briscoe et al. 2001).

To date, there has been no study to investigate the interpretation, understanding and enactment of relational contracts, agreement charters and frameworks. The aim of this paper is to propose a research strategy that would discover the reality of practices and processes of relational contracting by comparison with traditional contracting.

**PURPOSE AND NEED FOR THE STUDY**

The fundamental question of this research project is whether relational contracting is more efficient than formal contracting in construction procurement. Answering this question may be the key to allowing construction firms and organizations to decide when and where to invest in the development of RC. Little is understood about when one approach (relational or formal contracting) is better than the other. Indeed, the very question of what makes one method of contracting “better” than another is fraught with difficulty. The manner in which relational contracts are understood, communicated and acted out is also unclear.

The lack of information on mechanisms involved in administering relational contracts in construction is unfortunate because it is the sort of evidence that researchers and practitioners require if they are to demonstrate that the benefits of the so-called improvement agenda match expectations. There are views on the role of relational contracts as a substitute or complement to formal contracting. This ambiguity may lead to different agendas in relation to the agreements signed. Indeed, changes in the industry may have been suggested without the support of research to assess its impact.

**OVERVIEW OF UK CONSTRUCTION INDUSTRY**

The UK construction industry is characterized by a very large number of small and medium-sized specialist firms and numerous market arrangements from which a client can procure design or construction work (Hillebrandt 2000). Modern construction involves technology-intensive processes and virtual teams spanning several parts of the industry, utilizing a high degree of sub-contracting. Such fragmentation may lead to frustration among construction project teams (Gray and Hughes 2001).

The high level of sub-contracting has led to complexity in the structure of the supply chain. Some commentators identify this as the root cause of problems in the industry. Price (1994) describes the contractual environment in the UK construction industry as one of ‘order above and chaos below’ with balanced equitable terms and conditions at main contract level and onerous, one sided conditions at sub-contract level. This is supported by the findings of Akintoye et al (2000) in that main contractors prefer to partner with clients rather than sub-contractors and suppliers.

**Inherent problems of the building industry**

The influence of the historic development of the construction industry (Murdoch and Hughes 2000), coupled with the myriad firms and organizations and technological advances, have resulted in a high level of uncertainty. Skitmore et al (1989) state that uncertainty lies at the heart of many of the industry’s problems.
The increase in the number of roles and market forces means that many participants compete for the same business, leading to some of the adversarial attitudes seen in the industry. Palaneeswaran et al (2003) point out widespread problems such as inappropriate contracting styles, misguided selection of contractors, sub-contractors and suppliers, persistent adversarial relationships with unjustified conflicts, disputes, and claims. Another issue which prolongs the inherent difficulties is fragmentation. This has produced a diverse market from which clients and procurement professionals may source. The selection of suppliers is a key decision as this has a ‘knock-on’ effect on the other members of the supply chain.

Call for change
Over the years, joint government-industry reviews of the UK construction sector have repeatedly levelled criticisms at the traditional ways of procuring construction in the UK (Crichton 1966, Latham 1994, Egan 1998). These reports highlight the inherent difficulties caused by organizational systems and contractual arrangements. They usually exhort practitioners to reject past adversarial practices. The competitive business environment is continuously changing with clients and construction firms, at all stages of the supply chain, operating within rapidly evolving markets and as a consequence adopting different strategies. These varying conditions mean that there is no single business strategy or contractual relationship that will allow players within the industry to be highly profitable.

The current trend from traditional arm’s length relationships towards long-term collaborative working practices has the potential of exposing firms to the pitfalls of RC. Cox and Ireland (2002) argue that “an ethos of trust and commitment is critical for such an approach (RC) to be successful”. We suggest that even while people and organizational culture may be directed towards trustworthiness, firms may be forced to be opportunistic for sheer survival. It is contestable whether such a move towards RC can truly succeed within the current industry structure.

It is worrying that practitioners are being counselled to undertake relational practices without an understanding the consequences. The ethos of trust and commitment is not sufficient for addressing the problems of the industry. This view is supported by Briscoe et al.’s (2004) findings that “…clients … [were] found to engage in some practices that were not conducive to integrated team working”.

OVERVIEW OF THEORETICAL FRAMEWORK

Formal contracting
A formal contract signifies promises or obligations to perform particular actions in the future. It refers to an agreement in tightly written legal forms (Lyons and Mehta 1997). Contracts create a mutually agreed range of acceptable behaviours, backed by redress to the legal system in the event of a dispute. A complete contract is assumed to produce efficient outcomes, but at a cost of drafting, negotiating and safeguarding an agreement. The more complex a contract is, the greater it’s specification of promises, obligations and processes for dispute resolution. For example, a complex contract can specify roles and responsibilities, procedures for monitoring and penalties for non-compliance and outcomes or outputs to be delivered. As long as the contract is based on verifiable information, confidence in the contract is assumed, on the implicit assumption that the law provides a reliable and costless enforcement mechanism. However, in reality, it may not be possible or desirable to specify and enforce a complete contract as it may be very costly to do so because of set-up,
drafting and monitoring costs. Also there are the costs and risks of litigation. Litigation may have an effect on reputation and in so doing endanger potential future relations with others.

**Relational contracting**

Relational contracting (RC) is based on the proposition that economic exchanges contain a significant social component, which is reflected in the behaviour and social relationships of the parties to the exchange (Macaulay 1963, Macneil 1980). In such circumstances, the need to maintain the relationship overrides the gains achieved by enforcing the appropriate legal contractual obligations. These authors observed that in most long-term contractual and business relationships, the legal mechanisms offered by specific contracts are not followed strictly but governance emerges from values and agreed-upon processes. Relational contracts are motivated by the mutual recognition that the result of such exchange exceeds those that could be gained from other forms of exchange or exchange with different partner. Such exchange relations require high levels of relational attributes such as trust, commitment, mutual adaptation to exchange partners’ needs and the expectations of continuity of the relationship, commitment, communication, interdependence, cooperation, mutual goals and performance satisfaction (Mohr and Spekman 1994). The presence of legally non-enforceable elements and absence of a higher authority to ensure compliance often characterizes the agreement, but these features themselves may complicate such business relationships.

Relational contract theory postulates that through social relationships and the resulting norms of behaviour, relational governance may function to mitigate the precise exchange risks targeted by formal contracts – risks linked to exchange relationships, namely uncertainty, specific investments and difficult performance measurement. Norms of mutual adaptations and co-operation offer the flexibility to deal with expected uncertainties that occur in an exchange. Thus, norms of flexibility, information sharing and commitment help overcome the probable high cost of exchange risks. The expectation of continuity that goes with RC creates inducements to invest in exchange-specific investments, which are protected by mutually imposed costs of ending the relationship. Also the hope of continuity reduces the need for accurate performance measurement in the short run. Parties to the contract will therefore hope that short-term imbalance will be put right in the long run.

As high levels of trust are required for relational exchanges, trust becomes a feature that is entrenched in the exchange relationships and acts as a substitute for formal contracts, yielding efficient outcomes at lower costs (Gulati 1995).

The progress and preservation of RC with its dense network of social ties may entail substantial cost in terms of time and resource allocation for its development and maintenance. However as RC involves a continuous range of relational norms instead of one or two governance regimes, it is difficult to examine directly the considerable costs involved. While RC may reduce or eliminate tendering costs, it does not eliminate the costs of monitoring and enforcing. The dense social network ties in economic exchanges may also restrict individuals, firms and organizations from new information and new opportunities. These interpretations imply that construction firms and organizations should only invest in the development of RC when significant exchange hazards, particularly those associated with specialized asset investments, difficult performance measurement or uncertainty are present. The costs of RC may not be justified in the absence of known exchange hazards (Poppo and Zenger 2002).
For such relationally governed exchanges, the enforcement of promises and obligations occur through social processes that promote norms of flexibility, solidarity and information exchange. Information-sharing enables problem-solving and adaptation because parties are willing to share private information with one another, including short-term and long-term plans and objectives and aspirations, as well as an expectation of continuity of relationship.

**Relational contracting and transaction cost economics**

According to transaction cost economics theory (Williamson 1979), there are three categories of exchange hazard that necessitate contractual safeguards. These are asset specificity, measurement difficulty and uncertainty. High levels of uncertainty coupled with asset specificity or measurement difficulty make contracting risky. For example, if there are no appropriate safeguards in a contract, when uncertainty is high, a contractor may be discouraged from making specialized asset investments.

From a transaction cost economics perspective, an optimal contract is one which has been crafted with minimal cost but delivers desirable quantity, price and quality of the supplier’s service. Associated with the initial contract are the ongoing activities required to monitor the compliance with the terms of the contract. These formal and legalistic control mechanisms are categorized by several features such as standardized procedures, terms of payment, and technical reports on performance. In a relationship where risks are low, a simple contract will suffice.

In spite of the explanatory strength of transaction cost theory, many scholars have criticized it by saying that the theory considers transactions to be secluded from their environment because TCE focuses on a single transaction as the unit of analysis, not taking into account other relationships that surround the focal transaction and that could be dependent on them. Such embeddedness of transactions in social structures is especially likely to be present in recurrent sets of transactions in long-term client-supplier relationships. A second limitation is that TCE views individuals or parties to a contract as being motivated by self-interest. However, it seems that many forms of inter-organizational relationships are based on gradual development of the relationship, culminating in some form of trust and commitment on the part of one or both parties. This may facilitate the lowering of some part of the transaction costs linked to safeguards against opportunism. Third, TCE does not explicitly consider the dynamic evolution of governance mechanisms and transactions. Generally, TCE overlooks the implications of trust and its features. Considering these limitations of TCE, many scholars have observed that the governance of inter-organizational exchanges involves more than formal contracts and that the exchanges are typically repeated exchanges embedded in social relationships. Governance emerges from the values and agreed-upon processes found in social relationships, which may reduce transaction costs as compared with formal contracts.

**Information co-ordination**

Galbraith (1977: 36) defined uncertainty as “the difference between the amount of information required to perform a task and the amount of information already possessed by the organization”. Thus clarity of information will reduce uncertainty. For example, shared experience of deeper understanding, common vocabulary and use of documents reduce uncertainty. For firms to communicate effectively, it is necessary for them to communicate in a common language. Consistency of data may simplify data processing, aggregation, comparison and analysis. This allows data to be reused thus reducing costs. By addressing the co-ordination of information,
decision-making is improved and the efficiency problems reduced. Accurate and relevant information improves the quality of a decision, and the conservation of other resources (Casson 1994). Casson (1994) suggests that within the organization or project group, the decisions of different individuals need to be co-ordinated so that conflict is avoided. Here, co-ordination is defined as the ‘art’ of integrating dependencies between activities to achieve specific objectives. This definition follows the simple intuition that, if there is no interdependence, there is nothing to co-ordinate. Co-ordination mechanisms range from the formal standards through to informal communication. Informal communications supplement and sometimes bypass the formal channel of communication to communicate directly, allowing decisions to flow through the organizations independent of the formal channels.

When the degree of uncertainty is high, there are many ways in which firms try to reduce the amount of information required. However, these techniques need to be seen from different contexts for their appropriateness to be judged. In light of this, some commentators are of the view that, for conditions of high uncertainty, the more informal, communications-oriented techniques are most suitable. And for conditions of lower uncertainty, the more formal, control-oriented techniques are most suitable. However, some other views are that the more informal, communication-oriented techniques are more likely to deliver an effective project, with quality that meets clients’ needs. And the more formal, control-oriented techniques are more likely to deliver an efficient project, which is on time and on budget. According to Williamson (1996) contracts have access to these co-ordinating capabilities through detailing of clauses and procedures that make possible negotiations that invariably occur from information changes.

RELATIONAL CONTRACTING IN CONSTRUCTION

A review of the buyer-seller relationships in the construction sector reveals a direction towards promoting the benefits of partnering. Despite the strength of the argument put forward in favour of RC, there has been debate around its emergence as the vehicle for change and the conditions that encourage or inhibit such long-term relationships (Green 1999, Cox and Ireland 2002). Green (1999) criticizes the uncritical acceptance of ‘partnering’ by the UK construction industry, while Cox and Ireland (2002) suggest that the current industry structure and culture prevents the prevalence of such close collaborative working practices.

Indeed, the suggestion that the existence of relational norms will ensure that all adversarial and fragmentation problems of the building industry are limited or, indeed, absent, is a naive interpretation. For example, the presence of opportunism, as the norm in a business relationship, simply provides grounds for the exchange partners to prepare to negotiate in a way appropriate to the specific situation in which the parties find themselves. The extent to which RC strategies align with business strategies will vary widely among firms.

Strategic and operational alignment

Business strategies exist at several levels in any organization - ranging from the overall business through to individuals working in it. The main levels are strategic and operational. Strategically, the firms will be concerned more with how the firm competes successfully in a particular market. Operationally, the concerns are how each part of the firm is organized to deliver the strategy of the firm. The focus is on issues of resources, processes, people etc. In other words at the operational level,
efficiency and effectiveness are paramount while at the strategic level it is its market positioning and exploitation. This may lead to conflicts between the two levels. Strategic success does not necessarily guarantee an operational success, and vice versa.

**Key issues in relational contracting in the construction sector**

As indicated earlier, there are many ways in which RC is depicted. As a result there are varying views on issues such as the role of partnering charters and framework agreements; on interpretation and enactment in practice; and on RC as informal and organic development as opposed to a formal business relationship. These separate views are reflected in attitudes and behaviours towards the use of contracts and incentive systems based upon risk/reward formulae. For some the agreement between parties to the contract supersedes the contract while for others the contract acts as a crucial safeguard against breakdowns of agreement (Alsagoff and Mcdermott 1994).

Another problem is the presumption that there is a unity of interest and common frame of interest. This is perhaps unlikely in many contracting situations, as Bresnen and Marshall (1998) have argued. For example, in times of favourable economic (market) conditions, a powerful main contractor may transfer risks on to sub-contractors and press more effectively for changes to their methods of operation. RC can depart from its collaborative ideal when it is used as a mechanism to drive down costs.

The extent and type of relational norms in an exchange are highly influenced by the transaction specific assets in determining the success or failure of RC. Therefore, if RC exists in a business relationship, there will be evidence from the activities (norms) and common terms used by the parties to the exchange in describing their relationships. Common terms and activities can thus be collected and analysed for evidence of genuine collaborative behaviour and its impact on performance.

The contractual relationships between key actors are crucial (Hughes and Maeda 2002), yet the effect of RC is under-researched. Alsagoff and McDermott (1994) point out that clients in their survey usually followed legal and contractual sanctioning procedures when disputes occurred. Thus formal contracts serve as a ‘safety net’ should RC fail – which they might, given the uncertainty in the construction industry. A good example is Baird v Marks and Spencer[^1] reported by Harrison (2004).

For contractors, the direct benefits of collaboration lie in reduced bureaucracy, increased profitability and increased competitiveness (Akintoye *et al.* 2000). The more uncertain the environment and the harder it is to accommodate changing circumstances within the contract, the more likely it will be that parties will sacrifice the precision and ease of implementation of definite contract terms for more cumbersome but flexible “relational” contract terms that define performance obligations less precisely or establish procedures for negotiating adjustments in the terms of trade within the contract.

**FORMING OF PROPOSITIONS**

The literature review provides a wealth of information that can be developed into a number of propositions for further investigation. The propositions are based on the premise that relational exchanges tend to exhibit behavioural attributes that distinguish more intimate relationships from traditional business relationships. The propositions

[^1]: Baird Textiles Holdings Ltd v Marks & Spencer plc, CA, [2001] EWCA Civ 274, [2002] 1 All ER (Comm) 737, 28 February 2001
of this study are set out below and provide indications as to how data should be collected.

**Proposition 1**
For a given level of RC in a business relationship, there will be evidence about the activities, common visions, objectives and common terms used by the parties to the business exchange in describing their relationships.

**Proposition 2**
Formal or relational contracts as substitutes will lead to enhanced exchange performance.

**Proposition 3**
Formal or relational contracts as complements will lead to enhanced exchange performance.

**RESEARCH STRATEGY**
A case study research approach is to be adopted because exchange relationships occur naturally during the life of a construction project. It is especially useful in investigating real life situations and providing insight into a research object (Yin 1994), providing a richly detailed portrait of a particular social and economic phenomena in a real life context.

The value of case study approach is becoming increasingly recognized in exchange relationship research. It will also help contextualize the research as no two projects are the same, allowing us to take into account the specific purpose and context of a relationship and their changes to assess the role of RC on performance. All data will be collected anonymously and treated confidentially to protect the interests of participating companies and individuals.

**Research method**
*Semi-structured Interviews*
Semi-structured interviews with approximately 3-6 senior level managers who initiate policies and procedures for procurement will be conducted. The interviews will (a) contribute to the understanding and enactment relational contracts (b) add to the list of different cooperative mechanisms and activities used and (c) illustrate the motivation for using different types of mechanisms in the relationship.

*Interview instrument*
To facilitate the interview process, a checklist of questions focussed on RC mechanisms, activities and management practices informed from the literature review will be developed.

**CONCLUSION**
An exploration of the literature that documents RC in the building sector has revealed some critical issues and problems in understanding, interpreting and enacting relational contracts. It is interesting to note that since the emergence of RC in the form of partnering, strategic alliances, supply chain management and other collaborative working practices based on trust, cooperation and continuity of relationship in the late 1980s, the published literature and research have typically advocated guidelines and models as an alternative to traditional contracting. To date, there has not been any research on the *interpretation* and *enactments* (implementation)
of relational contracting at the strategic and operational management levels, justifying this research.

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