Supply Contract Risks:
An Approach That May Be Adopted to Support Client-Supplier Contract Negotiations

By Peter Sammons, Buy Research Limited August 2008

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SUPPLY CONTRACT RISKS: AN APPROACH THAT MAY BE ADOPTED TO SUPPORT CLIENT-SUPPLIER CONTRACT NEGOTIATIONS

EXECUTIVE SUMMARY

A growing number of client organisations – i.e. those that buy-in goods and services from third-party suppliers - want to explore possibilities to offset contract risk against price, so providing a new opportunity to deliver bottom line savings, but without increasing client risks in an unstructured, or non-deliberative way.

Directors of companies and public sector bodies should have a good appreciation of any risks to their business that could impact the way that they interact with their key stakeholders - especially customers. Special risks arise as a result of supply/procurement activity. The purpose of this Review is to identify common risks in supply/procurement contracts, whether capital buys, direct services or outsourcing, and to suggest methods for addressing and managing those risks.

Review purpose is NOT to define a new approach to contract risk-conditions. It is to enable client organisations to evaluate contractual risk in a general way so they can assess, on a case by case basis, whether there are commercial and/or economic benefits to be gained from reassigning the contractual ownership of ***project*** risks in a substantial way. Risk transfer could be either by transferring risk to the supplier or conversely, by the client organisation itself absorbing contract risk in a controlled manner. If the client accepts risk, it needs to put in place ***risk mitigation*** and ***risk management*** strategies.

COMMERCIAL REALITY

It is a basic principle of contracting that "risk should lie where risk is best managed". The party best able to manage a risk therefore carries that risk under the contract unless there are compelling reasons for another party to carry the risk.

<u>It is stressed that *risk management* is not the same as *risk elimination*</u>.

SUMMARY OF RECOMMENDATIONS

- Client organisations should identify in a formal way those projects to which systematic ***risk*** review shall be applied **(R1)**
- Identified risks should be listed in a ***risk register*** which should be appended to, or referenced in, the ***financial business case*** **(R2)**
- a contract ***materiality*** review should be undertaken by client organisations at the commencement of any ***project***, and repeated as necessary during the life of the ***project*** **(R3)**
- Under a formal Contract Risk Evaluation Framework (CREF) ***risk registers*** should be created in a systematic way for proposed contracts so enabling the client to have a good appreciation of the risk-profile of the ***project*** **(R4)**

- where insurance cover by suppliers is written-in to a ***contract***, clients should obtain a copy of the relevant insurance certificates **(R5)**
- Contractual loss recoverable from suppliers under Low or Medium ***materiality*** contracts should be capped at fee + 25%. Higher materiality contracts should be considered on a case by case basis **(R6)**
- Client organisations should define ***materiality*** on supply contracts taking due account of any sector-specific regulations covering "outsourcing". This will help with overall ***risk*** assessment, putting it into a regulatory context **(R7)**

1. DEFINITIONS

NOTE: in this Review defined terms are shown in bold where singular, not plural.

- ***risk*** – a risk is an adverse event that may happen, as opposed to an issue, which is an adverse event that has happened. Typical client-side risks will be risk of failure of the contract relationship, and risk of regulatory breaches
- ***risk elimination*** – a situation where identified risks no longer exist
- ***risk mitigation*** – things done to reduce effects of risk should an issue emerge
- ***risk management*** – control, evaluation and monitoring of risks, including risk mitigation and issue management. Use of risk logs/registers is a key element of risk management
- ***risk register*** – a list of risks and issues
- ***financial business case*** – (a) the document in whatever form used as the rationale for entering into a supply contract. May also include audit trail of management approvals. (b) a document that expresses the rationale in financial terms, being direct and indirect costs as well as 'savings' achieved and/or revenue earned as a result of the ***project***
- ***financial close*** – normally the time when all the contracts associated with the ***project*** are signed and the contractual liabilities are assumed.
- ***issue*** – a risk that has happened in practice, so becoming an issue to be resolved
- ***materiality*** – the importance of a ***project / contract*** to a client organisation measured in a consistent way against five key dimensions – * contract value; * market concentration risk; * risk of partner change during contract; * legal risk; * reputation risk
- ***project*** – a plan to develop and implement some financial opportunity, which may include the need to meet a regulatory requirement
- ***project developer*** – the person who is responsible for putting together a *project plan*, often including the *business case*
- ***project manager*** – the person who implements the project, carrying responsibility for its effective completion
- ***contract*** – complex supply involving e.g. planning, project development, design, execution (service delivery or supply of goods of some type) and possibly after-sales support (or enduring post contract obligations e.g. to secrecy)
- ***Vendor Manager –*** person in the client organisation who is charged with providing technically competent client control of Supplier operations, and especially specification-compliant delivery, or SLA-compliant delivery. Usually this is someone in the sponsoring group with appropriate technical knowledge. It is generally not someone in "procurement". Procurement departments often provide a *Supplier Relationship Manager* under their generic Supplier Relationship Management programme.

2. PURPOSE & SCOPE

The purpose of this Review is to suggest for client organisations a common way of evaluating and describing generic procurement / supply contractual risk, and a common framework for addressing those risks within the supply contract.

This Review applies to client organisations generally, as well as to procurement or Supply Management organisations.

3. BACKGROUND

In developing a ***project*** that involves external supply/procurement the ***project developer*** needs to evaluate the additional risks that the supply/procurement element of the ***project*** entails. Having identified special risks in the supply/procurement element the ***project manager*** must institute ***risk mitigation*** or ***risk management*** measures to address those risks as far as reasonably practicable. Although supply-procurement risks will be only a part of the risk profile attached to any ***project***, for the purposes of this Review supply-procurement risks are considered in isolation, as though they are the sole risks that impact the ***project***. In practice there will be other ***project*** risks.

In developing any ***project*** and the contractual structure within which it will operate, the ***project manager*** must develop a risk-sharing package that is acceptable to the parties, normally the client and a single contractor acting as 'supplier'. In some projects there may be other (third) parties that have an interest in the way that risks are distributed. Client organisations must make due allowance for this.

The risks discussed in this Review are those that normally affect high cost and high complexity contractual arrangements. Some of the risks described will apply to simple purchase orders. But ***risk*** evaluation, measurement and control measures will normally be applied only to 'contracts' for 'supply' ('supply' includes the supply of services), where by ***project*** scale or complexity risks tend to be magnified in their potential effects. We define a ***contract*** as being complex supply involving planning, development, design, execution (service delivery or fabrication of some type) supply, and possibly after-sales support. Unless their costs are high or delivery failure implications particularly acute, we ignore 'purchase-order' type risks in this Review.

- Client organisations should identify in a formal way those projects to which systematic ***risk*** review shall be applied **(R1)**

A ***project*** contract structure should normally balance risks in such a way that the party best able to price and to manage specific risks, ultimately bears them under the contract. In this way supply costs are optimised and returns for the client organisation's stakeholders maximised. It is occasionally necessary for clients to accept risks that they would not otherwise wish to; e.g. in order to enhance returns form a ***project*** or simply in order to make a ***project*** happen. In these cases it is doubly important that risks are identified, mitigated, monitored and managed through the life of the ***project***.

- Identified risks should be listed in a ***risk register*** which should be appended to, or referenced in, the ***financial business case*** **(R2)**

4. PROJECT SOURCING PHASE

Any ***project*** that is being developed will move through a number of sub-phases up to the signature of contracts (the "sourcing phase"). During these different sourcing sub-phases our appreciation of risks will develop and evolve. Although all projects are different it is suggested that the following minimum sub-phases are likely to be undertaken, and in the order shown. The 'percentage complete' column suggests a typical sourcing ***project*** and the cumulative time spent on its various phases up to the 'completion' of ***financial close*** - normally the time when all the contracts associated with a ***project*** are signed and the contractual liabilities are assumed.

Project Sourcing – sub-phases and risk considerations

Project Sourcing Phase	Risk Management	* % Complete
concept **	initial risk identification - highlight "show stoppers"	5
evaluation	detailed risk identification, categorisation and initial evaluation, including due diligence	15
tender/offer	risk evaluation and strategy to transfer or mitigate risks. Assessment of risks is a critical element in tender evaluation	50 - 70
negotiation	negotiate risk mitigation, negotiate contractual terms	70 - 90
financial business case	final approval of risk distribution and risk management strategies	95
financial close	completion of risk identification and risk distribution between contractual parties	100
implementation	on-going management of risks	n/a

* n.b. this is a suggestion for a typical sourcing project. 'Completion' of sub-phases is impossible to measure with such precision.

** this means proof of concept – basic steps to ensure that further work on the ***project*** is unlikely to be wasted

5. RISK IDENTIFICATION

The ***project*** needs to be broken-down into discrete activities and risks identified against each activity. In the early stages it is vital to identify the scope of risks to which the client organisation may be exposed. A key aim of the *proof of concept* phase is to identify any risk so severe as to be a potential "show stopper" and which would make further investigation pointless. Such risks could have the effect of terminating a ***project*** at that stage.

Sourcing Phase – Risk Identification

Project Sourcing Phase	Risk Identification	* % Complete
concept **	what are the biggest risks to this concept?	5
evaluation	what new risks or risk mitigation strategies are identified?	15
tender/offer	have we already established in principle which risks the supplier will shoulder? Do the terms of contract under which tenders are invited appropriately distribute risks?	50 - 70
negotiation	clarify that risks are appropriately distributed in the draft contract. If using e.g. the NEC family of contracts (or equivalent), does the supplier understand the implication of the idea that the client accepts only the risks listed as *client risks* and that all other risks are shouldered by the supplier?	70 - 90
financial business case	have we set out adequately the risks and do budget / sponsor managers understand them?	95
financial close	have any risks changed? Does the financial business case need to be amended or re-approved?	100
implementation	monitor risks identified as at financial business case and identify and mitigate any new risks that emerge during implementation	n/a

* n.b. this is a suggestion for a typical sourcing project -'completion' of sub-phases is impossible to measure with such precision.
** this means proof of concept – basic steps to ensure that further work on the ***project*** is unlikely to be wasted

During later phases of a project, as the overall project is being implemented, it is best practice to continue to monitor risks and try to identify new risks that may be emerging.

6. RISK MITIGATION

It is vital to understand that risks do not go away because a contract document states that they are shouldered by someone else (normally the supplier). Certainly for high ***materiality*** projects risks must be monitored and controlled. Should *risks* materialise and become *issues*, then there could be knock-on consequences to the client. These consequences may themselves become new *risks*. Prior to a contract being concluded, the client's focus on risk isses will be directed as suggested below:

tender/offer: the emphasis in this phase is to exploit as far as reasonable the client's power as 'buyer'. The opportunity should be taken to define the terms of the contract in detail, thus converting ***risk*** distribution from a negotiation factor into a part of the client's specification.

The specification then describes *what* is wanted and the *terms* on which they are wanted (usually the technical specification supported by the contractual terms and conditions).

negotiation: in this sub-phase the client organisation should achieve an overall understanding of project-contract risks and how they may be assigned under the contract(s).

Contract negotiators need to be realistic. Risk mitigation which aims to off-load all risk to the other contracting party may achieve this outcome only at an uneconomically high price, thus undermining the ***project*** concept. Off-loading all risk may encourage the supplier to become overtly 'contractual' in their dealings with the client, to the overall detriment of the concept/ ***project***.

7. CONTRACT RISK EVALUATION FRAMEWORK

Investment opportunities, whether capital investment, revenue expenditure, new business opportunities or outsourcing, where they involve external expenditure with a third party (or the assumption of risks as in a joint venture or contractual collaboration) must set out clearly the ***project*** risks and uncertainties and how they will be managed during the life of the ***project***. A formal *risk assessment* is therefore required for each ***project.*** The higher the ***materiality,*** the greater effort to be invested in ***risk*** assessment.

A valuable and simple step is to undertake a basic contract materiality review which measures the impact of any proposed contract against 5 key dimensions – * contract value; * market concentration risk; * risk of partner change during contract; * legal risk; * reputation risk. By doing such a simple and quick step (10 minutes for a low to medium materiality contract?) our organisation achieves a consistent view of the importance and possible impact of a ***project / contract***. This in turn suggests the extent of due diligence to be undertaken by our organisation before entering-in to the contract.

- a contract ***materiality*** review should be done by client organisations at the commencement of any ***project***, and repeated as necessary during the life of the ***project*** **(R3)**

(Buy Research Ltd uses a simple spreadsheet for this purpose).

A ***risk*** assessment framework, the Contract Risk Evaluation Framework (CREF) can be designed for use in conjunction with the ***financial business case***. CREF can provide a structured method to establish the contract ***risk*** profile. CREF also enables projects to be considered and compared on a consistent basis. The table below provides a simple mechanism for listing and measuring contract risks:

CREF - Risk Table

Risk description	Person responsible	Mitigation strategy	Dependencies	Weight	Score	Weight * Score

Weight – e.g. – L = 1 M = 2 H = 3 Score range – e.g. – 1 to 10 So, the higher the score, the greater the ***risk***

Client organisations should decide in their own context, the "score" ranges where aggregate contractual ***risk*** is considered acceptable / unacceptable and/or where senior management sign-off is required before contracts can be entered.

CREF ***risk*** registers, as above, enable client organisations to prepare mitigation strategies and keep ***contract*** and ***project*** risks in view throughout the ***project***. They also enable clients to have reasonable confidence that proposed conditions of contract properly anticipate the contractual effects should a ***risk*** become an ***issue***, and that those risks are properly assigned between the contracting parties.

- Under a formal Contract Risk Evaluation Framework (CREF) ***risk registers*** should be created in a systematic way for proposed contracts so enabling the client to have a good appreciation of the risk-profile of the ***project*** **(R4)**

7 A – TYPICAL PROJECT RISKS

- cost overrun
- completion delay
- failure to meet performance guarantees
- environmental risks
- force majeure risks
- credit worthiness of supplier/contractor
- after sales support delinquency
- client's business needs change during implementation
- adverse legal changes
- adverse exchange rate movements
- price inflation
- environmental risk

7 B - SPECIAL PROJECT RISKS

- reputation risk
- client risk
- intellectual property rights – risks
- regulatory risk

Clients should assess whether a particular ***project*** will encounter heightened/special risk within the typical risk areas above. If "yes" then this will suggest where ***risk mitigation*** activity will add most value. It will also assist in discussions with insurers should project specific insurance be required.

8. EVALUATION OF RISKS

The CREF can become the key mechanism for evaluating ***project*** risks. It is useful to consider ***contract risk*** in the context of risks versus rewards. At the end of the day, why do we run risks? A *risk/reward matrix* can help to put some perspective around ***project*** risks. Both supplier and buyer are vitally concerned about the allocation and management of risks. Their respective motivations as they discuss a proposed contract are suggested below:

Risk-Reward Motivation

Role	Risk	Reward
Buyer / Client	Revenue expenditure on supply	The contract deliverable and its contribution to corporate objectives
Buyer / Client	On T&M / Target priced contracts – risk of cost overrun	A mechanism for easily tracking costs
Buyer / Client	Regulatory compliance	Regulations drive best practice
Buyer / Client	3rd party Client interests	Doing deals with the client
Buyer / Client	Intellectual Property Rights – leakage to rivals	Develop new knowledge or competencies
Supplier	Fixed price contracts – cost overrun	If effectively priced and adequate margin, fixed price is always attractive to clients
Supplier	Performance guarantees	A mechanism to limit the client's demands
Supplier	Timeliness of delivery	Enhance reputation
Supplier	Supply pipeline	Being part of the client's "team"
Supplier	Sub-contractors	The ability to offload non-core activity to specialists
Supplier	Cost inflation	Profit

Under a CREF, an organisation should track – at least for high ***materiality*** projects – overall ***risk*** exposure to third party-supplier risks. If a decision is taken by the client to absorb more contract ***risk*** in return for other benefits in a particular ***project***, it may become necessary to ensure that, across a range of current key projects, the client is not over-exposing itself to aggregated risks. Note that risks, if encountered in combination across a range of projects, could potentially impact the client organisation should those risks materialise and become issues. Taking on too much contract ***risk*** could potentially invalidate or reduce a client's insurance cover.

9. INSURANCE OF SUPPLY RISKS

Many supply-type contracts are not sufficiently complex or risky to justify separate insurance of the risks. For exceptionally risky projects the following insurances, either with the client organisation as the insured, or the supplier as the insured (and covering the client organisation against claims) may be necessary:

Professional Indemnity
covers professional negligence - generally incorrect advice leading to client direct or indirect loss, or poor design leading to performance shortfall

Construction All Risks
provides protection against physical loss or damage to the permanent or temporary works, materials during construction and commissioning. Also some defects liability cover.

Consequential Loss
provides protection against financial consequences of loss of anticipated revenue as a result of delay following insured loss

Third Party Liability
protection against legal liability for compensation for bodily injury, property damage, nuisance and sometimes pollution

Business Interruption
protection against loss of revenue as a result of insured physical loss or damage at client organisation premises and/or at supplier premises

- where insurance cover by suppliers is written-in to a ***contract***, clients should obtain a copy of the relevant insurance certificates **(R5)**

As a general negotiating question, some reasonable limit should be placed on contractual loss recoverable from suppliers. A decision should be made as to whether 'professional indemnity type risks should be considered separately from other possible losses – and if so separately specified in the ***contract.*** Otherwise it is suggested that the indemnity limit should be set at ***contract*** value plus a percentage figure that liquidates a measure of losses likely to be encountered should particular risks become issues.

- Contractual loss recoverable from suppliers under Low or Medium ***materiality*** contracts should be capped at fee + 25%. Higher materiality contracts should be considered on a case by case basis **(R6)**

10. A RATIONALE FOR RISK DISTRIBUTION BETWEEN CONTRACTING PARTIES

There are 'red-line' risk issues for most organisations. These are issues on which they cannot compromise e.g. for an airline, safety in transport operations. The areas where they cannot compromise will always include areas where criminal liability attaches to board level Directors for failure.

It is important that client organisations understand which areas are red-line. Attempts to make every issue non-negotiable will ultimately fail and may be counter-productive. (A bad argument undermines a good one in negotiations). Red line areas do not have to be flagged-up for public discussion, but it is vital that contract negotiators are clear about where true "red-line" areas lie for their organisation. If it is necessary to trade-off risks, then negotiators need to understand which are important and then assess that risk in the context of the contract being contemplated. e.g. intellectual property rights may be irrelevant in the supply of food-related services.

Client organisations should periodically validate in a systematic way what are red-line areas in their context. The following simple framework may be helpful:

Client Red Line Issues	Why?

Issues not listed should be considered as potentially negotiable if the benefits to the client are compelling. Many client organisations use "standard" or "template" forms of contract. It is not unduly difficult to reassign contract risks in a CREF managed environment and it should be possible to make speedy decisions on requests to reassign risk for specific projects.

However strongly we feel about a particular contractual clause, it is potentially "tradeable" for other benefits. Specific legal advice will only be required for decisions to renegotiate red-line areas and/or for high and exceptional materiality projects. The overall package of ***risks*** need to be balanced so that the economic benefits of the ***project*** are not undermined by risks that may happen, so becoming expensive ***issues***.

- client organisations should define ***materiality*** on supply contracts taking due account of any sector-specific regulations covering "outsourcing". This will help with overall risk assessment, putting it into a regulatory context. **(R7)**

11. CONTRACT NEGOTIATION

The client organisation will enhance its negotiating position if it carefully evaluates ***risk*** at the beginning of the project and sets out its technical requirements in a technical specification document and its commercial requirements in a carefully drafted form of contract. The two documents taken together can be seen as the client's overall *requirements specification*.

The client will be helped if it uses an industry standard form of contract, where such is recognised (but always bearing in mind that trade association based contracts are often weighted unduly in favour of the supplier). An alternative approach is to use the client's own template form of contract, assuming that this has been drafted taking into account the principles set out above, and especially the basic rule that *risk should lie where risk is best managed*.

Having appreciated any red line ***risk*** areas and invited offers ("Proposals") based upon the client's requirements specification, the client can be open to requests to redistribute contract risks in exchange for other benefits. Alternatively, where a particular clause has become a deadlock factor, the client can offer to concede in return for a realignment of contract risks elsewhere. Or alternatively to hold the line on the deadlocked issue, but propose concessions on other contract clauses that could be of tangible benefit to the other party.

Providing that red line areas are not breached, the overall integrity of the proposed ***contract*** should remain intact. Where re-balancing risks it will be necessary to discuss with in-house or external legal advisers to ensure that they understand the overall context. It may be necessary to debate / resist legal protests that the risk balance has shifted adversely and therefore should not be allowed. Providing the client has an overall *Contract Materiality Review*, and works within a CREF environment for monitoring and managing risks, the client should be on safe grounds to adjust ***risk*** distribution.

Where concessions are made from standard positions, the reasoning should be flagged and a clear statement given that this should not be interpreted as setting a precedent for future contract negotiations. Significant concessions should also be flagged in the ***financial business case***.

12. CONCLUSION

There are potential financial benefits in evaluating contract risks and having an open mind on reassigning risks between contracting parties. The starting point should always be that risk should lie where risk is best managed. It is best practice, and certainly good business, to have a risk management strategy, and for this purpose a CREF to review and monitor risks is a practical, simple and effective tool.

Notes:

Note on the Author: Peter Sammons MCIPS freelances as a Procurement contractor, mainly in financial services and science-knowledge based industries. He is author of *The Outsourcing R&D Toolkit* (2000) and *Buying Knowledge* (2005) both published by Gower.

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Buy Research Ltd, "Windmill Hill" Bartlow Road, Ashdon, Essex CB10 2HR.

07847 621081