

MANAGING THE RISK IN COMMISSIONING WORK & SERVICES

Risk allocation

- 01** A widely asserted principle is that contracts of all types should allocate every risk to whichever party is **best able to manage it**.
- 02** This is not always right. Recent experience of big contracts, especially for IT and construction, suggests that the client authority may end up bearing the risk whatever the contract says, and that it would be more prudent to allocate every risk to whichever party will have **the greatest incentive to manage it**. For public services, this is often the client authority.
- 03** Authorities therefore need to think carefully whether it is realistic to transfer major risks to contractors. Authorities may get the worst of both worlds if contracts express given risks to be transferred, so that tenders are loaded accordingly, but if authorities end up carrying the risk themselves. They would have been better off carrying the risk from the outset.
- 04** The need for a new look at risk allocation was supported, as to IT, by the Treasury Task Force (**1165**) in 1999. The Task Force
- ¥ addressed some serious failures of PFI contracts for IT (all in central government)
 - ¥ noted that 'an authority may feel that with PFI it can . . . avoid the commercial reality of development risk, and contractors have accepted a great share of such risks in the past . . . This is not necessarily the best position for the authority to be in'
 - ¥ suggested relief for IT contractors for the extra cost of dealing with delays caused by factors outside their control 'for example where delays are attributed to loss of data, or interference with systems caused by viruses, where the risks would otherwise have been allocated to them on the grounds that they are 'best placed to manage the consequences'.
- 05** Any such changes would of course be out of step with standard practice for PFI contracts. To qualify for government support (through revenue support grant in England & Wales, and level playing field support grant in Scotland) any assets provided as a result of PFI contracts have to qualify for inclusion on contractors' not authorities' balance sheets. Assets appear on the balance sheets of whichever party enjoys the greater part of the benefits of their ownership, and bears the greater part of the risks (**1082**; *Appx E*) (**1107**).

TUPE

- 06** A special difficulty arises if the party best able to stop the risk arising is not the party best able to minimise it if it does arise.
- 07** For TUPE for example, whether or not will be a TUPE contract is wholly under the control of the **client authority**. Contracts are non-TUPE if the skills and assets which they need are sufficiently different from those of the old contract (**1018a**; **14.4**). The greater the incidence of innovation, the greater therefore the incidence of non-TUPE successor contracts. Authorities are free not to innovate if they think it would not be worth the non-TUPE costs.
- 08** On the other hand, the scale of the redundancy and other TUPE costs depends on what the employer (**the incumbent contractor**) is willing and able to do to control them, for example by finding other jobs.
- 09** Authorities naturally avoid any open-ended commitment to meet contractors' non-TUPE risks. It is therefore common practice to make contractors bear the whole of the risk (over which they have no control at any stage) of the successor contract being a non-TUPE contract.

Performance bonds

- 10** Non-performance is not the only risk for clients, but is usually the biggest. It can readily be covered by bonding contractors or their parent companies; but only if bonds are set at realistic levels. Bond levels are nevertheless often set at 10% of contract values, regardless of the size and nature of the risks. This is either not enough, or too much.

- 11 It is **not enough** for many large contracts. The levels of bonds should then reflect the risk, as indicated for example by
- ¥ contract size. The bigger the contract, the bigger the likely cost (as a percentage of the contract sum) of making alternative arrangements
 - ¥ claims from third parties for service failure, and other damages
 - ¥ the estimated net extra costs of termination and of making alternative arrangements (possibly at premium rates for work placed at short notice) in accordance with predetermined contingency plans
 - ¥ the cost of additional enquiries
 - ¥ irrecoverable delapidations
 - ¥ minus the likely value of work not paid for on termination
 - ¥ minus recoveries from other sources (for example other insurances required to be taken out (116; 27))
- 12 This normally justifies bond cover at levels much greater than 10%. In the USA, the Hills Act requires cover equal to 100% of contract value. Bonding on this scale is undoubtedly expensive, but this is not the same as saying that it adds unnecessarily to contractors' bonding premiums and therefore to their tenders. Bond providers are themselves subject to market forces, so have to be realists. If indeed real risk is to be transferred to them, they can be expected to relate their premium quotes to the risk to themselves. If they think the risk is less than the % required, they ignore the excess. If they think the risk is greater than the % specified, they quote only to cover this % of the cover, safe in the knowledge that they won't have to pay out on the rest.
- 13 Nothing is therefore gained by capping the % cover. Any saving to authorities via premiums and tenders can be obtained only by setting cover at a level below what insurers would consider to be the commercial risk. In other words, cover at levels below the risks listed in paragraph 8.02 is a false economy.
- 14 For many small contracts, **10% bond cover is superfluous**. Insurance cover is however not usually worth having unless the risk insured against would be, for the party insured, a catastrophe. This is because, in the long run, total premiums paid exceed total claims. It follows that, although realistic bond cover may be needed for large contracts, any cover at all for small contracts is unlikely to be cost-effective. For most third sector contracts, the cost of realistic bonding would in any case be so high (for tenderers) that insisting on it would damage relations between the parties.

What next ?

- 15 Current practice as to the allocation of risks, where (unlike PFI contracts) authorities are free to exercise their own judgements, therefore appears to call for review.

SOURCES

- 110 SI 1993/3228 - Public Services Contracts Regulations
 1018a Cabinet Office Statement of Practice on Staffing Transfers
 1082 The Local Government SORP
 1165 Treasury Taskforce - Standardisation of PFI Contracts – IT Discussion Draft 1999