Chapter 3
Risks, Rewards and Contract Targeting

Introduction

All contracts are awarded with a view to gaining some ‘reward’ (advantage to the contracting organisation). Such rewards should be well-known at the outset because they will represent the basic objective(s) of the contract. However, contract award often brings risks with it and in this chapter we will consider typical risks that might arise from the development and award of a contract. ‘Management’ of risks – being aware of them, their potential and developing strategies to reduce their impact – is also very important. Additionally, we will consider the concept of ‘targeting’ contracts. This involves being aware of the recipients or beneficiaries of what the contract has to offer. If contracts are ‘targeted’ appropriately, they are much more likely to have fewer, less serious risks and stand a much better chance of succeeding than might otherwise be the case.

Risk and Reward

When considering contracts and the process of contractor selection, appraisal, negotiation and final contract agreement, we need to be aware that all contracts have risk associated with them but at the same time, have potential reward associated with them. Risk, generally speaking, refers to anything that could go wrong during the contract’s lifetime and reward, whilst not necessarily financial, refers to any benefit that the contracting organisation might accrue from entering the contract. Before setting up and entering any contract, we should be aware of potential risks and rewards that might stem from it. We should also be aware of the extent of risk and reward.

What is risk?

As we stated above, ‘risk’ refers to anything that might go wrong with the contract process, which we need to try to assess before entering into a contract. Therefore the risk criteria are directly related to our business drivers, customer markets, technology, government legislation, and a host of other factors affecting the products and services we purchase.

Risks can be classified under the following general headings:

- **Commercial Impact**: the fact that, if the risk materialises, the company might lose money and/or reputation, the latter leading, in turn, to reduced sales.
- **Health & Safety & Environment (HSE) issues**: again, these can seriously affect a company’s reputation if problems arise during the performance of a contract.

- **Technology**: modern technology can bring many advantages but if it is not thoroughly developed and tested, it can cause many problems and create stoppages in operations while the problem is fixed.

- **Programme**: some contract programmes do not run smoothly with stoppages, quality problems, lack of suitable equipment and many other sources of problems that might halt or slow down a programme. These should be assessed and contingency plans put in place as much as possible before the programme (contract) commences.

- **Supply Market**: the activities and condition of the supply market can cause risks. These might be the risk of contractors going into liquidation or the need of contractors to increase or fix prices to maintain profitability.

  A good example of this risk is **Unilever and Procter & Gamble (P&G)** who have recently been fined €315.2 million (£278 million) by the European Commission for fixing the price of washing powder.

- **Quality**: this has always presented a risk, that of the quality of work not being up to the required standard. If work carried out by a contractor is not up to standard, this can reflect on the contracting organisation with a resultant reduction in sales or reputation.

- **Specific examples of risk could be**:

  - **The number of contractors who can supply the product/service**: if there are few of these, the risk associated with their going into liquidation becomes greater than it otherwise might be. This is not to say that they might be more likely to go into liquidation but that the risk of problems, e.g. of re-sourcing, would be greater if they were to go into liquidation. Also, there is the potential problem that, if the contractor knows that the contracts officer has not much choice of alternative contractors.

  - **The criticality of the product/service to our organisation**: what happens if it does not arrive on time?

  - **Lead time**: this is particularly risky if it is uncertain or unpredictable. These situations in supplied goods and services can lead to the contracting organisation’s lead time being unreliable.

  - **Imported goods**: additional elements to consider when importing/using overseas contractors to perform a service:
delivery time and delivery methods (see ‘late delivery’ below)
Exchange rates: change constantly and a trend of falling value of the contracting organisation’s currency can mean that the ‘real’ cost of imported goods increases. An example here would be during the autumn, the value of a Euro compared to the £Sterling increased from around 75p to around £1. This would have meant that a contract worth 1 million Euros at, say, the end of August would have cost £750,000 but would have cost £1,000,000 by the end of the same year. Also taxation issues: overseas governments might increase export taxes
  - or duties without any warning, the effect of which would be to increase the price of the goods being imported suddenly.
  - Political instability: the possibility of governments being suddenly replaced by a government that does not approve of exports to the West or to the specific contracting organisation. This can apply to countries through which goods are transported as well as to the country of origin of the goods. It should be remembered that civil wars/strife takes place in some parts of the world and that these occurrences can seriously affect the process of importing goods from these parts of the world

Late delivery: this can apply especially to items coming from overseas with long and difficult journeys between contractor and contracting organisation. If supplied goods are late, this can make delivery of the contracting organisation’s product or service late. This is different from the ‘lead time’ issue mentioned above and refers to situations where the forecast lead time is acceptable but for some reason, a problem occurs and the goods arrive late.

Contractor/contractor collapse: this is particularly serious in times of recession and refers to situations where the contracting organisation places a contract with the contractor only to find that the contractor has gone into liquidation after the contract’s running time has started. This can be a serious problem because, if it happens, the contracts officer must find a replacement contractor, which, in the case of complex or difficult products or services, can be a lengthy process.

Product safety hazard: this is the risk that products purchased for good reasons can be discovered to have safety problems during operation.

Lack of traceability: this refers to products that have long delivery journeys and whose position in the journey cannot be ‘traced’ (e.g. by GPS). This can lead to risk of non-delivery.

Consequential loss: this is the risk of items either arriving late or arriving on time but not working properly. The risk is that either of these occurrences might stop the contracting organisation’s operations to the point where it has to compensate its customers.
- **Key person**: if the contractor has a ‘key person’ such as an account manager looking after the contracting organisation’s supplies, it is likely that this person will have good knowledge of the organisation and its requirements but if that person leaves the contractor or has an accident, supplies might begin to fail. It is a good idea, with important contracts to try to ensure that the ‘key person’ has an assistant or ‘substitute’.

- **Dependency**: being heavily dependent on a contractor can be problematic because, if the contractor goes into liquidation or experiences the kinds of problems alluded to above, the result can be serious problems for the contracting organisation.

- **Yesterday's technology**: if contractors are supplying items using yesterday’s technology, there is likely to be a resultant effect on the contracting organisation. This would most likely be the gaining of a reputation for being old-fashioned and supplying old-fashioned products. This could be damaging even if the ‘old-fashioned’ products were extremely reliable.

- **Defects**: this is the possibility that goods might arrive with defects that have either occurred because of poor inspection/quality control at the contractor’s premises or be due to damage occurring during the journey.

We will consider ways of mitigating or removing (‘managing’) these risks throughout the book.

The Aberdeen Research Group recently surveyed 315 business managers from across the globe, 72% of whom were in sourcing, supply chain or procurement, to find that risk analysis was one of their “weak links”.

### Potential Rewards

We have said that there are many risks that might apply to contracts but there are also potential rewards. These can depend upon the nature and value of the contract. For example a routine gardening contract is unlikely to deliver much in the way of innovation. Here are some of the potential rewards that can be leverage from contracts

- **Cost reduction**: this one should be fairly obvious but well-sourced products or services with contractors who can reduce costs and therefore, prices, without reducing quality can lead to a reduction in costs in the contracting organisation.

  This is an example of the “opportunity” for reward, in the form of cost savings. The UK Ministry of Justice has failed to understand the cost of its services, states the UK Committee of Public Accounts The Parliamentary committee, which heard evidence from the ministry criticised the ministry’s poor financial management in a report recently
published. Margaret Hodge MP, the PAC chairperson, said: “If the Ministry of Justice is to minimise the impact on its frontline services of its tough spending settlement, it must fully understand the cost and value of those services. But the ministry and its arm’s-length bodies currently lack that detailed information.”

Another example is Surrey County Council in the UK expects to save £10 million by agreeing better deals with its main suppliers. The local authority is asking its major suppliers, who collectively receive £250 million of the authority’s £680 million annual budget, to “share the pain” of the economic climate and council funding cuts. The council expects its talks with suppliers to deliver rewards of £10 million over 18 months.

- **Quality improvements**: contractors who can supply high-quality goods can help improve the contracting organisation’s operations and potentially, the quality of its own product. If the contractor is able to work to improve quality continually, this effect will be even greater.

- **Service improvements**: contractors that can provide good service help keep the contracting organisation’s operations and (e.g.) product delivery reliable. If the contractor is able to improve service, it could mean that the contracting organisation’s service and delivery would be improved.

- **Innovation/New Product Development (NPD)**: contractors who have continual programmes of innovation or NPD can bring the results of these activities to the contracting organisation. This would help the contracting organisation to use such innovations to improve its own product.

- **Developing new markets**: contractors who can provide some of the aspects of the supply process mentioned above (innovation, quality improvement, etc.) can assist the contracting organisation in the development of new markets for its own products or service because these ‘supply chain improvements’ can, in effect, be passed on.

- **HSE**: contractors who can show that their goods and/or services comply with the latest HSE regulations can help the contracting organisation to keep up with such regulations.

**Procurement targeting**
This is a good starting point for the process of estimating potential risk and reward for a contract and a well-established method of ascertaining these variables is the Kraljic matrix.

This model, which has been in circulation for at least 25 years shows the product portfolio within the four boxes, according to spend and risk, i.e.

Routine = low value, low risk items or services  
Leverage = high value, low risk items or services  
Bottleneck = low value, high risk items or services  
Critical = high value, high risk items or services

In consideration of this model, we are only considering the intrinsic merits of the products we buy, not the contractors we buy them from. The model acts as a basis for further consideration of the supply base available to us. In terms of risk, it is contracts with high risk potential that require a good deal of attention to identify risks and similarly, it is likely that high value contracts are the ones that are likely to yield the greatest rewards. We should remember, of course, that ‘reward’ often relates to added value, which can help to increase profitability, rather than to direct profitability increases such as reduced purchase prices although, of course, in some situations, reward can increase profitability directly.

![Kraljic Matrix](image)

Fig. 2.4: Kraljic matrix

**Overview of the Four Procurement Targeting Groups**
Routine items

It is unlikely that major contracts or projects will fit into this category although the outsourcing of ‘small’ services could be included here.

Contracting and supply functions should be administering these items as efficiently as possible. Typical routine items are stationery, fixings and fastenings, and production consumables. Many contracting departments spend large amounts of their time managing these products. Contracting and supply departments should be concentrating their attention on minimising effort and paperwork and, instead, wherever possible, devolving responsibility to end users. Options may be:

- Set up a call off contract for all the products that will group together then pass back to the budget holder, who will draw product against the contract, at the predetermined prices which contracting has negotiated.

- Arrangements can be made by the contracting function, with contractors, to buy certain items from selected contractors by corporate contracting cards (charge card contracting) thus saving the contracting department time taken placing orders. E-procurement arrangements will, in many organisations, seek to achieve the same end result.

‘Routine’ solutions

All of these possible solutions are aimed at minimising risk and maximising reward.

- Long-term relationship (not partnerships, as such): this should facilitate the development of systems with the contractor that enable the items to be delivered regularly with the minimum of documentation or concern for risk.

- Cost-of-acquisition focus, rather than focus on purchase price alone.

- ‘Umbrella’ contracts (call-off, credit card, e-procurement, direct requisitioning, VMI etc.): such systems, in effect, ‘automate’ the contracting process and if they are implemented with contractors with which the purchaser has a good long-term relationship (see above), should mean that the contracting process for such items will operate with the minimum risk. Also, because such systems should mean that contracts officers and other staff need spend little time ‘managing’ them, there should be reward due to the fact that costs are reduced to a minimum.

- Find a contractor who is small enough to be enthused by our routine business, or alternatively, a large contractor whose business it is to deliver economies of scale and efficiencies to our routine business. The enthusiastic, small, contractor will work hard to satisfy our requirements meaning that risks should be reduced and rewards
maximised. Similarly, the large contractor able to deliver economies of scale will provide a fairly direct reward.

- Minimal formality, which can relate to ‘umbrella’ contracts (see above), could reduce costs and add to rewards by means of (e.g.) the following.
  - no goods-in checking
  - consolidated billing
  - prompt service
  - deliver direct to user/customer
  - no stocking
  - management reports.

**Bottleneck items**

Bottleneck items will usually have similarities with ‘routine items’ the key difference is the greater risk of non-availability and hence the risk, which might be relatively severe, of shortage of supply. The leverage, or negotiating strength, of the purchaser is limited because of the high degree of strength of contractors. The emphasis here is to try and ensure supply. This can be carried out by adopting a long-term relationship incorporating service targets for performance or, alternatively, by adopting a multiple-sourcing strategy, if it is possible to do so, to minimise the risk of over-reliance on any one contractor.

In terms of reward, the likelihood is that this will be low because contractors, typically, will not have a great interest in our custom when compared with that of other customers and might charge high prices.

**Bottleneck solutions**

- Try to develop close relationships focusing on how important the contractor/contractor is to the organisation.

- Focus on cost of acquisition, not price.

- Make much effort up-front to ensure that we have the ‘best’ contractor/contractor possible,

- Long-term contracts, again showing the contractor/contractor their importance to the organisation

It is worth commenting that some contracts officers might try to work with internal customers to identify alternative ways of satisfying the need in order to reduce risk and minimise the potential for poor reward. This might involve finding out whether an alternative item, that might be placed in one of the other ‘boxes’ in the matrix, to that being purchased might perform the function just as well.
Leverage items

Traditionally, the view of leverage items was that the contracting organisation should be exploiting their position, as the contractor market will be competitive and because the purchaser’s spend will be one that puts them in a more powerful position with contractors. The leverage box is complex, and the simple exercise of spending power may militate against other objectives, such as rationalising contractors. With these items, the traditional view is that there will usually be many contractors in the supply market meaning that the contracts officer can change contractors easily and quickly if the existing contractor lets them down or is forecast to be about to let them down. Also, with these items or services, the contracts officer should have much greater negotiation power than with other purchases and should be able to negotiate the lowest prices possible meaning that there would be a direct increase to reward.

Leverage solutions

- Traditional procurement approach; short-term spot buy (although it is worth noting that this is not really relevant to projects, as such).

- Use supply market competition for the initial sourcing exercise and negotiate a sound contractual base. Strict contract terms that, in effect, force the contractor into supplying in ways that suit the contracts officer should have the effect of reducing risk.

It might appear that few, if any, of these solutions would be relevant to projects but, for services/activities falling into this quadrant, there is no reason why we should not adopt some of the above approaches at least at the initial sourcing stage.

Critical items

Critical items will have a high spend on goods/services which have few contractors. A balance can exist between the power of the two parties and the two companies may in fact be dependent on each other. Much will depend on the size of the two organisations.

The choice of contractor strategy can be to pursue a long-term partnership agreement. This can be difficult if the contracting organisation is dealing with a more powerful contractor. Contractors that supply products/services to us in the critical box are the sort of contractors that we wish to invest time and money in, in the form of a contractor development programme, which will include techniques such as:

- Total cost modelling: using (e.g.) open-book costing in order to know the contractor’s actual production/provision costs

- Value analysis and value engineering,

- Continuous improvement, e.g. kaizen,
Critical solutions

- Long-term contracting: this should reduce risk because the contractor is assured of our business and increase reward because we might be able to negotiate good prices based on the contract length and subsequent total quantities purchased.

- Formal contractual base: this should be the case in all purchases but is particularly important here. It can reduce risk by ensuring that there are contractual terms that should cover all eventualities.

- Total life costs which might be Life Cycle based and should provide a complete picture of the Total Cost of Operation (TCO) of the product being purchased. This type of costing usually relates to purchases of major pieces of equipment or of other projects and should help increase reward by enabling the contracts officer to compare the projected TCOs of a number of potential contractors at the tendering/appraisal stages in order to be able to award the contract to the contractor showing the lowest TCO.

- Willingness to share risks and benefits (value engineering, co-make etc.).

It is worth noting that deciding which contractor to purchase from, how to negotiate with them and ultimately cementing the appropriate contractor relationship is not as simple as this segmenting process suggests. Sometimes we are locked into particular relationships; often we are unable to find contractors/contractors who match the ideal. Sometimes, although a contractor is selling something relatively off-the-shelf, their market dominance gives us little power or alternative. Sometimes it is a subjective assessment as to where a particular purchase falls in our market segmentation.

The underlying message of the model is that each product category demands a particular relationship type to be developed if the contracting function is to prosper.

Chapter summary

In this chapter we have considered an overview of risk and reward relating to contracts and ways in which such risks can be assessed and managed.

- Contract management is a lengthy process that originates with the perceived need for the contract and ends with the award of a contract to the ‘best’ contractor. It is after this stage that contract management, the ongoing process of ensuring that the contract progresses smoothly and in accordance with requirements, begins.
All contracts have risks attached to them. These are aspects of the contract process where things could go wrong. There is a large number of such risks and the contracts officer must try to be aware of them at all times.

Similarly, all contracts have potential rewards and the contracts officer must always be aware of these and be aware of whether they are being achieved by the contract.

There are mechanisms such as the Kraljic matrix can help us to be aware of the risks that may apply to a contract as well as how likely they are to arise and their potential seriousness.

Case Study

Donna Ltd is a large manufacturing company producing a range of very well known machines for the energy market, in the UK and the USA. It has a turnover of over £100m per annum. Recently it has designed and developed a new generation of high-tech machines, which employs the latest technology and the unique selling proposition of being able to operate using only 30 per cent of the energy consumed by traditional models; it also has a unique control system to reduce the amount of materials needed to achieve excellent results.

One of the key elements is the auto feed control unit, in the industry it is widely known that 95% of all equipment failures and breakdowns can be attributed to faults in this key component. Obviously the contract for this item is fundamental to the success of the product. As the managing director of the company has said in a memo to the production manager, the future of the company is staked on the new product.

Traditionally, the auto feed control unit used in Donna’s machines have been obtained from the UK market, in particular Omega Ltd. Jim Peterson, the Contracts Manager, has already suggested that the contract for the auto feed control unit be placed with Omega, a locally-based manufacturing company employing about 100 people. Unemployment in the area is quite high and the current recession has hit the company hard. In recent years Omega has reduced its R&D expenditure and cut back on several major investment programmes. Donna has a corporate strategy, part of which is to support local industry and the local community. The company has sponsored several education and training programmes in conjunction with the local community.

Omega has suffered from quality problems in the past and has had to employ inspectors and checkers to reduce the number of faulty products leaving the factory. Jim Peterson feels sure that with a contract full of clear contractual obligations and improved inspection and checking procedures at Donna’s end, he will be able to ensure the consistency of quality. Omega is very
competitive on price (up to 10%) a vital factor in the traditional Contracting decision.

Susan French, Director of Contracts, on the other hand, takes a different view. In recent times the improved quality and competitive price of several South Korean suppliers has called the traditional contracting decision into question. One contractor in particular, the SKS Corporation, which has recently established a sales office in London and has a very good reputation in the market place and are well know for their quality.

Jim and Susan have crossed swords on several occasions regarding sourcing decisions. Jim thinks that Susan does not understand the realities of the situation; Omega is a well-known company which has worked closely with Donna. Susan feels that Jim is too conservative and that a more pro-active approach would reap great quality and price rewards. She is determined to use SKS.

At a recent meeting to discuss the issue, the Managing Director had to step in to restore order as Susan and Jim got into a heated debate. Jane Tilly brought them back to earth by pointing out: “The key issue is not whether Omega or SKS are acceptable to us; it’s whether they are acceptable to our customers.”

This contracting decision is vital to Donna’s future. It must be made in the light of that and take into account the cost of having to go through the process again should the decision be less than optimal.

Tasks

Analyse risks and rewards associated with both contractors