Government
Commercial
Function

RISK ALLOCATION

Outsourcing Guidance Note

February 2019

Risk Allocation

Successful outsourcing arrangements rely on apportioning risks between government and the supplier so that the party best placed to manage the risk is responsible for them. This means that they will be responsible for mitigating the chance of the risk arising, managing risk and its impact and dealing with the consequences (both financial and non-financial). It may be appropriate for some risks to be managed by one party rather than another or for some risks to be managed jointly by both parties.

Although risks may be transferred commercially from the Government to a supplier, the public does not see it this way. Where we have public facing or public impacting services, the Government is responsible for the delivery of those services and government will always be (rightly) held to account, whatever the contractual risk position is. Reputational risk is not a risk that can be transferred; if services fail or performance falls below acceptable levels, the Government will be held to account in the public's eyes. Where these services are outsourced, the supplier is also likely to suffer a reputational impact, but this does not lessen the impact on government as being ultimately responsible for the delivery of that service. The failure of Carillion provides a recent and relevant example of this reputational impact.

Where a contract ends suddenly (for example because the supplier becomes insolvent or cannot fulfil their service obligations) government is responsible for maintaining services. In order to ensure this happens, contingency plans must be put in place by the supplier and maintained and reviewed throughout the life of the contract by the supplier and the department. In some circumstances, these may also need to be reviewed on a regular basis at a strategic level.

Some risks are driven by external factors and therefore may be more difficult to be managed by government or a supplier. For example, volume change risk, where this is driven by citizens' uptake of a particular service. In such circumstances, the department may consider that the risk of usage of the service (i.e. volume risk) should not be wholly transferred to the supplier.

Other commercial risks are driven by insufficient data or a lack of transparency or full awareness on the internal and external factors that contribute to the performance of the service.

Commercial strategy

When developing a commercial strategy the government should consider which risks it retains and which to transfer. Government should apply appropriate focus and governance to develop its approach to risk allocation, including through dialogue with potential bidders through the procurement process. Government also needs to be satisfied that risk allocation is being managed proactively during the contract's term.

Service providers and outsourcers are in business to deliver services and not to take unreasonable or unnecessary risks - but risk allocation to the supplier is only effective in the medium to long term if the risks are quantifiable and manageable. As a rule "risk should be managed by the party that is best placed to manage that risk."

Placing risk with the party best able to manage it will lead to:

- optimal pricing from the suppliers[1]
- fewer performance and commercial issues during the contract term
- a reduced likelihood that the contract fails completely, and the supplier prematurely exits the agreement or becomes insolvent.
- a climate of open and honest business dealings for mutual benefit

This approach can help avoid inappropriate risk allocation being a divisive influence between the parties throughout the contract term, which can negatively impact performance and relationships.

Why has the transfer of risk been an issue in government outsourcing contracts?
The main cause of issues arising in relation to risk allocation in government outsourcing is that departments often do not understand the risk sufficiently to understand its impact and therefore the extent it is appropriate to expect the supplier to be responsible for the risk.

Agreed risk positions are ultimately reflected in the contract (which includes the schedules, such as the pricing mechanism and the performance regime) and risk transfer often forms part of legal and commercial discussions.

Where a risk materialises during the contract term, the remedy or correction has a cost impact on the supplier or government. Consequently, in the past, it has been perceived as a

[1] i.e. with an appropriate risk premium - neither too large or too small

sign of a good negotiation or a good deal if this risk (of future costs) is passed from government to its suppliers as much as possible.[2]

However, issues arise with this approach if risks are transferred to the supplier without fully understanding how they might best be managed and the impact they could have if transferred inappropriately.

An example of this is inappropriately passing the full risk of unexpected increases or decreases in volumes to suppliers in output based contracts, where the suppliers cannot influence that volume, and changes can have a material cost consequence. This may mean that the supplier receives no additional payment for changes in the volume of transactions yet it has incurred significant additional costs. Sometimes the split of fixed and variable cost, and therefore the supplier’s ability to effectively manage its cost base when volumes change, can be the cause of issues. We commonly think of labour cost as being a variable cost, but in the provision of many Government services, staff need a level of training or qualification that means this cost may only be semi-variable.

[2] This is also true in the private sector, however the size of many government outsourcing deals and the lack of flexibility to negotiation on terms and conditions, has perhaps made this more prevalent in public sector procurement.

Considering risk allocation in commercial strategy

The primary objective of the approach to risk allocation in the commercial strategy is to set out an approach which:

- drives best value for the products or services that are being procured
- maintains service continuity
- ensures that if a business continuity risk does arise, there are contingency options

Two of the key factors that help determine the level of risk to be transferred to a supplier are:

- the level of control the Contracting Authority wishes to have in ***how*** the services are delivered
- the ability and readiness of the supply market to bear any risks associated with the delivery of the service and (if applicable) any transformation programme

Contracting Authorities should give consideration to these factors to help determine what level of risk should be transferred. Both these factors might be influenced by:

- whether the service is being outsourced for the first time;
- the maturity of the supply market in delivering similar types of services;
- the complexity of the services required;
- the scale of transformation the Contracting Authority is seeking;
- the extent and quality of supporting data;
- past experience of delivering similar types of services.

Government should identify and document all the key risks which may affect the contract and the delivery of the service. Government should then identify which party is best able to manage that risk, including whether it would be best managed jointly. Generic guidance on specific risk areas and where they should reside, for an output based contract[3] are captured in the table below. This view will help determine the commercial strategy and ensure the correct pricing mechanism to support that strategy. The view of risks should then be discussed with supply side input through the procurement process.

[3] Refer to section below for a definition of an output based contract

Key areas of risk in an output based contract and where they best reside

Type of risk	Specific area	Party with which risk should normally reside	Rationale	Exceptions	What does this mean in practice?
Solution / design risk	Solution design	Service Provider	Normally the solution designed by the Service Provider in an output based contract.	Where the Contracting Authority specifies all or part of the solution design.	Contracting authorities should avoid specifying areas of solution design in an output based contract.
Volume fluctuation	Pricing	Contracting Authority	The Contracting Authority has this risk if the services are not outsourced and in general the Service Provider does not influence the volumes	Where the Service Provider can influence volumes through its activities and obligations under the contract. Where the underlying business model of	• If there is an increase in volume, the Service Provider should be paid for that increase in volume (i.e. on a unit price basis). • If there is a decrease in volume, the Contracting Authority should pay less for that decrease in volume.

				the supplier / market allows for volume change (e.g. cloud based IT services)	• Banded pricing may be applied (normally a lower unit price for higher volumes and a higher unit price for lower volumes)
	Volume forecasting	With the party responsible for volume forecasting	The party who is best able to manage the risk, should be responsible for the consequences of an adverse impact materialising		If the Contracting Authority is responsible for the forecasting: • Consideration should be given to a banding within which the Service Provider is able to ramp up and ramp down capacity at short notice • If the actuals are higher than forecast and the Service Provider is not able to meet its SLA's - a let should be given on the SLA, but only on the portion incurred due to the over-forecast and which is outside the flexibility banding • If the actuals are lower than forecast and the Service

					Provider suffers stranded costs, the Contracting Authority should consider remedying all or part of those stranded costs through the pricing mechanism.
Risk of an increase in price of cost inputs / or implications of a failure of the supplier's supply chain		Service Provider	Typically the Service Provider has chosen to base its solution on inputs it has specified and it should therefore take any risk associated with these inputs on entering into the Contract. Service Providers are also best placed to manage risks associated with these cost inputs throughout the contract life.	If the increase in price is driven by changes by the Contracting Authority in the scope of the services (or the output requirement) then reasonable price adjustments to reflect a real change in costs (up or down) can be sort by either party through change control	• Service Providers should not seek / Contracting Authority should not provide additional financial remedy for input cost risk it has built through the bid process and taken at the point of entering into the contract. • These changes could include Labour costs / product costs / higher than expected inflation / extraordinary cost escalation due to exchange rate changes. • Indices which capture the expected increase in costs through the contract may be agreed in the

					contract. The indices should seek to reflect the real cost drivers in the contract. If the actual costs vary from those indices, this is at the supplier's risk.
Changing output requirements		Contracting Authority	In essence the Contracting Authority has changed the requirements for which the Service Provider has based their solution and pricing		• Managed through Change Control • Requires commercial mechanisms which allow confidence that VFM will be maintained through and new solution.
Solution Change		Service Provider		If the solution change has been driven by a change in requirements by the Contracting Authority	• Contracting Authority has a choice whether to accept proposed change (other than in limited circumstances (e.g. change required by law)) • Managed through Change Control
Delay in programme roll-out		Party responsible for the delay			• Authority must understand and manage its obligations effectively
Exchange rate		Service Provider / or	Service Provider	Service Providers	Where an exchange rate

risk		shared risk	determines inputs, including whether these are sourced overseas. Global supplier's will / should hedge to mitigate significant exchange rate movements.	may seek to cover more extreme movements outside a tolerance level.	risk is shared: • Normally a tolerance level within which exchange rates can move - outwith this invokes a pricing review • Contracting Authorities should exercise diligence to ensure such clauses work both ways.
Certain unforeseen external risks (Force Majeure)	All contract areas	Both parties (either party can suspend or terminate its performance obligations if this is invoked)			• Contracting Authority should follow the Model Terms and ensure this clause isn't broadened to cover areas of risk which are within supplier's ability to control (e.g. industrial dispute - see below)
Industrial Action		Service Provider	This is within the Service Providers ability to control and a core element of their delivery.		Service Provider is responsible for their own employee relations. This element should not be included in a definition of Force Majeure.
Policy		Contracting Authority	This is driven by the		Contracting Authorities

Changes			Contracting Authority or broader Government. Where this drives a change in the requirements, its the Contracting Authority responsibility.		should use the standard change of policy provisions set out in the Model Services Contract
Change of law - general		Supplier	This impacts the whole of the supplier's business and other contracts it has with other customers; it is not unique to the particular contract it has with the Contracting Authority		Refer to the provisions in the Model Services Contract terms.
Change of law - specific (i.e. impacting the scope of the contract)		Contracting Authority	The Contracting Authority has this risk if the services are not outsourced and Service Provider cannot influence this.		In practice the impact of the change would be assessed by the Service Provider and implemented through the contract change process.
Interoperability with systems managed by third parties		Service Integrator. Can be Contracting Authority and / or Service Provider	Normally the Service Provider acts as the Service Integrator.	In some cases a third party acts as the Service Integrator.	Any interoperability and dependencies need to be fully mapped out and understood during the procurement process, and consequences of failure

					made clear in contractual provisions.
Service Transfer risk		Supplier	The solution is the supplier's who will have proposed and developed its transition plan		The supplier will have submitted a draft transition plan as part of its tender. The contract should contain a mechanism for the supplier to develop and implement this. The contract should also require the supplier to maintain asset and information registers during the life of the contract and assist in transition on exit (e.g. to co-operate with the new supplier, provide information promptly when requested).