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LAWYERS

Guide

Contracts: Allocating Risk

P 07 3354 8888 • F 07 3257 0911 • W klaw.com.au • E info@klaw.com.au
Unit 2, Calibre, 31 Helen St. Newstead Q 4006 • PO Box 2193 Fortitude Valley BC Q 4006

What is risk?

Risk is defined as "the possibility of suffering harm or loss: danger"[1]

Going one step further, a construction engineering academic has defined "risk" as[2]:

…[a] variable in the process of constructing a … project whose variance results in uncertainty in the final cost to the owner.

It is almost certain that the eventuation of a risk will lead to lost time and money and possibly the failure of a project or a particular transaction. While taking "risks" in business is an essential part of doing business, and is what allows us the opportunity to prosper, parties can and should eliminate or reduce risks wherever possible.

To do this, organisations must act "preventively" – by proactively putting in place measures that will prevent a problem from occurring rather than reacting to the problem when it occurs. This occurs through managing risk firstly on a "project" level and then on a "transaction" or "contract" level. Such risk management is often referred to as risk allocation.

This paper seeks to provide an outline to effectively manage or allocate risk by an organisation when considering a project and negotiating the project's necessary commercial transactions or contracts with contractors and other suppliers.

Why manage risk?

Put simply, the correct management of risk reduces the impact and/or likelihood of risk events occurring, helping to reduce costs and improve the success of the project or transaction. For example, in a construction project, the recognition of the wide range of risks that could materialise during the planning, design and construction phases of a project will result in:

1. better informed and more prudent designs;
2. improved specifications;
3. better informed bids; and
4. improved project relationships and communications and enhanced administration practices.

This should lead to:

1. fewer misunderstandings and unfulfilled expectations;
2. less acrimony;
3. less time and money spent dealing with attempts to mitigate the adverse consequences of unanticipated risks.

The end result is that many disputes will be avoided and others will be susceptible to resolution on the job - the entire project benefits.[3]

Notwithstanding such obvious benefits, a 2001 study by The Chamber of Commerce and Industry of Western Australia and the Institution of Engineers Australia identified that effective risk management is far from common. Their report Effective Risk Allocation in Major Projects: Rhetoric or Reality?[4] found that:

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[1] Dictionary.com

[2] Levitt, RA., Ashley, DB., Logcher, RD., and Dziekan MW.: A Quantitative Method for Analysing the Allocation of Risk in Transportation Construction, at 2 Massachusetts Institute of Technology Research Report R79 (1979) as cited by Smith, J.: Risk Identification and Allocation: Saving Money by Improving Contracts and Contracting Practices: International Construction Law Review (1995) at 41

[3] Mills, M.: Insurance and Risk Solutions for Commercial Projects: AMPLJ (2001) at 41

1. Formal risk assessments were not undertaken;
2. Risks were not being allocated to the party best able to manage the risk;
3. Risk clauses were often varied from those in the standard forms of contract;
4. Risks were being transferred to consultants and contractors which were impossible for them to manage;
5. Cost savings would have occurred had risks been more efficiently allocated; and
6. Contractors, consultants and principals have widely different views on current risk allocation.

These findings provide an important back drop to the process of risk management.

How to allocate risk?

Risk management has the following steps[5]:

1. an identification of the risks facing the organisation, normally done through development of a "risk register/matrix" or "risk profile";
2. an analysis of the risks, especially an analysis of the likely frequency and severity of the risk identified, followed by an evaluation of the risks;
3. treatment of the risks which broadly revolves around 4 options:
   a. risk avoidance - such as not engaging in the particular activity;
   b. risk control - implementing procedures which minimise the likely frequency and or severity of an identified risk;
   c. risk retention - where risk is deliberately retained but plans are put in place for the consequences of such retained risks, such as means of financing the consequences;
   d. risk transfer - when the organisation decides not to manage that particular risk itself or where another party shares all or some of the risks – use of warranties/conditions in contracts, indemnities and insurance arrangements.
4. Monitoring and reviewing those risk management strategies on an ongoing basis.

In identifying risk – the most important question to ask is "what if?" Try to consider all possible scenarios that may affect a project by asking "what if x happens" or "what if Y happens?" Schedule 1 contains a representative listing of risks, risk groups and risk sources subject to allocation via contract terms.

Determining the applicable treatment of a risk should be done on a "risk by risk" basis. Organisations treating every risk by transferring it are likely to be disadvantaged. Such organisations usually believe that there will always be contractors willing and available to take major risks and that this approach "locks in" a price at the beginning of the project. These owners are basically saying "I will pay the contractor so many dollars for their services and if anything unexpected occurs or anything goes wrong, that is their problem, not mine". This logic has some theoretical appeal however in practice things seldom work out this way.[6] This opinion is reflected in the Private Funding Manual of the Australian Government – Department of Defence which states "… maximum risk transfer is unlikely to achieve value for money. Forcing risks on bidders that they are not in a position to manage will be reflected in higher priced bids. As parties bear more risks, the requirement for compensation for carrying the risk increases."[7]

Risks should belong with those parties who are best able to:

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[4] By Athol Yates & Bill Sashegyi at 1

[5] Mills, M.: Insurance and Risk Solutions for Commercial Projects: AMPLJ (2001) at 47

[6] Mills, M.: Insurance and Risk Solutions for Commercial Projects: AMPLJ (2001) at 42

[7] www.defence.gov.au/cfo/privfin/manual/06.htm

1. evaluate the risk;
2. control the risk;
3. bear the cost and benefit from the assumption of risk; and
4. who can bear the risk at the lowest possible cost.

Therefore, the typical situation of organisations shifting risk to contractors, who in turn shift risk to subcontractors, will not result in an efficient allocation of risk.[8]

Organisations that properly allocate risk have found that they had fewer delays and disputes and better relationships among the members of the construction team. In addition, they found that they themselves have done a better job of managing and administering contracts and have obtained more competitive bids. At the same time they report that the incremental cost of allocating risk have been quite minimal. Obviously, if a major risk retained by the owner materialises, the owner will pay more. However, if the risk was logically that of the owners in the first place, the cost to the owner is no greater[9]

Example

So let's look at an example in relation to Sampson's Electrical Pty Ltd (Sampson's).

The Background

Sampson's is a national private company that does electrical work predominantly for various telecommunications companies.

Every time a network installation is done for a customer, Sampson's is required to send out an electrician to connect the electricity to the installed equipment.

As a very successful company, Sampson's is receiving 100's of orders per day.

The issue

Currently, the orders are being received by "purchase orders" faxed through to the relevant state office.

Sampson's is finding that orders are going missing leading to late jobs and upset customers.

It is also paying late penalty fees pursuant to the contracts that it has signed with some of its major customers – such fees are adding up.

Also, as they are getting busier and busier, they are having problems with their workflow procedures – getting the orders to their staff and the staff out to do the job in the required time frame.

The project

Sampson's believe they can solve this problem by implementing an online ordering system where its customers place there orders online at Sampson's website.

This will ensure that orders are received promptly.

Sampson's will then implement an automated workflow system which will ensure that the order will create a "job number" which will be issued to the appropriate staff member promptly for their attention.

Also, Sampson's would like their customers to be able to monitor their jobs on-line by having access to a secure web site using a password.

Sampson's has an IT consultant (Mad Max Computers) that looks after its computer hardware and network. Max is the brother of the major shareholder and is very good at what he does.

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[8] Mills, M.: Insurance and Risk Solutions for Commercial Projects: AMPLJ (2001) at 43

[9] Ibid at 42

The Matrix

Sampson's then go about identifying the risks, and an analysis of the likely frequency and severity of the risk identified, followed by an evaluation of the risks. This is firstly done on a project level. Here are some of the risks.

Table A – Project Level Matrix

Risk	***Likelihood***	***Severity***	***Avoid/ Control/ Retain/ Transfer***	***Responsible Party***
After implementing the procedure, customers do not or are unable to use the technology to place order	*Low – most organisations (particularly the type of customers Sampson's have) will embrace the technology*	*Low – loss of customers small or can run 2 systems if deemed necessary (but must be avoided if possible)*	*Control – get customer buy into idea*	*Sampson's*
A hacker cracking the pass code for online customer access for work flow progress and obtaining confidential information including customer details, pricing and service information.	*Moderate – if adequate security (which is commonly available) is set up*	*Moderate – most competitors generally know who doing work for who and idea on prices*	*Avoid - Notwithstanding only moderate risk – as turnover of "jobs" are relatively quick and therefore in and out of the system quickly – benefit does not outweigh risk.*	*N/A*
Server hardware failing causing inability to order or access order	*Moderate*	*Serious*	*Control/Transfer*	*1. IT Provider to recommend required hardware;* *2. Sampson's to purchase recommended hardware;* *3. Hardware provider to provide warranty and urgent (within 3 hour) on site support.*
Customers or public finding out Mad Max is involved in the business. Max while in his early twenties spent a year training with a military group overseas that is now well know as a terrorist group. He admits he was disillusioned at the time and regrets his actions. He is now 30.	*Low*	*Moderate*	*Retain – ensure appropriate PR plan in place to deal with it*	*Sampson's*

Software implemented breaches IP	*Low*	*Serious*	*Transfer*	*IT Provider to ensure all Software is properly licensed*
Network fails causing inability to access server and transfer "jobs"	*Moderate*	*Serious*	*Transfer*	*IT Provider to provide urgent support (within 3 hours) on site if necessary*

So overall, after completing the matrix and allocating the risk – it seems that the benefits of the project certainly outweigh the risk.

Schedule 2 contains a list of important questions to ask at each stage or the risk allocation process.

Risk Transfer

Risks should belong with those parties who are best able to evaluate, control, bear the cost and benefit from the assumption of risk and who can bear the risk at the lowest possible cost. In the energy industry, for example, especially after the Exxon Valdez and Piper Alpha disasters, this method was adopted by the various organisations. The rationale of this approach to allocation of risk, is that it will reduce costs and claims and prevent over and under insurance.

If the organisation decides to transfer the risk ie it will not handle the specific task required for the project itself, it will seek to engage contractors or other suppliers to deliver the service or product. Sometimes, all it requires is one party to provide such services or products. Other times it requires many. At this time, a further risk matrix should be established, but this time identifying the specific risks associated with the engagement of the particular contractor. This matrix is therefore done on a "transaction" or "contract" basis. These risks will then be allocated specifically in the contract between the organisation and the contractor. Often, such risks will include many of the risks already identified for the project – particularly if the organisation is only required to appoint one contractor to handle the "task".

Such matrix should then be provided to the contractor for their consideration or made part of the tender documents in the case of a tender. The matrix should be realistic and not an ambit starting point for negotiations. Unrealistic claims will lead to time consuming and expensive negotiations and may deter organisations from bidding for new projects.[10]

Example

So in the example of Sampson's, the "transaction" matrix might look like this:

Table B

Risk	***Likelihood***	***Severity***	***Avoid/ Control/ Retain/ Transfer***	***Responsible Party***
Server hardware failing causing inability to order or access order	*Moderate*	*Serious*	*Control/Transfer*	*1. IT Provider to recommend required hardware;* *2. Sampson's to purchase recommended*

[10] www.defence.gov.au/cfo/privfin/manual/06.htm

				hardware
Network fails causing inability to access server and transfer "jobs"	*Moderate*	*Serious*	*Transfer*	*IT Provider to provide urgent support (within 3 hours) on site if necessary*
IT consultant not having ability to complete project through lack of skill or because of negligence	*Moderate*	*Serious*	*Transfer – ensure obtain references and evidence of skill*	*IT Provider to provide warranty on service*
Software implemented breaches IP	*Low*	*Serious*	*Transfer*	*IT Provider to warrant all Software is properly licensed*

You will see that most of the content of the matrix in Table B for the transaction with the IT consultant resembles the matrix for the project contained in Table A. The only addition in this example has been the issue of software licensing and appropriate skill. There would not have been anything wrong with raising these 2 issues in the original project matrix. However, the transaction matrix is an important step to ensure nothing was missed when thinking about the situation on a project "bigger picture" basis.

This risks identified by the matrix are then allocated by contract through contractual clauses outlining responsibilities – tied in with indemnity and insurance clauses. The relevant clauses are drafted so that risk is allocated to one party or the other for matters such as personal injury, property loss or damage, public liability, pollution, negligent workmanship and indirect loss or damage.[11] These differing types of clauses are looked at below.

The contractual clauses

The preparation of the most cost effective and cost efficient allocation of risk, and the drafting of the appropriate clauses in the contract, requires a thorough legal understanding of the statutory and common law exposures of the transaction and an understanding of the capacity to transfer risks and the extent of insurance cover available.

For example, there are many laws that are "strict liability" and cannot be contracted out of. Many occupational health and safety, environmental and trade practice laws are an example. There are also many common law rules that apply and affect the provisions contained in a contract. It simply cannot be considered that what is contained in a contract will apply without some influence from the law as it applies to the subject matter.

Warranty and Condition Clauses

With the common law and applicable legislation in mind, applicable clauses are now inserted into the contract outlining the:

1. who;
2. does what;
3. to whom;
4. by when;
5. where; and
6. why.

[11] Mills, M.: Insurance and Risk Solutions for Commercial Projects: AMPLJ (2001) at 49

This will clearly define the responsibilities of each party with respect to the transaction.

In the case of Sampson's, clauses are likely to be inserted into the contract that:

Mad Max warrants:

1. *it has the skills, know-how and ability to complete the Services in a proper manner and to a high standard.*
2. *it is the proprietor of and/or will obtain the necessary licences for Sampson's required for any intellectual property required in the provision of the Services.*

The contract would have also defined the meaning of the Services to be undertaken by Mad Max – the contractor.

Indemnity Clauses

Purpose
Indemnity clauses are then used to[12]:

1. confirm and reinforce the existing obligation or liability of a party (this is necessary to cover the gap between damages as would be assessed at common law and those that would be suffered in the event of a breach;
2. to transfer the natural incidence of liability to another party – that is, if liability would naturally fall upon a party in a given situation, it is necessary to transfer that liability on to another party.

Indemnification may be defined as the obligation of one party (the indemnifier) to reimburse the other party (the indemnified) for the losses the indemnified incurs or the damages for which it may be held liable for.[13] The purpose of an indemnity in a contract is to protect a party from the effects of an action, non-performance, negligence or the wrongdoing of another.

Types
There are generally 3 types of indemnities[14]:

1. Broad Form: where the indemnifier assumes any and all liability regardless of fault, even if that liability is due to the indemnified's sole negligence. When enforced this type of clause serves to transfer the entire risk of loss from the indemnified to the indemnifier.
2. Intermediate Form: the indemnifier assumes any and all liability except that which is due to the indemnified's sole negligence/fault. This imposes liability on the indemnifier for its sole negligence as well as for the joint negligence of itself and the indemnified, without regard to the indemnified's degree of fault – be it 1% or 99%. This type of clause excludes only actions where the indemnified is solely at fault.
3. Limited form: The indemnifier assumes liability to the extent of its own negligence or fault.

It is most common to insert limited form indemnities into the contract so that[15]:

- If Party A is in error up, Party A is responsible for their direct consequences.
- If Party B is in error, Party B is responsible for their direct consequences.
- If someone under Party A's control is to blame, Party A is responsible and similarly for Party B.
- If Party A and Party B share the blame, then they share the blame to the extent that they are each to Blame.

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[12] Adoranti, F.: Understanding Indemnity Clauses (2003) CLED at 18

[13] Katz, G.: Contract Risk Allocation: International Risk Management Institute (2001) at 11, 12, 14

[14] Ibid at 8

[15] Adoranti, F.: Understanding Indemnity Clauses (2003) CLED at 8

- If someone other than someone under the control of Party A or Party B are to blame then neither is responsible.

The consequences of an indemnity can be far reaching and serious for any organisation not exercising due care in the indemnities provided. An ill considered indemnity can lead to financial ruin. Therefore, be sure that the indemnity clearly specifies the nature of the consequences indemnified against and any limits on the indemnity.

Example

With the Sampson's issue, a fair and evenly balanced indemnity clause might look like this[16]*:*

Mad Max shall indemnify Sampson's against:

1. *loss or damage to any property, person or Sampson's; and*
2. *claims by any person against Sampson's in respect of any losses whatsoever;*

(the above section is the operative part of the indemnity. It specifies the nature of the consequences indemnified against)

arising out of or as a consequence of the Mad Max's negligence in carrying out the Services pursuant to the contract.

(the above section operates to limit the indemnity only to matters arising out of or as a consequence of negligence in carrying out the services.

The Contractor's liability to indemnify the Principal shall be reduced to the extent that such loss, damage or injury was caused or contributed to by the act, omission, direction or negligence of Sampson's, its servants, agents or any third party over which Mad Max does not have direct control.

(This section further limits liability to indemnify the Principal).

Insurance Clauses

Purpose

An indemnity on its own – no matter how cleverly worded – may not be sufficient to protect you. An indemnity is only as good as the financial strength and stability of the party providing it. If a party providing an indemnity is of questionable financial strength, the indemnity could potentially be worthless.[17]

Therefore, placing a contractual obligation on a party to the contract to obtain a relevant insurance policy over the risk in issue is a further mechanism to reduce the risk.

The changes in the insurance market recently have generated significant repercussions for the drafting of insurance clauses in contracts. The scope of cover generally available from the insurance market is much less than was available up until a few years ago, particularly so for public and product liability coverage. The rate of change has made it very difficult for lawyers to produce contract wording which reflect this reduced insurance availability. For their part, contractors often sign contracts without considering insurance compliance. When they agree to placing insurance coverage which they cannot obtain they are immediately in breach of contract and may assume significant uninsured exposure.[18]

Overlapping Insurance

When considering insurance, parties should avoid the costs or overlapping insurance and worse, the potential for overlapping insurance giving rise to double insurance and therefore pro-rata recovery.[19] This

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[16] Ibid at 28

[17] Ibid at 63

[18] Aon Corporate Risk Services: Insurance Aspects of Contracts Client Guidelines: August 2004 at 1

[19] Mills, M.: Insurance and Risk Solutions for Commercial Projects: AMPLJ (2001) at 54

means that if the same risk for the same interest in the same property is insured with 2 insurers, each insurer will only be liable for its rateable proportion of the loss (though the insured party can recover in full from either). However, any dispute amongst the insurers about this could lead to delay in the payment of the claim. [20]

Also, often the cost of a particular risk is paid for three fold. A party's risk of negligence is built into the contract price. The obligation of that same party to provide an indemnity and insure the risk is also no doubt built into the price to be paid. Finally, the indemnified party probably has insured the risk in its wrap around cover and this risk is reflected in the premium paid.[21] Considering the current cost of insurance, this factor needs to be seriously considered in risk allocation.

Further, in deciding who should be responsible for obtaining insurance, it should be noted that the party responsible to obtain the insurance will control the insurance policy, the claims process in the event of the claim and negotiate the specific cover. For these reasons, it would be preferable for an organisation to obtain the insurance itself.

Waiver of Subrogation

If parties wish to avoid the insurer of any parties instituting cross claims after it has indemnified its insured party for loss, a waiver of subrogation clause is also a good idea. This is because after the insurer has indemnified the party for its loss, it will usually seek by way of its legal right of subrogation to pursue the responsible party to recover its loss.[22] This could be and indemnified party. Clauses which waive any subrogation rights of the insurer may prejudice insurance cover unless allowed by agreement with the insurer. This needs to be checked with the party's insurance broker as insurers these days rarely waive subrogation rights and if signing any contract which requires such waiver, then insurance cover may be void in circumstances where the waiver applies.[23]

Insurance Broker

The organisation should instruct its insurance broker long before any agreement is reached to review both the scope of insurance on the market and the precise terms of insurance cover provided by the chosen insurer to ensure there is no gap between the terms of the insurance policy and the risks proposed to be allocated to insurance.[24]

Insurance policies will generally not respond "in accordance with the indemnity clauses" and especially not in relation to all losses whatsoever, unlimited losses or to the assumption of liability of other parties. An insured cannot comply with this form of insurance requirement and insurance clauses in contracts need to be risk related and specific. [25] Common insurance clauses require the following[26]:

- "to cover strictly in accordance with the indemnity clauses" – insurers will not usually be able to comply due to policy coverage terms, conditions and exclusions. It is not reasonable, given the current insurance market for an organisation to require insurance being effected on this basis.
- "all losses whatsoever, all claims and demands" – insurance cover will never fully respond to all claims. The contracting party carries the risk for the difference between insurance claim payments (if any) and the total payout required by the indemnity clause.

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[20] Ibid at 54

[21] Ibid

[22] Ibid at 55

[23] Aon Corporate Risk Services: Insurance Aspects of Contracts Client Guidelines: August 2004 at 6

[24] Mills, M.: Insurance and Risk Solutions for Commercial Projects: AMPLJ (2001) at 58

[25] Aon Corporate Risk Services: Insurance Aspects of Contracts Client Guidelines: August 2004 at 19

[26] Ibid at 10

- "consequential/economic loss" – not normally available except in a professional indemnity policy arising out of breach of professional duty/errors and omissions usually irrespective of whether fees are charged for the advice, service etc.
- "Personal injury and property damage or loss of use" – normally covered by a public and products liability policy.
- "risks normal for the business" – refer to insurance broker for programme which would accommodate this clause;

Example

In the example of the Sampson's, the contract would specifically provide an obligation on Mad Max to obtain professional indemnity insurance to cover its negligence. Also, Mad Max will be specifically required to keep the insurance current and provide evidence of insurance in writing to Sampson's when requested.

Practically, insurance should be the treatment option of last resort for risks. This is because a risk management approach which seeks to avoid or control a risk is clearly far more preferable to a strategy which, in effect, accepts the risk and seeks to transfer it off the balance sheet. [27]

Review

Managing risk by minimising it or transferring it is very important to the success of a business transaction or project. The problem is that many organisations' practice on risk allocation arises from past practice. This is sometimes based on assumptions which are no longer valid.

Existing procedures and documents dealing with risk are usually the result of incremental additions over the years, with few subtractions. Many times both procedures and documents are "handed down" from one person to another – the "we've always done it this way" approach. Organisations need to take the time to sit down and ask themselves how they are allocating risk, why they are doing it that way and if there is a better way.[28]

Conclusion

Risk is certainly opportunity. The benefits or properly allocating risk are obvious and the basis upon when it should be transferred is highlighted. It is noted that it is not always beneficial to an organisation to transfer risk – particularly if the other party does not have the means to control or deal with the risk if it eventuated. The manner in which risks are identified and allocated is also considered. The application of the risk matrix at the "project" stage and the "transaction" stage will help to identify and allocate risk – which is the first step to its elimination or reduction.

Once the decision to transfer risk is made, effective clauses in the contract, including indemnity and insurance clauses are drafted into the contract for goods or services. This will clearly bind that party in contract to the allocated risk. Finally, insurance is obtained to ensure that such risks are covered in the circumstances where the contractor can't make good a breach of contract or negligent act.

Lawyers and insurance brokers should be part of an organisations process to allocate risks. Lawyers will not only assist with the drafting of applicable contract provisions but can also help in the identification of risks – particularly those that arise as a consequence of the application of law. Insurance brokers will ensure that an organisation understands the available insurances and that any gap between a party's risk and what is insured is kept to a minimum. Early consultation of lawyers and insurance brokers, the objective input of all the parties in a project, and the implementation of the practices outlined in this paper will significantly reduce an organisations risk profile, and with it the "suffering of harm or loss" in its commercial projects.

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[27] Mills, M.: Insurance and Risk Solutions for Commercial Projects: AMPLJ (2001) at 57

[28] Ibid 54

Schedule 1

Representative listing of risks, risk groups, and risk sources subject to management/ allocation via contract terms or contracting practices

Acts of God (force majeure)

Adequacy of project budget/funding

Adequacy of design

Adverse weather

Ambiguous specifications

Asbestos

Attitudes of other parties

Bidding procedures

Changes in law and regulations

Changes in pricing

Changes in procedures

Clarity of plans

Competence of cost estimating

Concurrent work

Consequences of delay

Consequences of disruption

Constructability of design

Cost escalation

Delays in decision making and in addressing and solving problems, approaches

Delays in transmitting drawings and instructions

Delays in presenting problems

Differing site conditions

Embargoes

Environmental compliance

Environmental constraints

Equipment availability

Equipment quality

Equipment suitability

Exchange rates

Existing utilities and underground facilities

Government acts

Government stability

Ground subsidence

Ground support requirements

Ground water

Hazardous waste

Labour availability

Labour force substance abuse

Labour productivity

Labour skills

Managerial and supervisory capacity/availability

Managerial and supervisory efficiency

Material availability

Material quality

Material shortages

Means, methods and techniques

Measurement of pay items

Mobilisation cost payment methodology

Owner bureaucracy

Owner furnished material and equipment – quality

Owner furnished material and equipment – timeliness of delivery

Payment cycle

Permits and licences

Quality of construction management, contract administration and coordination

Quality of inspection and monitoring

Quality of plans

Pretension

Safety

Schedule constraints

Site availability

Site access

Site congestion

Site drainage

Site security

Soil stability and strength

Subcontractor availability

Subcontractor qualifications

Subcontractor reliability

Sufficiency of plans

Supplier/vendor competence

Suppler/vendor performance

Third party impacts

Timeliness of constructions management, contract administration and coordination

Timeliness of inspection and monitoring

Union strife and work rules

Unproven designed

Unrealistic performance time

Unreasonable contract terms

Utility availability

Variations in quality

Warranty obligation

Schedule 2

Questions to ask at each stage[29]

Do we understand the risks?

- Have we identified all the key risks relating to this project or transaction?
- Have we made a thorough assessment of each one – the probability of it happening, the likely impact and costs?
- Do we understand the interdependencies between risks?
- How do these affect our key objectives?
- Have we taken a long-term view, to identify possible future risks?
- What is our overall exposure to risk?

What can we do about risks before we decide where to allocate each one?

- Have we considered the best way to deal with each risk – minimize them, mitigate them or build in contingencies?
- Are there other steps we should take now – such as improving quality assurance regimes?

What are the options for allocating risk?

- Which are the risks that we should manage ourselves? For each one: why?
  - because we can control it better ourselves?
  - because it is not cost-effective to allocate it to others?
  - because its likely impact will not affect critical objectives?
- Which are the risks that others should manage for us? For each one: why?
  - because they are better placed to influence the outcome?
  - because we can identify cost-effective payment incentives that will deliver value for money?
  - because the cost to us is affordable and reflects their ability and willingness to control the risks?

Negotiating risk transfer with suppliers

- Can we obtain the optimum risk transfer, or balance between the benefits of transferring a risk and the costs of compensating the supplier for taking it on?
- Do we need to obtain variant bids to decide the optimum offer?
- Have we negotiated with each supplier to achieve the optimum balance of risk, cost and benefits?
- Are our decisions on risk allocation based on a realistic assessment of the way in which risks will be managed?
- Does the entire supply chain have a shared understanding of the risks and consequences if they materialise?
- Have we validated our risk plans by obtaining proposals and indicative prices from suppliers, assessing each risk and its price, taking into account:
  - the nature of the requirement – high or low risk?
  - the expected length of the contract – long or short term in which to recover the development costs?
  - the likelihood of predicted service volumes being exceeded, with the opportunities for increased revenue?

Have we allocated risks to the right parties in the supply chain?

- Can we be sure that we have not transferred the wrong risks, leading to poor value for money and unacceptable exposure to risk?

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[29] Office of Government Commerce, UK: Best Practice: Risk Allocation in Long Term Contracts: www.ogc.gov.uk

- Have we made sure that we have only transferred risks that are commercial in nature, where the supplier can influence the outcome?
- Where risks have been transferred, is the supplier genuinely able to manage them?

Can we avoid taking transferred risks back?

- Is there a danger that we could 'take back' transferred risks – that is, to get too involved in the supplier's business and the solutions they provide, preventing them from managing the risks they have agreed to take on?
- Are we certain that we have not taken risk back, by:
  - attempting to define a technical solution?
  - attempting to define how a service should be provided?
- Have we preserved our supplier's freedom to propose alternatives?
- Will our supplier have the freedom to choose how to handle and minimise it?

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