

Risk allocation: categories of risk

Let us know what you think

Key terms

Risk is defined as uncertainty of outcome, whether positive opportunity or negative impact. **Risk** allocation is the process of apportioning individual risks relating to projects and service delivery to the party best placed to manage each risk. Risks are allocated across the supply chain – that is, between the department, its customers, its suppliers and their sub-contractors.

Business risks: risks that the department must retain; responsibility for business risks cannot be passed on to other parties

Business risks relate to the business requirement:

- achieving business objectives
- continuing need for the service
- changes in business direction

Ultimate business risk cannot be allocated to a supplier because if they fail to deliver what is required, the department remains responsible for delivering the service and for contingency plans in the event of risks materialising.

The department can allocate a contractual risk, but not the components that relate to departmental reputation, political, environmental and consequential financial risks.

There are also risks relating to the government environment – policy, legislation and regulatory issues.

In addition, the department may be unknowingly exposed to risk that is not being managed at all. Recent experience has shown that in most instances the inadequacy of the business case is the major source of risk, because the requirement and its implications has not been thought through. This means that the department does not fully understand the risks relating to its project or operational service and cannot make a realistic assessment about how its risks should be allocated.

Service risks: the risks that the public sector is seeking to place with the party best able to manage and control them. Some elements of individual risks will be retained by the public sector and others will be transferred to the private sector

Suppliers can take responsibility for design, development and operational service delivery phases. Where the requirement is for organisational change, this may be outside the control of suppliers; extra care needs to be taken by the department to determine how best to allocate risks relating to complexity and uncertainty.

In construction projects, the procurement strategy determines how much risk is transferred during the design and build stages. The recommended approaches are *Private Finance Initiative (PFI)*, *Design and Build*, and *Prime Contracting*.

Availability and performance risks: most of these risks can be transferred. The supplier takes on the risk of absorbing the cost and resourcing consequences of making the service available when required, to the agreed levels of performance. Incentive mechanisms can be developed that reward the private sector in return for performance gains.

Service continuity risk: this is the acceptance of responsibility for uninterrupted delivery of the service. Some elements are usually assumed by the supplier (technical maintenance, fault fixing and continuity arrangements). Other elements may be unpredictable, such as changes in government regulation; or they may be beyond the supplier's complete control (such as power failure) and may attract a high premium.

Revenue risks: these relate to volume (in terms of usage) and residual value. Volume risk (fluctuations in service use), can be transferred by relating payment to the amount of use made of a service such as a contact centre, the number of users of a service (such as drivers using a road bridge) or the number of transactions. In each case, it is important to identify where the benefits of relating payments to usage are most likely to be realised. Certain levels of volume may have to be guaranteed so that the financial risk is reduced to a level that the supplier can manage. The public sector retains some of the business risk of flexibility. Payments can also be related more closely to availability/ performance criteria.

Residual value risk: the residual value of assets previously used to deliver the service will be realised by the supplier who takes on or retains possession of buildings, IT and other assets. The public sector will want to develop mechanisms for reduction in price or increased flexibility over the life of the contract to reflect the residual value that will accrue to the supplier.

Business change: suppliers may not be best placed to manage the risk of major business change (such as policy, regulatory or legislative change) and may potentially attach a very high price to being exposed to such risk. But they could be contracted to adapt the service to meet periodic planned changes, building the cost of this change into their agreed service price. The intention is to give incentives to suppliers to design services that are adaptable to changing business needs and place limits on the cost of change once contracts have been signed.

Obsolescence risk: the risk that buildings or IT will be superseded by technical advances that affect the cost of service delivery. The price of transferring this risk may be beyond the control of the supplier and must be examined very carefully.

Supplier marketplace risks: risks relating to the ability of the private sector to offer a price that offers value for money. These risks will be identified during the negotiation stage.

The private sector will only invest in a project if the return is commensurate with the risks it undertakes in comparison to other opportunities in the marketplace. The public sector can reduce the risk of lack of supplier interest by allowing scope for innovation and added value wherever appropriate.

See the successful delivery toolkit for related sources of best practice, tools and techniques; www.ogc.gov.uk/sdtoolkit

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Key questions to ask at each stage

Risk allocation and risk transfer - Risk allocation is about deciding who is best placed to manage a specific risk. A risk is described as 'transferred' when the department decides not to manage that particular risk itself. The main advantage of transferring risk is that it can provide incentives for suppliers to deliver cost-effective services; this is a key feature of long-term service contracts.

Do we understand the risks?

- Have we identified all the key risks relating to this project or operational service?
- Have we made a thorough assessment of each one - the probability of it happening, the likely impact and cost?
- Do we understand the interdependencies between risks?
- How do these risks 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 - minimise them, mitigate them or build in contingencies?
- Are we using the Gateway Review process to help?
- 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 risk?

Negotiating risk transfer with suppliers

- Can we obtain the optimum risk transfer, or balance between the benefits of transferring a risk and the cost 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, costs 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 the 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?
- Have we made sure that we 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?