Uncertainty Management

A framework for anticipating and managing uncertainty, risk and disruption through enhanced contracting

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World Commerce & Contracting

Introduction

The economic value of contracts is gained or lost during the post-award phase, yet this study has confirmed that there is no established 'best practice' governance model to safeguard their performance.

This research, funded by the WorldCC Research Forum[1] has lead to the creation of a new approach to the management of contracts portfolios. This report provides a summary of one of the key frameworks within the research which establishes a new, structured approach to manage contracts portfolios. It offers exclusive insights that have the potential to transform the efficiency and effectiveness of post-award contract management.

Winning and awarding contracts is fundamental to the success of any commercial organization and these activities often receive far greater attention than is given to their subsequent performance and delivery. In consequence, improvements in post-award management offer significant opportunities, with potential to reduce delays and cost overruns and to capture incremental savings or revenues.

The purpose of this new framework is to provide a framework to consider the likely uncertainties in relation to an opportunity. In doing this it enables organizations to better and more consciously design and implement commercial solutions that align with the environment that they will have to operate in. This enhanced alignment leads to better outcomes and value creation in an environment of greater disruption and uncertainty.

It is a well-established fact that a significant proportion of contract relationships under-perform in the delivery of expected benefits.

While the scale of value erosion and missed opportunities shows wide variation across contract types and industry sectors, WorldCC research has suggested an average loss equivalent to 9.2% of annual revenue.[2]

The research and interviews that have been undertaken as a component of the study confirm that there is a general lack of structure and maturity in post-award contract management. Therefore the report is not promoting a set of current leading practices; rather, it is advocating more fundamental change, based on scientific analysis and segmentation of contract relationships. This segmentation draws on uncertainty and value analysis as determinants of the appropriate governance model and consequent allocation of resources.

The framework offers guidance on the practical steps required for operationalizing this new, advanced method of governance and performance management in an environment of uncertainty.

Under-performance of contracts leads to an average loss equivalent to 9.2% of annual revenue

1. The WorldCC Research Forum was formed in 2018 bringing together a group of organizations, from across diverse sectors, who could see the benefits of collectively funding forward-looking research into areas of common interest and importance.

2. Estimates range from 3.5% to more than 20%. They are calculated on both sales contracts and procurement contracts, meaning that the gross financial value is typically *c.*160% of revenue. Contract complexity has a major influence on value loss – e.g. capital projects represent a much higher percentage than standard commodity acquisitions, explaining the scale of average variation at an industry level.

What do WorldCC insights tell us about the future?

Increasing uncertainty and the need for dynamic adaptability

When Oliver Hart states:

"Economists are drawn to areas with simple, elegant, and uncontroversial models. The area of incomplete contracts is not like that; it is messy. But contracts are incomplete in reality and contractual incompleteness underlies numerous significant phenomena, some of which have great policy relevance."[3]

What does Oliver Hart, Nobel prize-winning economist, mean by this statement? He explains that in a rational world contracts would be 'complete', which he defines as "contracts where everything that can ever happen is written into the contract".

This 'classical' approach to contracting has led to negotiators and contract drafters spending their time desperately trying to anticipate every potential issue, in turn creating voluminous and complicated contracts that have very limited operational relevance or use.

He also acknowledges that in the real world transactions involve parties that are far from rational which "is in many ways an unfortunate conclusion since while there is one way to model rationality there are many ways, perhaps infinitely many, to model irrationality".

While technology may help us increase rationality and forecasting in many areas, some level of irrationality and unpredictability inevitably remain and with them comes uncertainty. We can see this as a negative, or purely as a risk, but uncertainty also contains opportunity and therefore an enhanced ability for its management represents a significant source of value and differentiation.

One of the challenges organizations face in the context of CCM is that many of the key players have been educated and trained to focus on maximizing certainty, in the face of the irrational world that they inhabit. 'Risk' has in many cases come to be viewed in an entirely negative context and, in consequence, something to be avoided rather than grasped and managed.

In the case of a simple transaction, easily defined and quickly performed, this is typically a valid mindset. But, while the volume of such transactions may be high, they often represent a relatively low proportion of an organization's revenue or spend. Applying a similar mindset to more complicated situations is itself a major source of risk and value loss.

A clear implication of Oliver Hart's work is that 100% certainty is neither attainable, nor is its pursuit desirable. Indeed, research shows that 'loss aversion' can itself feed irrationality, to the point where opportunities for gain are either avoided or irreparably damaged.

3. *Incomplete Contracts and Control*, Hart, Oliver, American Economic Review 2017, 107(7): 1731-1752

This report is based on the fact that transactions operate across a spectrum of uncertainty and that this requires a series of increasingly sophisticated approaches to their management. For example, is there an opportunity to consciously design trading relationships, along with their contracts and governance structures in a way that they are ‘predictably unstable’ and by doing so make them more dynamically adaptable?

If we look at the WorldCC Top Negotiated Terms research, participants have consistently confirmed that the ‘most important’ terms are those dealing with areas of uncertainty and variability – for example, scope and goals, change management, price changes, and responsibilities of the parties. It is these aspects of a transaction that need to be better understood if we are to create models that are inherently adaptable, yet much of the time and effort associated with contract negotiation is instead focused on issues of asset protection and risk allocation – indemnities, liabilities, liquidated damages, data security and intellectual property all coming high on the list.

As we move across the spectrum of uncertainty, it is increasingly important that the management model considers not only what we want to be delivered and when, but how it will be delivered and how the parties will work together to manage change.

This report suggests that optimum agreements will be those that have been designed to address the level of uncertainty they may face and to leverage the opportunity that this offers.

What does this mean for CCM?

By acknowledging that contracts are incomplete at their outset, we can start to see the role of CCM as essential in delivering success. Today, organizations apply major levels of resource to managing problems and issues associated with contract performance, but frequently in a reactive mode where ‘change’ tends to be seen either as something to be avoided, or something that causes controversy.
By accepting that change will occur and planning for it, change is no longer seen as value eroding, but as value enhancing. This means there is a need not only for obligations management and compliance, but also pro-active change management and adaptability. This is not so much important in terms of the level of effort required (it may well be less), but rather in the nature, style and focus of the effort.

Change management becomes proactive, rather than reactive, and is based on an end to end approach that starts with the identification of value adding change, defining its scope, assessing its impact, and then implementing it.
In short CCM will be seen as a core business capability.

“Governance structures [are] the institutional matrix within which transactions are negotiated and executed.”

Oliver Williamson

Source: Transaction-Cost Economics: The Governance of Contractual Relations. Author Oliver E. Williamson. Journal of Law and Economics, Vol. 22, No. 2 (Oct, 1979), pp. 233-261. Published by The University of Chicago Press

The Value Compliance Uncertainty Framework

Creating a portfolio approach to CCM

To better leverage the value in our 'contract assets', we need to consider the whole portfolio as well as the individual contracts.

In practice, organizations typically recognize the need to deploy differing levels of skilled resource depending on the nature of the desired outcomes and therefore balance of the contract, governance and relationships put in place. Sometimes this is planned, though in most cases it is discretionary. Segmentation, where it exists, is often rudimentary – for example, based on contract value or spend, rather than strategic importance or complexity. Even then, it is often left to a 'contract owner' to decide whether dedicated or professional resource should be deployed – and because this carries a visible cost, they may have little motivation to apply such resource.

If we want to truly leverage the full value of our contract portfolio then there is a need to create a more formalised segmentation framework that is then supported by a more defined and sophisticated set of approaches to CCM for each category within the segmentation.

A simple framework for segmenting contract portfolios

Figure 1 shows a simple framework that has been developed as a result of the research discussions.

On the vertical axis – value focus

If we first take the vertical axis, the value focus, then this relates to 'what' we are trying to achieve through our post-award CCM. What is its purpose and how does it deliver value.

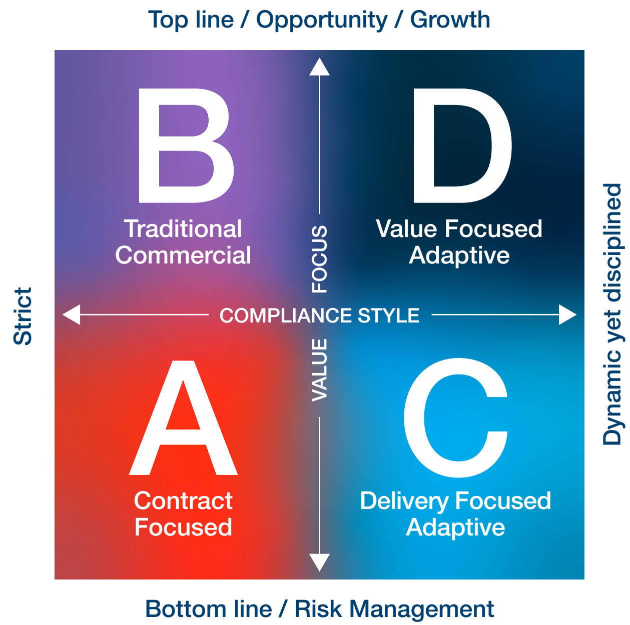
From the research it was seen that in many cases organizations' focus is towards the bottom of this axis with post-award CCM being seen as focused on risk management.

On the horizontal axis – compliance style

If the value focus on the vertical axis represents 'what' we are trying to achieve from a strategic business perspective, then the emphasis on the horizontal axis is on 'how' it should be approached from a governance perspective.

Today, most customers favor a strict compliance approach since they perceive a loss of power once the contract is signed and expect the supplier to take advantage of their weakened position. In reality, this expectation often becomes self-fulfilling because of the weaknesses in the governance system that is applied. The result is sub-optimal performance for both parties.

Figure 1. The Value Compliance Uncertainty (VCU) framework



Charting the levels of complexity, risk and value

By overlaying the two axes, described on page 5, we create a simple framework that articulates the level of uncertainty that is inherent in a particular transaction and allows segmentation across a portfolio of projects or contracts. The most certainty is for agreements in the bottom left corner of the framework. As we move to the right and / or up, the level of uncertainty grows and therefore we need to adjust our approach not only to how we design and balance the contract, the governance and the relationships.

It is also possible to overlay other dimensions on the framework such as level of complexity, risk, or value to create a more detailed multi-dimensional assessment as shown in Figure 2.

To help us understand how the post-award CCM approaches might vary for each of the four quadrants we have identified four distinct models (A-D):

Model A Contract focused approach

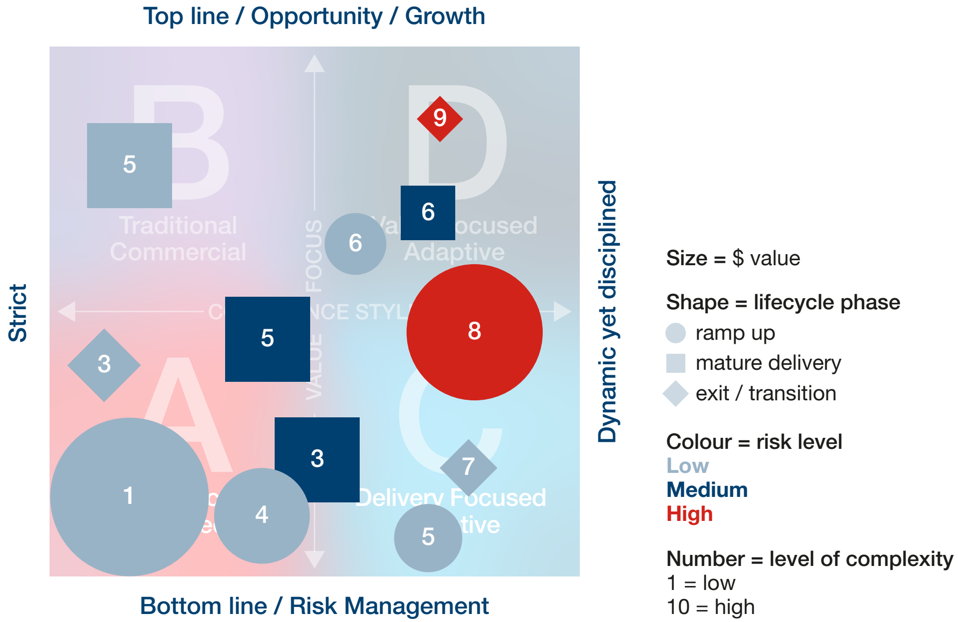
Model B Traditional commercial approach

Model C Delivery focused adaptive approach

Model D Value focused adaptive approach

The aim is to use these models as a starting point or 'blueprint' for how we approach post-award CCM for transactions in each of the quadrants.

Figure 2. Example of portfolio assessment with additional information overlays



The role of uncertainty management

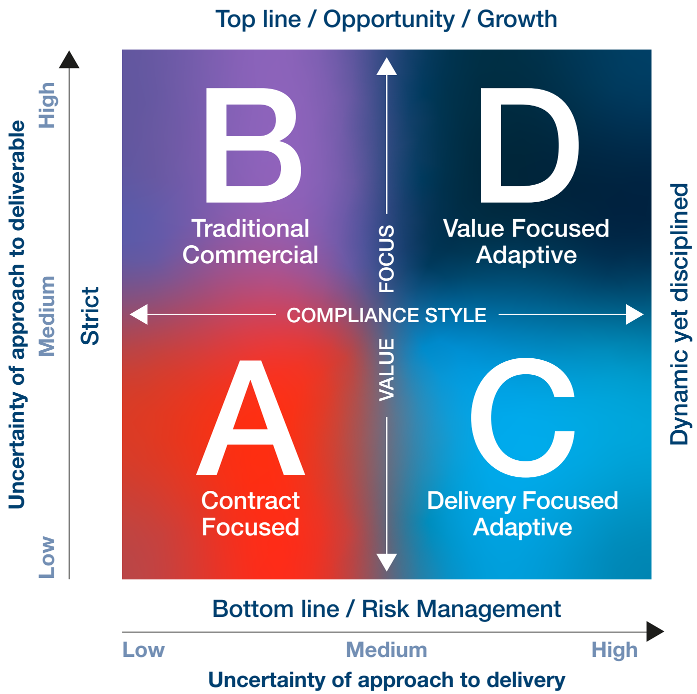
As we have already observed, traditionally many of those involved in contracting and risk management attempt to anticipate every event that could negatively impact contract performance, which has contributed to increasingly voluminous contracts. However, as Oliver Hart's research explains, contracts are by their very nature 'incomplete' and therefore with almost all contracts there is a tipping point beyond which the cost of attempting to create certainty is not only unrealistic, but becomes value destroying and ultimately may undermine success.

We suggest uncertainty analysis is the method to use in making this assessment. It is a technique familiar to the world of engineering. Figure 3 illustrates how this method can be applied, with the vertical axis evaluating 'uncertainty in the approach to deliverables' and across the horizontal axis evaluating 'uncertainty in the approach to delivery'.

Operationalization

In order to create impact from the framework it is necessary to embed the framework. Through the Research Forum, WorldCC has developed a portfolio of tools, guidelines, and models to support operationalization of the VCU framework to deliver business impact for the Research Forum members.

Figure 3. The VCU framework with uncertainty axes



About WorldCC

World Commerce & Contracting is a not-for-profit association dedicated to helping its global members achieve high-performing and trusted trading relationships. With 75,000 members from over 20,000 companies across 180 countries worldwide, the association welcomes everyone with an interest in better contracting: business leaders, practitioners, experts and newcomers. It is independent, provocative and disciplined existing for its members, the contracting community and society at large.

Tim Cummins, President
tcummins@worldcc.com

Sally Guyer, Global CEO
sguyer@worldcc.com

General or media enquiries
info@worldcc.com

www.worldcc.com

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