CLCC GUIDANCE

UK Government Investments

Contingent Liabilities in Procurement

Summary of Current Guidance

The Contingent Liability Central Capability (CLCC)

August 2022

CONTENTS

AUTHOR

Robert Williamson – *Manager, Insurance Branch*

Robert joined UKGI in spring 2021, on secondment from the Government Actuary's Department, to work in the insurance branch of the CLCC. Robert is an actuary with experience in a variety of government indemnity schemes including clinical negligence and academy insurance. Robert completed his secondment and returned to GAD in July 2023.

The Contingent Liability Central Capability (CLCC) is an analytical and advisory unit within UK Government Investments (UKGI). The CLCC has been established to strengthen contingent liability expertise across government by improving the overall ability to manage the government's portfolio of risk from contingent liabilities.

This document is part of a series to provide guidance to departments regarding the establishment and management of contingent liabilities. The guidance is not exhaustive and each case may have specific and/or additional considerations that need to be addressed.

For more information on this document or the others in the series contact CLCC@ukgi.org.uk.

PURPOSE AND SCOPE

What is this guide about?

This note summarises the current guidance on contingent liabilities when carrying out government procurement. We have relied on central government guidance, so this should be considered in the context of a department's internal guidance when applied in practice.

In particular, this note focuses on:

1. **The risk management process** – How risks fall to government through the risk management process.

2. **Value for money** – Considerations when allocating risks in order to achieve value for money.

3. **Liabilities** – Different options when allocating liabilities.

In all procurement exercises there is the potential for financial risk. However, in most cases standard contract terms are applied, or the risks are small and well understood. Therefore, in these cases it is unlikely that any additional approval or reporting relating to contingent liabilities will be necessary.

This guidance is primarily intended to be applied in cases where procurement involves large, complex risks or non-standard contract terms. In these cases, this guidance helps to structure the consideration of risk and highlights other important sources of guidance from across government. This will likely only apply to gold-tier contracts, as defined by the Contract Tiering Tool, and will be most relevant to government officials carrying out the development and implementation of a procurement.

While these cases arise in the minority of procurements, they represent a significant proportion of the government's contingent liabilities by both count and value, as disclosed in annual accounts, with especially large indemnities arising from infrastructure contracts and defence spending. Ensuring that all contingent liabilities in procurement are appropriately designed could provide significant reductions to government's aggregate risk exposure and ensure that risks are adequately managed.

In the context of this note, unless otherwise stated, we consider contingent liability to mean a financial obligation which could arise if certain events occur. For more information on the accounting definition of a contingent liability please see IAS 37.

When carrying out a procurement you should be sure to seek advice and guidance from your department's commercial team.

In addition, the Cabinet Office's Sourcing Playbook provides mandatory policy, as well as best practice guidance, to enable us to achieve better value for money from our procurements. The policies include risk allocation and pricing, which complement the advice in this document. The Sourcing team provides regular training courses and can offer 'On the Shoulder Support' which is intended to assist departments with specific projects.

Limitations and compliance

This note is intended to provide some helpful advice summarising current cross government guidance on contingent liabilities in procurement and highlighting sources of additional guidance. However, this note is not exhaustive, and does not cover all possible considerations. The CLCC has no liability to any person or third party for any action taken or for any failure to act, either in whole or part, based on this paper. It is strongly recommended that you obtain further specialist expertise to help support you in your procurement. The CLCC will be pleased to discuss how we can support you in this regard.

You can approach CLCC with all issues related to contingent liabilities, including those outside the scope of the HMT contingent liability checklist process. We are particularly interested in large or complex risks that require more thorough analysis. You can contact CLCC at clcc@ukgi.org.uk.

INTRODUCTION TO THE CLCC

What is the role of the CLCC?

The Contingent Liability Central Capability (CLCC) is an analytical and advisory unit formed within UK Government Investments (UKGI), the government's centre of excellence for corporate finance and corporate governance. Its purpose is to strengthen contingent liability expertise across government.

The CLCC assists departments and arms-length bodies with assessing, quantifying, and pricing risk from contingent liabilities, allowing departments and government to better understand the scale and distribution of their risk exposure from contingent liabilities. Working closely with departments, the CLCC aims to provide guidance, promote best practice and build capability across government.

When should I approach the CLCC?

Departments are encouraged to come to the CLCC with all issues related to contingent liabilities, with early engagement particularly helpful for the team. In addition to providing advice on checklists completed as part of the Contingent Liability Approval Framework, the CLCC can provide insights which support the policy making process, including:

- Departments conducting early-stage policy thinking, including identifying potential options
- Departments developing risk frameworks to delegate authority to take on risk, e.g. to their ALBs
- Departments considering the impacts of policy changes on existing contingent liabilities
- Departments negotiating or renegotiating contracts containing contingent liabilities

CLCC will either be able to provide advice and support ourselves or we will signpost you to the Government Actuary's Department (GAD) if specific policy support or more detailed analysis is required.

Which contingent liabilities are the CLCC focusing on?

The CLCC focuses on contingent liabilities where the government takes on risk that the private sector cannot and can assist departments with:

Guarantees - Where government agrees to pay the debts of a third party if they default, such as the No Interest Loan Scheme which provided small loans to people in vulnerable financial situations.

Indemnities - Protection similar to insurance where government agrees to cover costs if a certain event occurs, such as the Production Restart Scheme which provided cover for covid related costs to film and TV productions.

THE RISK MANAGEMENT PROCESS

When carrying out procurement a key aspect is the risk management process. As a result of this process, contingent liabilities may arise through limits to a supplier's liability leaving some risk with government or as an explicit indemnity provided by government.

The risk management process is summarised below:

1. **Identification** – In order to manage risks they first need to be identified. This should involve all members of the team working together across functions to identify all possible financial risks related to the procurement.

2. **Assessment** – Risks should each be assessed to evaluate their expected impact and maximum loss. Usually this will involve considering the likelihood of the risk arising and the expected cost if the risk did arise. The CLCC is available to assist with technical analysis of insurance and credit type risks and we have produced guidance on these types of calculations.

3. **Treatment** – Identified risks don't necessarily need to fall to government completely. So a decision is needed whether to avoid, accept, mitigate, or transfer each risk. Importantly the answer may be conditional on the allocation decided below.

4. **Allocation** – Once the risks are understood and treated they should be allocated. This involves defining which party holds the risk or if the risk will be shared. This should aim to achieve value for money, which is discussed in the next section.

5. **Monitoring and reporting** – The risks held need to be monitored and reported appropriately, following departmental and cross-government guidance.

Some risks allocated to government in this process may result in a possible future financial obligation for government, ie a contingent liability.

For more detailed guidance on the risk management process during procurement please see the Commercial Finance Function's Risk allocation and pricing approaches guidance note. More widely, HM Treasury's Orange Book is the key resource on general risk management.

Further information is also available in the Cabinet Office's Model Services Contract guidance in its Risk annex, this includes a risk identification template (which is summarised here in Annex A).

VALUE FOR MONEY

Once risks have been identified and assessed, they need to be treated and allocated to the appropriate party to ensure value for money. Value for money means securing the best mix of quality and effectiveness for the least outlay over the period of use of the goods or services bought. This is not about minimising up front prices.

To ensure value for money, you should consider the risk allocation decision in the round, including both the cost benefit analysis and wider considerations.

Cost benefit analysis

When risk is transferred from the private sector to government, where appropriate the government looks to charge a premium for the risk it is taking on. The same concepts apply to procurement, however the value of the risk transferred will be reflected in the overall price paid to the supplier rather than charged for separately.

In order to ensure value for money in risk transfers during procurement it is necessary to compare:

- **Government's view of the value of the risk** – This should have taken place during the assessment stage of the risk management process. Usually this will involve considering the likelihood of the risk arising and the expected cost if the risk did arise. The CLCC is available to assist with technical analysis of insurance and credit type risks.

- **The supplier's view of the value of the risk** – This should be reflected by the change in price for the contract with and without the risk transfer, and may be dependent on the cost of insuring the risk.

In practice, the procurement process means that the supplier's view of the value of the risk may not be known until the bids come in, after the risk allocation decision has already been made. To avoid this issue, you should carry out early market engagement to gain a better understanding of supplier views. 'Should Cost Modelling' can then provide a clear view of expected market costs for managing the risk. In some cases, you could also include a range of options within a variant bid, which will allow you to carry out scenario analysis to identify to best choice.

Note that risk treatment may reduce the value of the risk, at some expense, and so could impact this analysis.

Where a supplier would charge more than the government's view of the value of the risk to take it on, it may be better value for money for government to retain the risk.

Wider considerations

In general, it is preferable to allocate risk to the party in the greatest position of control for that risk, as this will allow them to add the most value. However, there are some other considerations which need to be taken into account:

Capacity to hold risk	It is important to consider whether the supplier has the financial capacity to bear a risk occuring without being rendered insolvent, as this would result in the risk passing back to government. Therefore in most circumstances only limited liability is expected to be allocated to suppliers, or suppliers are required to insure the risk to reduce their exposure.
Supplier behaviour	Holding risk can impact a supplier's behaviour. When risk is shared between government and a supplier their interests can be aligned. This may encourage the supplier to act in the interest of the government and therefore result in better value for money.
Scenarios	The chosen solution will need to provide value for money in a range of scenarios. Therefore, it is important to think through each potential outcome, to ensure that the chosen approach is appropriate. These considerations should account for the probability of these scenarios arising, to maximise value for money.
Constraints	The ability to transfer risk can also be constrained by supplier demands, market capability or limits on the contract terms that can apply. In particular, the value of the contract will have a significant effect on supplier appetite to hold risk. The allocation of risk will need to work within these constraints while also achieving value for money. Importantly, if constraints are too severe, risk allocation may need to be reconsidered.
Options	Who holds the risk may also impact the risk treatment options available, and therefore the size of the risk exposure. This will influence the cost benefit analysis, and so should be considered during risk allocation.

For more detailed guidance on value for money and policy appraisal more generally, please see HM Treasury's Value for Money Supplementary Guidance and Green Book.

For further information on Should Cost Modelling, please see the Government Commercial Function's Should Cost Modelling guidance.

For further information on assessing supplier capacity to hold risk, please see the Government Commercial Function's Assessing and Monitoring the Economic and Financial Standing of Bidders and Suppliers guidance.

For further information on monitoring and promoting market health, please see the Government Commercial Function's Market Management guidance.

LIABILITIES

Liability can be allocated in a number of ways, and the appropriate method will depend on the specific liability and a value for money assessment. Below we discuss types of liability allocation.

Unlimited liability

As set out above, in most circumstances only limited liability is expected to be allocated to suppliers, however there are some exceptions.

The Model Services Contract guidance sets out the circumstances where government and suppliers are expected to retain unlimited liability:

Both parties retain unlimited liability for:	Suppliers retain unlimited liability for:
• Death or personal injury caused by negligence • Fraud • Breach of obligations under section 12 of the Sale of Goods Act 1979 or section 2 of the Supply of Goods and Services Act 1982. • Employment indemnities • Staff transfers • Liabilities which cannot be limited or excluded by Law	• VAT • Income tax and NICs • Intellectual Property Rights

There is also specific policy relating to the General Data Protection Regulation (GDPR). Government should not accept liability clauses where the supplier as Data Processor is indemnified against fines or civil claims under GDPR. However, as outlined below, supplier liability limits can be put in place relating to government losses.

For further information and standard contract terms relating to data protection please see the Crown Commercial Service's Procurement policy note – Changes to data protection legislation and General Data Protection Regulation.

Limited liability

In general, liability limits will take the form of a value, below which the supplier is responsible for the risk and above which the government retains the risk. As set out above, in most circumstances supplier liability is expected to be limited.

These liability limits can be designed in variety of ways to suit the needs of a project and ensure value for money. Below we have set out some potential options, however this is not an exhaustive list.

- Limit value:
  - Fixed monetary value, e.g. £10m
  - Percentage of a known value, e.g. 150% of contract value
  - Percentage of a currently unknown value, e.g. 150% of next year's payments
  - Linked to an index, e.g. increasing with CPI
  - Minimum or maximum of combinations of the above, e.g. the minimum of £10m or 150% of next year's payments.
- Limit applicability:
  - Time based, e.g. liable for claims occurring in the first year of the contract
  - Types of claim, e.g. liable for claims resulting from a certain event
  - Limits by claim or aggregate, e.g. liable for individual claims up to £1m and total claims up to £10m

In line with risk allocation more generally, it is important to consider the financial strength of the supplier when setting liability limits. Suppliers will increase their price as the liability they hold increases, and if the supplier was to default the costs may fall to government anyway. Therefore an excessively high liability limit may result in government paying both the cost of transferring the risk and the cost of the risk itself.

In most cases a limit of liability for the residual risks of a project will be appropriate, including lesser or undefinable areas of risk. This avoids the supplier being exposed to potentially unlimited residual risk and so will represent better value for money, in line with the reasoning above.

The Model Services Contract sets out some standard limits to be applied to losses or damage as a result of supplier default. These are set per contract year equal to £10m for assets losses, £10m to £20m for data protection losses or 150% of charges, but should be adjusted in accordance with the risk in order to achieve value for money, as discussed in the previous section.

Importantly, the size of the contract will have a significant impact on the supplier's appetite to take on risk. While a supplier may have capacity to take on a risk, given a contract's size they may be unwilling to take it on or may charge an excessive price. In these cases it may be appropriate to set a lower limit.

Where the probable maximum cost of a risk is larger than the liability limit, government has potentially retained a contingent liability. In these cases, the standard contingent liability processes should be followed as outlined in the Approvals section below, and CLCC can be contacted to assist with policy design and analysis of indemnities and credit type risks.

Indemnities and guarantees

Beyond the limiting of liabilities, in some cases it may be appropriate to provide an explicit indemnity or guarantee as part of a procurement. These are defined below:

- **Indemnity –** When the government agrees to cover costs if a certain event occurs.
- **Guarantee –** When the government agrees to pay the debts of a third party if they default.

If these agreements are made, they will create contingent liabilities for government. The standard contingent liability processes should be followed as outlined in the Approvals section below, and CLCC can be contacted to assist with policy design and analysis of indemnities and credit type risks.

Insurance

In line with HM Treasury's Managing Public Money, central government organisations should not normally buy commercial insurance to protect against risk, because it is better value for money for the taxpayer to cover its own risks.

However, where the supplier retains risk, it may be better value for money if that risk is insured. This can allow for large risks which may threaten the stability of the supplier to be allocated away from government, with a much lower chance of the risk falling back on government. There is also the potential for efficiency where a supplier already holds insurance for a certain risk across its entire business, and so can take on that risk at little additional cost. Additionally, insurers may be able to offer greater value at a lower cost due to their expertise and economies of scale.

Supplier insurance does not always provide value for money however, as insurers will charge the supplier for taking on the risk. The charge for the risk will include expenses, profit margins and other loadings above the expected cost of the risk itself. If the cost of this insurance is then passed back to government by the supplier, it could result in worse value for money than government taking on the risk itself. As set out above, it is important to consider the price charged by the supplier for retaining a risk when considering the value for money of different options.

In some cases, insurance is compulsory. For example, unless the employer is exempt, Employer's Liability Insurance minimum cover of £5m is fixed by law. Therefore any supplier insurance cover should be reflective of the nature of the work, the risk involved and relevant legal requirements.

For further information on purchasing insurance, please refer to the Crown Commercial Service's insurance brokerage service.

CASE STUDY

Below we set out a case study of a procurement contract demonstrating some of the techniques discussed in this note, focusing on risk treatment and allocation.

Identification and assessment

The contract involves the supplier carrying out works in a public place, meaning there is a risk of an accident exposing the supplier to third party personal injury claims.

Based on previous experience, and consultation with relevant experts, the risk has been quantified over the lifetime of the contract as follows:

Maximum probable loss		
1 in 1000 event	=	**£10m**

Expected loss		
0.1 claims expected X £1m average cost of claim	=	**£100k**

Treatment and allocation

Allocation

To determine the appropriate allocation, we need to consider treatment, cost benefit analysis and wider considerations.

Treatment

The supplier is best placed to manage this risk, as they will be directly responsible for any accidents. If the government retains any of this risk, there are also some potential mitigations that could reduce the risk held:

- Reviewing the health and safety policy of the site, ensuring risk is being minimised.
- Retaining litigation rights for any large claims, to ensure government can defend the claim as it deems fit.

Cost benefit

The supplier has stated that they will not reduce the price of the bid if the liability is limited to £5m, but they would reduce the price by £25k if the whole liability was taken on by government.

We have already calculated that the expected loss of the whole risk is £100k. Additional analysis shows the expected loss relating to losses up to £5m is £85k.

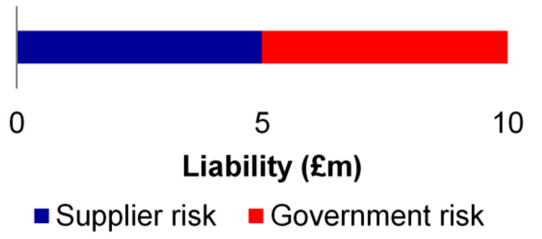
Wider considerations

Capacity to hold risk	The supplier could not absorb a cost of £10m if it arose, so there may be a need to limit the liability.
Supplier behaviour	The supplier has the most control over the risk, as they are carrying out the work. Even with insurance, due to the excess and reputational concerns, by holding the risk they are incentivised to implement mitigations.
Scenarios	In the event of no or only small claims, there would be no issue with the supplier holding the risk. However, they have limited capacity, and in the event the supplier could not pay a claim, it would fall to government.
Constraints	The supplier has stated they are only willing to hold up to £5m of the risk, which represents 150% of the contact value, and plan to purchase insurance to avoid cashflow issues. However insurance is not available for costs over £5m.
Options	The supplier has the most options available to them to reduce the risk, however in taking on some of the liability government may be able to enforce some risk mitigations.

Conclusion

Based on the figures above, as well as consideration of the potential outcomes, the appropriate decision appears to be to allocate a limited liability of £5m to the supplier and require that they take out insurance to avoid cashflow issues.

This is because the supplier cannot take the full liability, and the expected cost of retaining the whole risk is larger than the cost saving. This also aligns incentives between the supplier and government, encouraging better risk management.



Monitoring and reporting

As government has retained some of the risk, it is key to put appropriate monitoring and reporting in place. For example, requiring that any health and safety incidents are reported back to government, enabling pro-active risk management.

The government has retained a contingent liability of £5m relating to the risk above the limit. Before finalising the contract with the supplier, this contingent liability will need to be approved through the standard departmental processes set out in the Approvals section below.

APPROVALS

There are standard processes and reporting requirements which apply to contingent liabilities. These are described below.

Where government commits to a possible future financial obligation to another party, that may be a contingent liability. In these cases, the standard management and reporting processes for contingent liabilities need to be followed.

Your finance team will be able to assist you with the departmental process. Proposals that are novel, contentious or repercussive may also need to follow HM Treasury's Contingent Liability Approval Framework. This includes an assessment of whether the arrangement is consistent with Treasury's objective of safeguarding the sustainability of public finances. And this framework still applies even if the Model Services Contract terms are applied.

In all cases the CLCC's insurance and credit risk experts can assist you in developing your procurement approach. This includes advice on risk identification, assessment, treatment, allocation and reporting. Additionally, we can assist with preparations for engaging with HM Treasury through their approval framework.

If you have any questions or would like assistance related to contingent liabilities, please contact the CLCC at clcc@ukgi.org.uk

ANNEX A: TYPES OF RISK

This list is taken from the Risk Identification Template in the Model Services Contract guidance with some additions.

Bodily injury, disease or death

Injury to employees	Losses due to legal liability in the case of negligence in providing safe working conditions for employees.
Injury to third parties	Losses due to public liability in the case that someone other than an employee is injured.

Property damage

Damage to own property	Losses to buildings, moveable property, vehicles etc.
Damage to third party property	Losses to buildings, moveable property, vehicles etc. owned by a third party.

Other liabilities to third parties

Professional negligence	Losses resulting from negligence in the provision of a service by a professional.
Environmental pollution	Losses due to bodily injury or property damage relating to pollution.
Product liability	Losses due to bodily injury or property damage relating to product faults.
Motor/Marine/Aviation/Rail	Losses due to bodily injury or property damage relating to specific vehicles.

Business risks

Business interruption/keyman	Losses resulting from not being able to conduct business due to loss of premises, tools or personnel (keyman).
Cyber liability	Losses resulting from cyber or data loss events.
Credit/Surety/Bonds	Losses due to unpaid financial obligations.
Legal expenses	Losses due to expenses incurred in defending or initiating legal proceedings.
Directors and officers	Losses due to legal liability to third parties owing to any wrongful act as a director or officer of a company.