NEGOTIATION REVIEW

Negotiating Risk

By Roger Greenfield
Negotiating risk

Risk: one of the most under-valued variables available during contract negotiations.

When the person conducting the negotiation is directly exposed by potential risk, they are generally geared up to ensure that they are accounted for. However, with less experienced negotiators the ‘total contract value’, which includes risks, is not always at the centre of their priorities. In such cases, risks and total costs can be too easily under-valued. Retrospective discounts or payment terms, trade term agreements based on performance levels, due diligence exercises, penalty clauses for delays and minimum quality levels are but some of the ways in which negotiators set about minimising risks.

Risk – a definition:

There are a number of definitions of risk we can look at:

1. The possibility of suffering harm or loss; danger.
2. A factor, thing, element, or course involving uncertain danger, a hazard.
3. The danger or probability of loss.
4. The chance of non-compliance.

Risk is where there is a potential for realisation of the unwanted, adverse consequences to human life, health, property the environment, or wealth. Estimation of risk is usually based on the probability of an event occurring, times the negative consequence.

Note that the term ‘risk’ has not been used in the 4 points opposite, so that an independent definition is possible.

In understanding risk, we need to look at a number of factors – the various dictionaries of the world give a variety of different definitions, ranging from pure risk to economic risk and so on. We also need to consider human behaviour, as this gives us a feel for how individuals interpret risk. The perception of risk is often more of a barrier in negotiation than the actual risk itself however both should be considered when seeking to factor in this critical contributor to the total value of the deal.

Take the case

A manufacturing company which buys aluminium cans to package their consumable product. Their average yearly spend is in excess of £15 Million, and there are only three suppliers in Europe who can supply this volume of cans. Their dilemma is: do they place one big order with one company – and therefore maximise the volume discount, or do they order from more than one company in order to minimise the corporate risk of that company having problems delivering the huge volume. In cost terms, it will be more expensive, but it is worth the reduction in risk of non-supply. They need to identify the risk associated with non-supply – i.e. the knock-on effects to their business – delays in manufacturing and canning process, lack of stock at peak demand times, possiblity of non-supply to their own customers etc., in order to calculate how much they are prepared to pay extra for this contract by going to more than one supplier.

Abstract:

The commonly adopted definitions of risk and uncertainty generate conceptual problems and inconsistencies, and they are a source of confusion in general. However, alternative and proper definitions are:

1. Firstly there is the distinction between certainty and uncertainty.
2. Uncertainty forks into known (assumed) and unknown probabilities.
3. Unknown probabilities fork into known categories and unknown categories.
4. Known categories fork into ‘including the uncertainties in the probabilities by explicitly assuming a uniform distribution’ (Laplace) or neglect (or use other non-probabilistic techniques).
General types of risk

Availability risk
The risk that the quantum of the service provided is less than that required under a contract.

Construction risk
The risk that the construction of physical assets is not completed on time, to budget and to specification.

Decant risk
The risk arising in accommodation projects relating to the need to decant staff/clients from one site to another.

Demand risk
The risk that demand for a service does not match the levels planned, projected or assumed. As the demand for a service may be partially controllable by the public body concerned, the risk to the public sector may be less than that perceived by the private sector.

Design risk
The risk that design cannot deliver the services at the required performance or quality standards.

Economic risk
Where the project outcomes are sensitive to economic influences. For example, where actual inflation differs from assumed inflation rates.

Environmental risk
Where the nature of the project has a major impact on its adjacent area and there is a strong likelihood of objection from the general public.

Funding risk
Where project delays or changes in scope occur as a result of the availability of funding.

Legislative risk
The risk that changes in legislation increase costs. This can be sub-divided into general risks, such as changes in corporate tax rates and specific ones which may affect a particular project.

Maintenance risk
The risk that the costs of keeping the assets in good condition vary from budget.

Occupancy risk
The risk that a property will remain untenanted – a form of demand risk.

Operational risk
The risk that operating costs vary from budget, that performance standards slip or that service cannot be provided.

Planning risk
The risk that the implementation of a project fails to adhere to the terms of planning permission or that detailed planning cannot be obtained, or if obtained, can only be implemented at costs greater than in the original budget.

Policy risk
The risk of changes of policy direction not involving legislation.

Procurement risk
Where a contractor is engaged, risk can arise from the contract between the two parties, the capabilities of the contractor, and when a dispute occurs.

Project Intelligence risk
Where the quality of initial project intelligence (e.g. preliminary site investigation) is likely to impact on the likelihood of unforeseen problems occurring.

Reputation risk
The risk that there will be an undermining of customer/media perception of the organisation’s ability to fulfil its business requirements e.g. adverse publicity concerning an operational problem.

Residual value risk
The risk relating to the uncertainty of the value of physical assets at the end of the contract.

Technology risk
The risk that changes in technology result in services being provided using non-optimal technology.

Volume risk
The risk that actual usage of the service/product varies from the level forecast.

How people interpret risk
We must understand the process that people go through in identifying risk and the assessment of that risk, as a means of trying to establish acceptable levels of a risk and/or levels of risk for an individual or company.

We can identify specific personality types which influence the way different people understand, assess and respond to risks and the perception of risk. These personality types can be classified in the following way:

Risk averse
A person who will do everything they can to avoid any exposure to risk. This sort of person will avoid things like gambling, lotteries and gaming. They are prudent in the short term, but recognise they are sacrificing potential long-term gain. They are the sort of person who always carries an umbrella in their briefcase in case it rains!

Interest rates are set by companies based on a number of calculations often resulting in the categorisation of the borrower and the level of risk they carry. This risk is simply factored into the rate offered.

Risk seeker
This person is someone who actively seeks out risk, as they get a thrill from all types of risk – they are more likely to enjoy gambling, gaming etc. They enjoy the thrill of taking a risk because they seek the large potential return and are prepared to accept any short-term loss. Risk seekers are often more financially secure, and can therefore afford to take a loss in the short-term.

Bookmakers and gaming companies understand how to employ percentages to manage probability and risk, ensuring that it is the punter who is taking the risk.

“It is important to understand that individuals are not necessarily consistent in their approach to risk”
Risk balanced or risk neutral

These people have a balanced view of risk; they are often more logical and rational in their thought process. They will try and take a balanced view to risk, allowing themselves to take risks but offsetting high risk against low risk to obtain the risk neutrality. An example of this might be a fund manager who typically will invest in Stock and Shares (high risk), Commercial or Residential property (medium risk) and Cash or Securities (low risk). They will offset the high risk against the low risk to achieve a balanced portfolio.

In negotiation we must consider the personality type of the other party in order to try and understand how they will respond or react to risk. People often identify themselves or others according to their own attraction to risk.

However, it is important to understand that individuals are not necessarily consistent in their approach to risk. This can be dependent on a number of factors, but there is a suggestion that people are risk averse when confronting potential gains and are risk seeking when faced with potential losses.

This suggests that most people who are risk averse are prepared to forgo value to minimise risk. The risk-averse choice is to accept an offered settlement, but the risk-seeking choice is to wait for future concessions. Conflict will therefore always exist in negotiation. The marketing world is famous for exploiting these dynamics with great front line offers backed up with significant small print which outlines such terms and conditions that enable the original offer to be commercially viable.

When a risk-averse company negotiates with a risk-seeking company, the risk-seeker is often more willing to risk the potential agreement by demanding more and being less concessionary. To reach agreement, the risk-averse company can end up making additional concessions to induce the other to accept the agreement.

Because of the way people will interpret risk, low cost high value (all gain) trades can often be found more readily with risk related trades than with tangible trades where the values involved are more transparent.

Assessing risk

So how can we start planning for risk in every negotiation? And then understand the factors which will influence risk in the lifetime of the contract.

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<th>Likelihood (probability)</th>
<th>Impact (seriousness)</th>
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<tr>
<td>High</td>
<td>Could easily or does occur</td>
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<tr>
<td>Moderate</td>
<td>Likely to occur</td>
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<tr>
<td>Low</td>
<td>Unlikely to occur within the contract life</td>
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Common unhealthy attitudes towards risk

“Risk is outside my control”

“There is a risk – but it’s not mine”

“We do that at the year end – don’t we?”

“Managing risk is one of the responsibilities of the management”

“I have reviewed our exposure and there is nothing new”

“I’m too busy to check for every risk”
The management of risk is important to all commercial negotiations, so developing a planned and structured way to analyse the impact of all risks associated with the negotiations we are involved in makes sense.

The PS tool provides a means of identifying and evaluating all potential risks associated with a particular deal or contract.

When using this tool, identify any potential risks that may arise during the lifetime of the contract, assess their probability of occurrence and the seriousness or impact they would have on the outcome of the contract.

List the potential, known risks.

Calculate S divided by P = cost/value of trade off in the negotiation. = (S)

Rank each potential risk based on probability

(1) = very high (10) very low. = (P)

If you were to take responsibility for the consequence of the risk estimate the cost and enter under seriousness. = (S)

Calculate S divided by P = cost/value of trade off in the negotiation.

When we have assessed the probability and likely impact, we can build this into tradable issues - a strategy of factoring risk into the process of the negotiation.

Risk is therefore another intangible issue that the skilled negotiator can place a tangible value on, and must be factored into all commercial business operations. The skill is to balance risk with return, so maximising deal value, whilst minimising potential failure.

### The PS tool

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### Take the case

The price of a seat on a budget airline starts off at a low price point and gradually, as the seats are booked, the price is increased. However, as the flight date nears, depending on the number sold, the ticket prices drop, until the few hours before take off, when assuming the flight has availability, the price drops further. This is one pricing model. The airline industry use many others based around forecasting and influencing supply and demand and ultimately balancing occupancy, risk and profit. Other business routes operate at premium rates, often half full yet still achieving respectable margins.

### Potential risks

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<th>Potential risks</th>
<th>Probability (level of exposure)</th>
<th>Seriousness (cost if liable)</th>
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### Active risk management

Effective management of risks within contract negotiation involves:

- Identifying possible risks in advance and putting mechanisms in place to minimise the likelihood of their materialising with adverse effects;
- Having a processes in place to monitor risks and access to reliable, up-to-date information about risks;
- The right balance of control in place to mitigate the adverse consequences of the risks, if they should materialise;
- Decision-making processes supported by a framework of risk analysis and evaluation.

### Early consultation

Experience suggests that costs tend to increase as more requirements are identified. Early consultation will help to identify what those needs are and how they may be addressed.

### Avoidance of irreversible decisions

Where commitments are irreversible, a full assessment of costs should include the possibility of delay, allowing more time for investigation of alternative ways to achieve the objectives.

### Pilot studies

Acquiring more information about risks affecting a project through pilot studies allows steps to be taken to mitigate either the adverse consequences of bad outcomes, or increase the benefits of good outcomes.

### Design flexibility

Where future demand and relative prices are uncertain, it may be worth choosing a flexible design adaptable to future changes, rather than a design suited to only one particular outcome. For example, different types of fuel can be used to fire a dual-fired boiler, depending on future relative prices of alternative fuels. Breaking a project into stages, with successive review points at which the project could be stopped or changed, can also increase flexibility.

### Precautionary principle

Precautionary action can be taken to mitigate a perceived risk. The precautionary principle states that, because some outcomes are so bad, even though they may be very unlikely, precautionary action is justified. In cases where such risks have been identified, they should be drawn to the attention of senior management and expert advice sought.

### Contractual buy-out

Risk can be contractually transferred to other parties and maintained through collaborative contractual relationships, both formal and informal. Insurance is the most obvious example of risk transfer.

### Incentive contingencies

To provide incremental benefit in over-achieving where risk is probable to neutralise risk. For example, a supplier may provide an over-rider to a retailer in return for over-achieving a volume target beyond the forecast. This carrot effect can be considered prior to the precautionary stick effect of the penalty clause.

### Minimise technology exposure

If complex technology is involved, alternative, simpler methods should also be considered, especially if these reduce risk considerably whilst providing many of the benefits of the option involving leading edge technology.

### Re-package risk options

Following the risk analysis, the appraiser may want to develop alternative contingency proposals that are either less inherently risky or deal with the risks more efficiently.

### Abandon proposal or insure

Finally, the proposal may be so risky that, whatever option is considered, it has to be abandoned or simply insured against, with the cost of insurance being built back into the agreement.
In summary

Risk is generally considered by many negotiators as an intangible variable for consideration after the point of agreement. By adopting a more considered approach in planning and proposal formation, we can alter the differential between the two parties in the level of future exposure. In examining probability and seriousness, we can minimise the effect of gambling and trade the tangible consequence of risk through active risk management, prior to the point of agreement.

The key thing with risk is either to quantify it (by identifying a tangible value to it) or limit your exposure to it, by passing it onto others – this is done through more effective planning and preparation.