Commercial Contracting

[L4M3]

Core

Study Guide

Level 4

Diploma in Procurement and Supply

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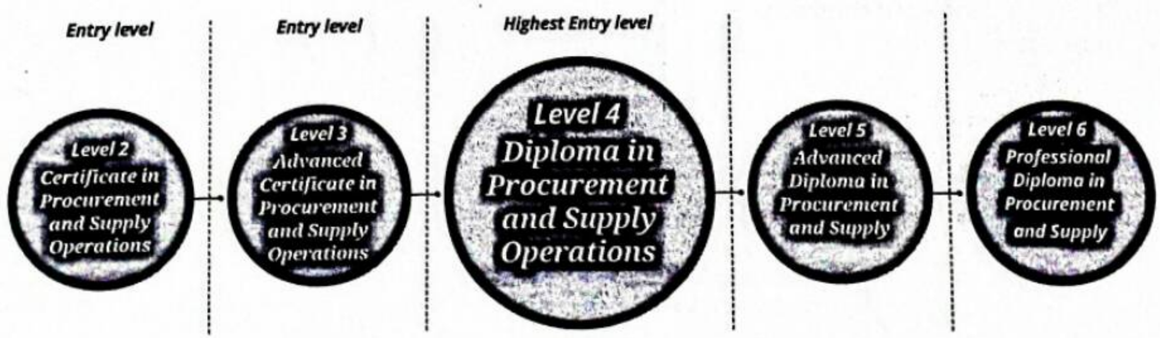
Your qualification

CIPS qualifications are regulated internationally to ensure we offer a recognised, professional standard in procurement and supply. CIPS Level 4* Diploma in Procurement and Supply is a vocationally related professional qualification. Formal recognition is included within the regulatory frameworks of an increasing number of countries such as the UK (England, Wales and Northern Ireland), UAE (including Dubai) and Africa (including Zambia). Further information on this recognition and the details of corresponding qualifications levels for other international qualifications frameworks are detailed on our website. CIPS members can have the confidence in our regulated qualifications, which reliably indicate the standard of knowledge, skills and understanding that you, as a learner, are required to demonstrate.

A step up from the Level 3 Advanced Certificate in Procurement and Supply Operations, the Level 4 Diploma in Procurement and Supply is a stepping stone to study on the CIPS Level 5 Advanced Diploma in Procurement and Supply. The content has been written using the CIPS Procurement and Supply Cycle as its focus, which presents a cyclical process of key steps faced by those procuring goods or services. The Diploma offers the most common entry route to the profession and should be used by learners to develop a professional 'tool box' which learners can apply in the practical environment and further develop at Levels 5 and 6.

In this way successful learners will possess transferable workplace skills, developing their operational and tactical abilities as they strive for managerial roles and responsibilities. It is aimed at those in the profession who have procurement and supply activity at the heart of their role. Learners will be expected to provide advice and guidance to key stakeholders on the performance of organisational procedures and processes associated with procurement and supply and will aspire to manage developments in and improvements to the related functions. Transferable skills are those such as communication, teamwork, and planning and completing tasks to high standards, all enable the learner to add value to the organisation.



Next steps

This qualification provides progression to the CIPS Level 5 Advanced Diploma in Procurement and Supply.

Level 5

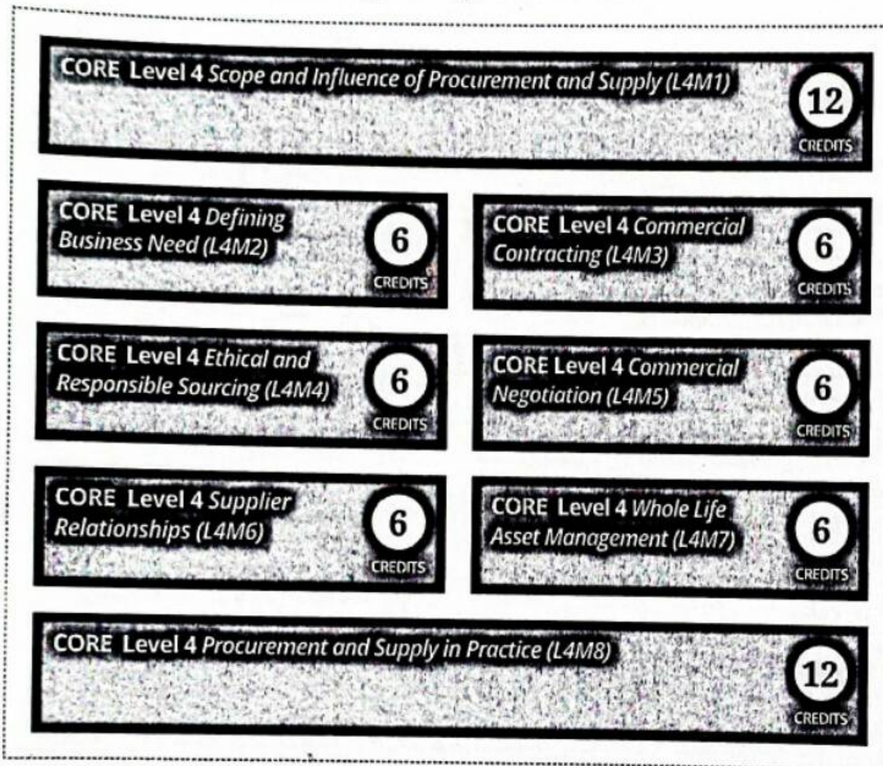
** Refers to levels within the UK RQF. Other regulatory bodies may have different corresponding levels*

Based on the Tactical competency level of CIPS Global Standard

Guide to qualification content

What will I study?

Eight CORE modules make up 60 required credits



CORE Level 4 *Scope and Influence of Procurement and Supply (L4M1)* — 12 CREDITS

CORE Level 4 *Defining Business Need (L4M2)* — 6 CREDITS

CORE Level 4 *Commercial Contracting (L4M3)* — 6 CREDITS

CORE Level 4 *Ethical and Responsible Sourcing (L4M4)* — 6 CREDITS

CORE Level 4 *Commercial Negotiation (L4M5)* — 6 CREDITS

CORE Level 4 *Supplier Relationships (L4M6)* — 6 CREDITS

CORE Level 4 *Whole Life Asset Management (L4M7)* — 6 CREDITS

CORE Level 4 *Procurement and Supply in Practice (L4M8)* — 12 CREDITS

Who is it for?

This qualification is the essential toolkit for anyone planning a career in procurement and supply. Developed and written using the Procurement and Supply cycle** as it's focus, it is at the same level as the first year of an undergraduate degree course. It's suitable for those in operational roles or those managing or supervising the procurement and supply function who want to develop their career and work towards MCIPS Chartered Procurement and Supply Professional.

What will I learn?

You will learn about making procurement and supply happen within an organisation, and you will be equipped with an essential range of knowledge and tools that you can apply immediately in your workplace. Learn how to apply practical, theoretical and technical knowledge, gain a clear understanding of procurement and supply and develop the ability to address complex, non-routine problems.

On completion, you will be able to analyse, interpret and evaluate relevant information and ideas and have an informed awareness of differing perspectives and approaches within the profession. You will also be able to review the effectiveness and appropriateness of methods, actions and results.

Entry requirements

This is the only entry point onto our Diploma qualifications. A minimum of at least two A-levels (or international equivalent) or a CIPS Level 3 Advanced Certificate qualification is required. Alternatively, you will need a minimum of two years' relevant experience in a business environment.

Credit values

To gain a qualification you are required to complete a total number of credits. This is a way of quantifying the required number of study hours. 1 credit is equivalent to 10 hours of study. Each module is given a credit value of 6 or 12 credits.

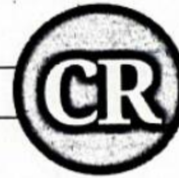
Total credits required for completion	**60**

*** The Procurement cycle is the cyclical process of key steps when procuring goods or services. www.cips.org/en-gb/knowledge/procurement-cycle/***

About our exams and your study commitments

Objective Response exam format (OR)

These questions allow you to select a response from a list of possible answers. You will find these types of exams across all our qualifications levels and they are marked by computer and then moderated by CIPS examiners.



Constructed Response exam format (CR)

These questions require you to create or 'construct' a response to the question such as an essay or case study. You will find this type of exam in our diploma level qualifications and they will be marked by subject expert examiners.

Your total qualification time (TQT)

The TQT indicates the overall number of guided learning hours, additional self-study and assessment time that is required.

Guided learning hours (GLH)

It is expected that you will undertake 250 GLH. The definition of guided learning hours is: 'A measure of the amount of input time required to achieve the qualification. This includes lectures, tutorials and practicals, as well as supervised study in, for example, learning centres and workshops'.

Self-study requirement (SSR)

Additionally, we recommend that you also commit to at least 335 SSR hours. This includes wider reading of the subject areas and revision to give yourself the best preparation for successfully achieving the qualification.

Total exam time

All the modules in CIPS qualifications are assessed by an examination.

How to use this book

Welcome to this study guide for Procurement and Supply Operations. It contains information to help you prepare for the assessment in this module.

This study guide follows the order of the module specification and each chapter relates to one of the learning outcomes below. You can also see the assessment criteria for each learning outcome.

Learning outcome 1

By the end of this chapter you will understand the legal issues that relate to the formation of contracts.

Learning outcome 2

By the end of this chapter you will understand the fundamentals of specifications and key performance indicators that are included in contractual arrangements made with suppliers.

Learning outcome 3

By the end of this chapter you will understand the most important (key) clauses that are included in formal contracts for purchase and supply.

Book features

Throughout this book there are a number of features to aid your learning and simplify your revision. Take a look at the different features you will find in the book below.

Glossary
These are the key terms and their definitions

Remember
This information is important, so you should make a note of it.

Check
These revision questions give you a chance to check you understand the content in this chapter.

Apply
These tasks give you a chance to test out your knowledge and understanding.

Recap
This information will summarise sections from previous chapters.

Case study
These case studies will relate the content you have learned to real-world examples.

Recommended reading
These books can give you more understanding on the subject.

Link to CIPS knowledge where members will be able to access additional resources to extend your knowledge, plus links to online eLearning content including videos, audio and interactive quizzes to recap and test your knowledge and understanding.

End of chapter assessments

At the end of each chapter in the book there is a set of exam-style questions to prepare you for your assessment.

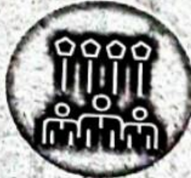
End of Chapter Assessment

IDENTIFY

1. The National Health Service (NHS) in the UK is an example of an organisation from which sector?
   a. Public
   b. Private
   c. Third
   d. Primary

CORE MODULE

Commercial Contracting [L4M3]



CIPS GLOBAL STANDARD
1.3 · 4.1 · 5.1 · 5.2
5.3 · 7.5 · 8.2 · 8.3

OBJECTIVE RESPONSE EXAM

EXAM DURATION HOURS

MODULE LEARNING TIME

Module purpose

On completion of this module, learners will be able to describe the key elements and legal aspects of formal commercial contracts, and analyse and interpret the fundamentals of specifications and key performance indicators that are included in contractual arrangements made with suppliers.

Module aim(s)

In any organisation, a significant element of the procurement and supply function is based around the contracting process. If they are to be successful, contracts must be clearly defined, be cognisant of legal requirements and contain key clauses and terms. This module is designed for those working in the procurement and supply field, or those who have responsibility for the development of legally binding contracts with suppliers.

Credit value

CHAPTER 1

Legal issues in relation to commercial contracts

Learning outcome

By the end of this chapter you will understand the legal issues that relate to the formation of contracts.

Chapter overview

1.1 Analyse the documentation that can comprise a commercial agreement for the supply of goods or services

You will understand:

- Invitation to tender or request for quotation
- Specification
- Key performance indicators (KPIs) and performance management frameworks
- Contractual terms
- Pricing and other schedules
- Contract variations

1.2 Analyse the legal issues that relate to the creation of commercial agreements with customers or suppliers

You will understand:

- Invitations to treat or invitations to negotiate
- Rules relating to offer and acceptance, consideration, intention to create legal relations and capacity to contract
- The battle of the forms and precedence of contract terms
- Risks presented by contracting on suppliers' terms or through oral contracts
- The Vienna Convention on the International Sale of Goods
- Misrepresentations made pre-contract award

1.3 Compare types of contractual agreements made between customers and suppliers

You will understand:

- One-off purchases
- Framework arrangements and agreements
- The use of mini-competitions
- Call offs
- Services contracts
- Contracts for the hire and leasing of assets

Introduction

A significant element of the procurement and supply function is based around the contracting process. To be successful, contracts must be clearly defined, contain key terms and conditions, and take account of the legal framework within which they sit. They must also accommodate the reality of the business environment, which means that – within limits – there must be a degree of flexibility allowed.

This module is designed for those working in procurement and supply, or otherwise involved in responsibility for the development and use of legally binding contracts with suppliers. Although aimed at those involved in the formation of contracts, it will also be useful to those whose function involves contract management.

On completion of this module, you will be able to describe the key elements and legal aspects of formal commercial contracts and be able to analyse and interpret the fundamentals of specifications and key performance indicators (KPIs) included in contractual arrangements.

1.1 Analyse the documentation that can comprise a commercial agreement for the supply of goods or services

This section looks at the elements that make up the contract documents. In practice, these may be produced as separate documents that become 'linked', so that there is a core document with a number of attached schedules, or they may be combined into a single document.

When talking about 'the contract', this means the totality of the agreement between the parties as evidenced by the contract documents. When using a format that involves a core document and a number of separate schedules it is useful to remember this concept of the 'whole agreement'.

Remember that the contract as originally signed is likely to allow for variations, so at any point in time 'the contract' may well be different from that originally signed and sealed. There is a tendency to think of contracts in an archaic sense as something fixed and unchangeable. Modern commercial contracts are designed to accommodate the fact that change is inevitable. Therefore it is important that there is a mechanism in place to ensure that 'the contract' – the current, up-to-date agreed version of the agreement – is easily accessible.

Invitation to tender or request for quotation

Difference between estimate, quotation and tender

In law, when considering the contractual process there is no difference between a quotation and a tender. The legal basis for this is discussed in section 1.2 (which covers offer and acceptance) and you should revisit this section once you have completed section 1.2.

For now, just be aware of the following.

- An **estimate** has no legal standing: it is merely a supplier's best guess of what the supply might cost. In commercial contracts, estimates should be avoided.
- A **tender** and a **quotation** (sometimes quote) are essentially the same thing – they are both a firm offer to do something for the quoted price or at the quoted rates, although a tender will be more comprehensive and detailed.

Estimate
A supplier's best guess at what the price will be. It has n legal standing

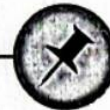
Tender
A bid obtained via a formal process; normally (not always it includes quality variables as well as price aspects

Quotation
Sometimes called a quote, this is a firm price offer obtained via a formal or informal process; normally it only relates to price on the basis of indicated quality

In procurement and supply, a distinction is made between quotations and tenders, but it is a fairly artificial one.

- **Quotation** is normally used when the only variable is price. The process for arriving at the quotation will often be simple, perhaps even informal, but generally it will involve a buyer describing in precise terms what they wish to buy, and a supplier offering a price at which they are willing to supply it. The terms and conditions are (in poor practice) often not specified in requests for quotations, which can lead to the infamous 'battle of the forms' (see section 1.2). Quotations should only be used in any of the following situations.
  - For low-value, low-risk purchases
  - Where the specification and delivery terms are fixed
  - Where suppliers have been pre-qualified
  - Where a framework or dynamic purchasing system has locked down the contract terms and price is the only variable
- **Tender** is normally used when there is potentially more than one variable. This is not always the case: tenders can be used where everything other than price is already locked down, but this is becoming less and less common. The process leading to a tender will be quite formal. It will require sealed bids not to be opened before a specified deadline. The format of responses will be dictated by the purchaser. The contract terms will be specified in the invitation and required to be accepted as part of the tender offer. Tenders should be used in the following situations.
  - For complex projects
  - For high-value or high-risk purchases
  - For projects where quality and price need to be assessed
  - Where access to unknown suppliers is required and there is a need to either pre-qualify them as part of a two-stage process, or to assess their suitability as part of a single-stage open tender process

Remember
An estimate is not a firm offer. A quotation and a tender are both firm offers. Tenders are more detailed than quotations and will include quality aspects as well as prices.



Framework agreement
A formal agreement between two organisations that is intended to become legally binding in the event that a contract is created

Request for quotation (RFQ)

Requests for quotation (RFQs) are often misused, e.g., where a purchaser simply asks for a price without adequately determining the contract terms and specification. However, they do have a valuable function when their use is properly controlled. They work well under **framework agreements** where the contract terms are already fixed. Table 1.1 sets out the main features of RFQs, along with the advantages, risks and controls.

Feature	Risks	Advantages	Controls
Degree of formality	Unless the organisation has its own strict rules and standard documentation there is a risk that RfQs may be done via a simple phone call. Potential lack of an audit trail of the basis for the quote 'you asked for/we quoted for' disputes. Possible lack of transparency – potential for collusion or bribery if quotes are opened at different times. Limited (if any) market engagement. Small and known supplier pool.	Reduces administration costs where specification is clear e.g., by reference to make and model number or supplier product code. Frees up professional resource for more complex requirements. Small and known supplier pool.	Set maximum value limits. Set minimum acceptable formality, e.g., all quotes to central point and to remain sealed until specified deadline. Use 'quick quote' e-tendering platforms. Issue standard terms and conditions with all requests. Monitor usage. Train staff in possible risks.
Speed	If price is the only variable, turnaround times can be short. Quick implementation is sometimes unavoidably necessary.	Not always appropriate for price to be the only variable and may be used in the wrong circumstances. Temptation to seek quick quotes when a more considered approach to aggregated spend is indicated. Notional compliance with internal rules, without understanding the wider procurement landscape. No thought given to contract terms. No thought given to supplier vetting.	Use category management approaches to aggregate spend. Set up framework agreements to ensure contract terms are fixed. Only permit quotations to be sought from pre-qualified suppliers.
Relationship to contract documents		Having no cross-reference to contract on the order risks a lack of clarity as to the contractual nature of the request. Quotes often issued on supplier's terms and conditions.	Ensure terms and conditions are included in request and reiterate them at the point of order. Cross-reference any information provided in the request with the order.

Table 1.1 Main features of RFQs

Invitation to tender (ITT)

Public (or state) sector
Service organisations run by the government and usually funded by taxes

Utilities sector
Normally includes energy supplies, water and sewage, and telecoms networks

Tenders are more formal sourcing exercises than RFQs, which means more thought is given to the selection of suppliers and the working up of contract documentation. They are sometimes also called requests for tender (RFTs).

The tender process is well-developed in most organisations. In sectors where procurement is regulated by law (e.g., the **public (or state) sector** and the **utilities sector**), the permitted processes are set out in regulations. Some sectors may also have their own codes of practice. For example, the UK construction industry has a 'Practice Note' published by the Joint Contracts Tribunal – a body set up to include various stakeholder groups from both constructing and client sides of the industry.

Tender returns (or submissions) are generally more detailed than quotations, including variables such as method statements, timescales or other quality aspects of the delivery, as well as price. In open tenders, where suppliers have not been pre-qualified, there will generally also be supplier vetting information.

There are still risks, however, as shown in table 1.2.

Feature	Advantages	Risks	Controls
Formality	Full audit trail, especially if electronic platform used. If process is robust, can provide transparency, reducing risks of bribery and corruption. Potential for wider market engagement.	Requires specific documentation. Process-driven tender exercises risk a lack of project-specific thought. Can create unnecessary administrative burdens. May be regulated by law – creates risks of challenge by suppliers if rules are not followed.	Clear process, including options appraisals, reporting and accountability. Ensure processes match legal requirements. Audit random sample for compliance. Train staff on formal processes.
Lack of speed	Proper understanding of the time needed to deliver a tender process can drive improvements in forward planning.	Perceived or self-created urgency can drive poor practice. Lack of understanding in the appropriate use of tenders. Poor documentation leading to prolonged clarification processes and/or poor results.	Ensure the forward plan is robust. Have a clear authorisation process for urgency, e.g., a tender waiver process Standardise documentation wherever possible. Train staff in processes to ensure efficiency.
Relationship to contract documents	Clear and robust response schedules can easily be inserted into formal contract documents if the draft contract is properly designed to accommodate them.	Inserting full tender response document into formal contract can create inconsistencies, especially where clarification exercises have been necessary.	Design the tender return documents and the contract documents to ensure ease and clarity of use.

Table 1.2 Main features of ITTs

Bribery
The promise, offer or giving of financial advantage to someone in the expectation that they will improperly perform their functions, or to reward them for having done so; also accepting such a promise, offer or advantage (whether or not the function is improperly performed)

Corruption
A wider term than bribery, includes any improper performance of function in return for some kind of advantage which may or may not be financial, e.g., facilitation payments, nepotism (favouring of family members), or career promotion. Both the providing and receiving of the advantage are corrupt practices

Collusion
Where two or more potential suppliers (or the purchaser and one or more suppliers) secretly co-operate to undermine the competitiveness of a tender process

Real-world comparison of quotations and tenders

The issues are summarised on the previous pages, but here are some points to consider in a real-world context.

Process administration costs

Sourcing (seeking tenders and quotes) is a resource-intensive activity, as submitting bids is resource intensive. It is in the interests of both buyers and suppliers to keep these administration costs within limits that are proportionate to the value and/or risk of the contract under consideration.

Purchasers should be aware that cost and risk are not the same thing. A relatively low-value contract could be sufficient to bring a business to a standstill if it collapses. Conversely, a high-value contract may have little impact on failure if the supply need can easily be filled from other sources.

Naturally, the amount of documentation issued with an RFQ or ITT increases the costs of preparing the request and the supplier's costs in responding to it. However, these upfront costs are repaid during the contract process by having a clear, concise, mutually understood contract. Costs to unsuccessful bidders are not recouped, but simplicity and clarity of documents can reduce the costs of bidding and the risks of accepting a contract, so it is still in the supplier's (even the unsuccessful potential supplier's) interest for these to be fully scoped at the outset.

Audit trails

An audit trail is the written or electronic record of what was done, when and by whom. Audit trails are important for the following reasons.

- They reduce **bribery**, **corruption** and **collusion** by increasing the likelihood of being caught.
- They provide solid evidence in the event of such activity occurring.
- They improve accountability – even where there is no criminal or fraudulent intent, staff members tend to take more care when they know the actions can be traced back to them as individuals.
- They help trace errors, e.g., identify skills and knowledge gaps and/or procedural weaknesses which can be used positively for personnel development and systems improvement.
- They provide solid evidence of the facts of a situation when disputes arise, particularly in relation to specification and/or offers of service.

> *Remember*
> RFQs are useful in that they are quick and informal, but they carry the risks that they only look at price not quality, and they may not be tied adequately to contract documents. ITTs are more formal and take longer, but they have full audit trails, consider quality aspects as well as price, and are usually more closely reflected in final contract documents.

Quotations often have weak audit trails, but with the increasing use of e-tendering systems for quick quotation purposes, this risk should now be on the decline. There is no reason why a quotation cannot have a robust audit trail.

Tenders have always been more formal and therefore have some auditability built in automatically. But there is still scope for this to be breached, so again, electronic systems vastly increase robustness in the tendering process.

Transparency of process: controlled opening of offers

Transparency
Operating in such a way that everyone can see the actions performed

Whether quotations or tenders are being sought, it is important that both buyers and suppliers can trust the process: it must have **transparency**. Suppliers will not be willing to expend the time and effort needed to prepare offers, unless they believe they have a fair shot of winning the contract.

If the system allows for bids to be opened on receipt without a deadline or witnesses, there is a risk of early offers being shared with those yet to submit. The latter may then have an advantage and be able to reduce their price, or conversely (if they have colluded with the early bidder), to increase their price as a way of either driving up price overall or simply determining who wins the contract. Either way, the buyer will not be getting the best value deal. The use of e-tendering systems ensures that fixed deadlines are set. Most systems ensure that no further bids can be submitted via the system once the electronic vault has been opened.

Urgency and speed

Good category management and market awareness should eliminate most of the need for immediate-action scenarios. Most procurement should be properly planned and timelined. Even the best of organisations will occasionally have urgent needs which have arisen due to a sudden change in circumstances.

Waiver
A considered and deliberate decision not to apply normal rules

The process for selecting a replacement supplier must still be controlled. The organisation's internal rules must include a section which sets out when normal supplier selection processes can be waived. This tender **waiver** process requires high-level authority (normally a director) and must include a full business justification for not using the normal process. The waiver process should include a requirement to state what has been learned from the situation and how (if) that can be built into operational improvements.

Case study

Waiving the tender process

A regional organisation employing nearly 2000 staff had its payroll managed externally by a well-known facilities and business services provider. All employee records were held by the provider, who managed all the individual salary payments and tax and pensions deductions, at an annual cost of approximately $150,000. For business reasons of its own, the provider decided to pull out of payroll provision. It gave two months' notice. Clearly there was no time to carry out a full tender process. The new provider had to be contracted, on-boarded and ready to go live in eight weeks.

This case clearly illustrates why there is sometimes a need to act quickly, whatever the normal rules of engagement.

Could the situation have been avoided? The contract allowed the supplier to give only two months' notice – but even if that had not been the case, the supplier was a multi-national company and the contract was low value; it is probable that the supplier could easily have carried the risks of simply defaulting.

Apply
Consider tables 1.1 and 1.2. Write a list of types of purchases for a particular organisation (e.g., a manufacturing company, hospital or any other organisation with which you are familiar). For each type of purchase, state whether a quotation or a tender would be more appropriate and why.

Is there any circumstance where you might need to waive normal tender or quotation rules for each of those purchases?

Remember
Tender processes must be transparent. If there is a reason for normal processes to be waived, this must be fully documented and approved at a high level.

Specification

The specification is absolutely central to all commercial contracts. Any ambiguity, misunderstanding, lack of clarity or confusion about the specification will result in the following issues.

- Poor bids being received – either overpriced or underpriced
- Claims for extensions of time or additional payments
- Administration costs resulting from contract clarification orders
- The potential for goods or services being delivered that do not serve the desired purpose, or being delivered in the wrong place, at the wrong time or in the wrong quantities
- The potential for goods or services being delivered which do not meet the required standards, which may be written in law, putting the purchaser, end users or the general public at risk

The specification is the document which sets out the detailed requirements for the goods, services or works that you are procuring. The specification will normally be included as a schedule to the contract.

Defining what you want to buy can be one of the most difficult stages of the procurement process. There are risks at both extremes of detail.

- Describing exactly what you want in miniscule detail can make you miss out on opportunities for change and innovation.
- You may write a wish list that the supply market cannot meet or that is too vague for you to enforce contractually.

Clearly the aim has to be to find the middle ground between the two.

Types of specification

There are two main types of specification: performance specifications and conformance specifications (sometimes called prescriptive or technical specifications). A third approach would be to use an outcome-based schedule of outcome requirements. This is looser and more flexible than a specification and often encourages the use of innovative approaches to meeting the procurement need. However, care should be taken as the terms 'output' and 'outcome' are often confused.

The key differences between performance and conformance specifications are shown in table 1.3.

Performance specification	Conformance specification
Focus on outputs Sets out result to be achieved The 'what', not the 'how' Gives supplier flexibility to present solutions that the buyer may not have considered	Focus on inputs Gives specific methods, processes and materials May identify specific manufacturers or components The 'how' as well as the 'what' Ties supplier to set details

Table 1.3 Comparison of performance and conformance specifications

Using a central heating system as an example, a performance specification would simply require a system capable of maintaining a temperature of 21°C when the external temperature is zero, with the additional capability of being time-programmable and having the facility to vary the temperature between individual rooms. A full conformance specification would detail the make and model of the boiler, set out how many radiators (of which size, make and model) should be in each room, the type of thermostats to be used, where they should be placed, and much more additional detail besides.

In practice what is likely to be used is a specification which says that the system is to be gas-fueled, using an A-rated boiler, giving the temperature to be achieved and desired level of programmability and controllability. For reasons of compatibility with existing installations – and the impact that has on maintenance costs – it is likely that a specification would also specify a preferred make of boiler. In other words, the specification would be a hybrid between a performance specification and a conformance specification.

There is one further problem, however. It is possible that what sounds like a conformance (technical/prescriptive) specification is actually a hybrid – and a hybrid specification opens up the possibility of compliance which does not actually deliver the intended result.

Case study

Permeability is no proxy for durability

As information provided by the American National Ready Mixed Concrete Association[1] illustrates, it is possible to comply with what looks like a conformance specification without achieving the desired outcome.

The industry uses a w/cm ratio: a water-cementitious ratio. This has to do with the permeability of the concrete and is sometimes used as a proxy measure for durability.

However, low w/cm ratios might increase the potential for shrinkage, when the intention is to reduce it. The problem is that a low w/cm ratio can be achieved by different means, only some of which will achieve the durability required. The NRMCA's website indicates that different mixtures, all using the same w/cm ratio, could achieve strength values as different as 3800 psi, 5000 psi and 6000 psi (psi = pounds per square inch).

Clearly, the difference between 3800 and 6000 psi tolerance is significant enough to show that specifying a w/cm ratio does not ensure a certain durability will be achieved.

This provides a clear demonstration as to why procurement professionals must engage with technical stakeholders when designing or agreeing specifications.

This does not mean that the procurement team should simply defer to the technical personnel from the commissioning department when it comes to producing the specification. Technical specifying can easily become locked into 'what we know' or 'the way we have always done it'. While no specification starts from a blank piece of paper, it is helpful to go back to first principles.

> *Remember*
> Procurement professionals have a role in challenging specifications. Technical experts can get things wrong and asking naive questions can be useful in bringing these to light.

Designing a specification

Figure 1.1 shows ten key things to think about when designing a specification. (The drafting of specifications is considered in more detail in section 2.1.)

Purpose
Ask yourself what you are trying to achieve. Consider the following.
- Current needs
- Future-proofing
- The make or buy question

Type
Decide whether to use a conformance or performance specification, taking the following into account.
- Whether a specific technical interface or compatibility with other systems is required
- Interoperability between suppliers' products, including any risk of today's solution locking

Perspective
Decide what the different stakeholders need.
- Identify the stakeholders.
- Consider what influence they have.
- Decide what their needs are.
- Remember to consider the perspective of the supplier.

Relevance
Include everything you need, and nothing you do not. Ask yourself the following.
- What are the minimum and maximum standards? How would they differ in cost, and would extra cost be offset by greater benefit?
- Would a higher investment bring indirect benefits? For example, would investing in higher-specification equipment allow the company to complete more work in-house?

Scope
Decide what should be included and excluded, by answering the following.
- Are there geographical, business unit and value limits?
- Will the scope change during the contract, and if so, how?
- Are there any test, implementation or user training needs?
- Is any internal input required?

Performance
Define an acceptable quality standard by doing the following.
- Set KPIs and targets.
- Make complaint and remedy processes clear.
- Clarify the coverage as well as the time period for warranties and/or defects liability periods.

Improvement and Innovation
Never reuse an old specification. If revising an old or template specification, ask yourself the following.
- What has changed since it was first written?
- What might change while the contract is in place?

Clarity
The specification must be clear and unambiguous.
- Use plain language where possible, and technical language where necessary.
- Are costs of delivery easy to assess and price?
- Can the contract manager easily check whether the delivery meets the contract specification?

Regulatory compliance and quality
What standards must be met? The following are possible examples.
- Laws, codes of practice and regulations
- National or international quality standards such as ISO
- Health and safety, the environment, equality and diversity
- Data protection and data security

Service conditions
Take into account any impact that is made by the point of delivery itself, including the following factors.
- Operating and storage conditions
- Availability of energy, water and other resources
- Safety considerations
- Cultural issues

Figure 1.1 Key points of designing a specification

The specification as a contract document

It is important to be clear from the legal perspective that the specification is only a contract document if it **says** it is. A specification issued with an RFQ or an ITT will not be fully incorporated into the contract unless care is taken to ensure that it is. For example, changes to the original specification might arise as a result of queries during the tender process, or through post-tender negotiations with the winning bidder. It is also possible that the supplier has qualified the specification in its offer, and if this has not been picked up, then there could later be disputes as to which version of the specification is the contractual version.

The simplest method is to ensure that a final and agreed version of the specification is reproduced and appended to the core contract document as a schedule, clearly referenced from the contract terms.

Potential problems

If care is not taken to fully incorporate the specification into the contract, but instead reliance is placed on the fact that it was set out in the invitation document, the problems that can result include the following.

- Any total agreement clauses in the contract will invalidate anything not actually laid down in the contract documents, including anything included in the tender information.
- Any clarification or amendments taken during the tender process are likely to be omitted. This could potentially undermine the whole contract, as the parties may be agreeing to something different to what they believe they are agreeing to. At the very least, it creates scope for dispute and the costs of dealing with uncertainty and ambiguity.

> *Remember*
> Construct the contract documents as a single package. Make sure all of the cross-references work. Ensure all schedules are referenced in the main agreement terms.

Key performance indicators (KPIs) and performance management frameworks

A specification sets out what is to be delivered, but there must then also be a mechanism for comparing actual delivery against what has been specified. It is a fact that commercial life is complicated and things can go wrong. Some of those things can be controlled, others cannot. A performance management framework can manage this.

A performance management framework is a series of standards and targets to be achieved by the supplier, definitions of how those standards will be measured, and actions to be taken on the basis of the measurement results. Its aim is to promote the best control possible of the things that can be influenced, and to ensure the best possible outcomes against agreed measures.

Remember
These are the key components of a performance management framework.

- Key performance indicators (KPIs) – what you are measuring
- Targets – the performance level to be achieved
- Consequences – what happens if the measures are not achieved and/or if they are exceeded

The design and use of KPIs is explored in detail in section 2.2. The focus here is on the nature of the documentation and its status as part of the contract.

KPIs

Are KPIs necessary?

It is still surprisingly common to find contracts with no stated performance indicators. With good suppliers, a strong relationship and good luck this might not matter. The job will still get done to the desired standard – more or less – and the few issues that do arise will be amicably resolved. However, it is still worth investing the time and effort to set up and measure KPIs for the following reasons.

- 'More or less' is never good enough. The contract sets a standard that should be a minimum standard. You cannot know whether that standard is being consistently met unless you measure it.
- You cannot rely on good luck.
- Even the good relationship that you know to exist at the beginning of the contract cannot be guaranteed to continue. The supplier's own operating environment could change, making it more difficult for them to provide the level of service that you are accustomed to. The share of the supplier's business which the purchaser has can shift, making them less important to the supplier. Personnel changes can erode the basis for good working relationships.
- Measuring performance demonstrates whether it is stable, improving or deteriorating – each of which can and should provoke a response.
    - **Stable** performance might sound like a good thing but could mean that opportunities for improvement are being missed.
    - **Improving** performance should be analysed to understand why. What is working well on one contract might be transferable to others. It is important to learn from success as well as failure.
    - **Deteriorating** performance should be analysed to understand why. Once understood, action can be taken to halt the decline. Lessons can then be learned for other contracts: perhaps the issues can be designed out at the pre-procurement stage?

Do KPIs need to be contractual?

Many organisations seek to manage KPIs outside the contract. This is poor practice. Unless the KPIs are set within the contract, tied to firm targets and set consequences (for both worsening performance and improvements), then there is no leverage.

More fundamentally, KPIs should be an intrinsic part of the specification. In agreeing to pay a given price, the purchaser expects a defined service level and/or quality of goods supplied. That is the cost–benefit balance which has been achieved either through a tender process or a negotiation. If KPIs are subject to a side agreement and not included within the contract, it can be difficult even to enforce the measurement aspect. It will vary from one measure to another, but much of the data required will need to come from the supplier. Unless there is a firm contractual requirement to provide it, the costs of doing so may make the supplier reluctant to engage.

Case study

Introducing performance management

A service organisation worked for many years on contracts that operated without any performance measures, although there were regular or random checks against specifications (depending on the nature of the contract). Standards were met, costs remained largely within budget, and there were few disputes and no early terminations. This was only possible because they were working with a number of small suppliers, for whom they were a key client. Keeping the business was very important to these suppliers.

As they started to professionalise procurement, the following became apparent.

- Staying within budget did not necessarily mean getting good value.
- There was no incentive either to drive down costs (e.g. through eliminating waste) or drive up quality.
- Carrying out reviews of the available suppliers in each product and service category led to larger contracts with larger suppliers. This meant the client status changed, and buying power was effectively reduced. (It seems counter-intuitive that combining spend can reduce buying power, but it can have that effect by taking the purchaser from one supply market into another, in which it has much less influence, e.g. from small local suppliers to large national or international suppliers.) Goodwill was no longer a good enough incentive: there was a clear need to measure and manage.

Targets

A KPI is merely an indicator of a level of performance. It may, for instance, show that end user satisfaction levels are 85%. That sounds like a high figure but, much like exam scores, it is meaningless on its own. You also need to know the 'pass mark'.

In a sector where satisfaction scores in the high 90s are regularly achieved, 85% would be cause for concern. If market research has shown that average satisfaction rates hover around 80% then, despite the fact that you still have 15% dissatisfaction overall, your score does not look quite so bad.

Therefore whenever KPIs are set within a contract, they must also be linked to a target.

Both the indicators and the targets should be developed as part of the overall contract design. In negotiated contracts it may be possible to revisit them during the negotiation, but for tendered contracts they must be part of the original tender invitation package.

As with the specification, KPI targets can affect the following.

- A potential supplier's ability to actually perform the contract (e.g., they may simply not be able to resource next-day delivery)
- A potential supplier's interest in the contract (e.g., they may be able to resource it, but cannot do so cost effectively, or they have other more profitable opportunities, perhaps with lower targets)
- The price at which the supplier is willing and able to perform the contract

Consequences

Incentive
Something which encourages a particular action or behaviour

Disincentive
Something which discourages a particular action or behaviour

Finally, the contract must set out the consequence of meeting or not meeting the KPI targets.

If there are no direct consequences, there may still be **incentives** or **disincentives** embedded in the nature of the KPIs themselves. Simply bringing the information into the light and reporting on it enables lessons to be learned. An enlightened supplier will use the KPI information for its own purposes, outside of the contract in which they are set. If, for example, Purchaser A is reporting that 10% of deliveries are incomplete against order, then the probability is that this is common to all purchasers. The supplier will be very aware that this could affect future business and will want to address the problem. However, the supplier has a choice on how to address the problem, especially if A is the only purchaser actually complaining.

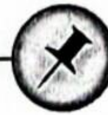
- **Option 1:** manually intervene to ensure that all of Purchaser A's orders are correct. This will take additional resource, especially if the delivery times are not to be affected.
- **Option 2:** investigate and resolve the root cause of the problem. This is a sensible approach, but might take some time. If the supplier continues to operate as before while the problem is being investigated, Purchaser A will not immediately benefit from the process.
- **Option 3:** do both Options 1 and 2.

The purchaser will want a speedy resolution to its own position and will care somewhat less about the supplier's underlying issue. If they can get their orders delivered correctly, it will not matter to them that this only happens because the supplier is manually intervening to check every single order that goes to them, rather than addressing the root cause.

To ensure that either Option 1 or Option 3 is chosen – i.e. an option which immediately addresses Purchaser A's problem, whether or not it also looks at the root cause – there has to be a contractual remedy or incentive. This usually means either a penalty for failing to achieve the targets or a bonus for exceeding them. If there is no explicit contract clause setting out what will happen in the event of targets being missed, then the purchaser has no grounds to seek redress – unless the failing is so bad that it can be considered a fundamental

breach of contract under other clauses (e.g., non-compliance with specification, fitness for purpose).

Remember
The KPIs and performance management framework are only contract documents if they say they are. Information issued with an RFQ or an ITT may not be fully incorporated into the contract unless care is taken to ensure that it is. The simplest method is to append it to the core contract document as a schedule, clearly referenced from the contract terms.



Check
What are the potential problems with relying on the information sent out with the ITT as a means of making a specification or performance management framework contractually binding?

Contractual terms

The contractual terms (sometimes referred to as 'terms and conditions') make up the main body of the contract document. They are what might be thought of as the 'core contract'.

Although the expressions 'core' and 'main' are used here, in practice the contract terms often comprise the smallest part of the contract and will not be understood without the schedules and other supporting documentation that sit alongside them.

Key terms are considered in more detail in section 3.2. At this point, it is important that you understand the nature and purpose of contract terms and how they are established.

Formal contracts

At the simple level, a formal contract is any contract or agreement which is 'evidenced in writing' and is intended to be legally binding. Generally speaking, you have a formal contract under the following circumstances.

- The terms are set out in detail.
- The parties have agreed the terms and want to be able to enforce the agreement, with the power of the law if necessary.
- The evidence of this is that the parties have written down these terms, and signed, or signed and sealed, the document.

Service level agreement (SLA)
An agreement between the provider and the user of a service that details what performance and quality will be provided; this agreement is legally enforceable if it is referred to in a contract

Remember that these are the conditions for a contract to be considered formal (see section 1.2 for the conditions that must be satisfied for a contract to exist and be legally binding). While formal contracts are generally written down, it is possible for a contract to exist without being recorded in writing. You should also bear in mind that a 'contract' might go by another name, such as an agreement, a commission, a letter of appointment, or a **service level agreement** (be careful with this last term because it means different things in different contexts).

Remember
The contract is the total agreement and may consist of a number of different documents. It may not actually be labelled 'contract' but might be called 'agreement', 'commission' or 'appointment'.

The use of templates or standard terms

Draft (a contract)
The formal drawing up of a contract, formulating the words and clauses

Drafter (of a contract)
The person(s) who design(s) and develop(s) the contract wording

Few contracts are written 'from scratch' (i.e. starting with a blank sheet of paper). Most commercial contracts will either be industry standard forms or based on a template developed by the organisation itself, its legal advisors, or some other body such as CIPS, a government department or a commercial procurement consultancy.

There are a number of advantages to using standard or template forms to **draft** a contract but, as always, there are also potential hazards for the unwary **drafter** of the contract.

There are several things to consider when deciding your approach to drafting contract terms. Tables 1.4 and 1.5 show the advantages and disadvantages of using standard templates and bespoke contract forms respectively.

Advantages	Disadvantages
All of the key risk areas will be set out and therefore unlikely to be missed. Standard clauses prompt drafters to think about relevance to current contract. The legal meaning of expressions and words will have been fully considered, possibly even tested in the courts, leaving less room for misunderstanding and misinterpretation. Standard list of schedules to be attached prompts their inclusion.	Potential to use inappropriate template, e.g., supply of goods form for a services contract. Can result in complacency on the part of drafters resulting in a tendency to only check the clauses which normally need amendment and not think about the specifics of the current procurement. Failure to cross-check references between clauses or sections (e.g., where one clause has been deleted but is still referred to elsewhere) creating nonsensical requirements or conditions. References to legislation and standards may become obsolete or not updated. Schedules may be appended with no firm reference to them in the contract terms, so they are not properly incorporated into the contract. Definitions used in schedules might differ from those in the standard contract, creating ambiguity and the potential for dispute.

Table 1.4 Advantages and disadvantages of using standard contract templates

Advantages	Disadvantages
Focuses thought on the precise needs of the procurement. Avoids the risks of using standard forms.	Language may be inconsistent with established legal interpretation. Potential to omit less obvious areas of risk. Potential to identify risk and remedy but not consider wider consequences (e.g., consequences of termination).

Table 1.5 Advantages and disadvantages of using bespoke contract forms

The importance of selecting the correct template

Although there are clear advantages in using template forms, there is a risk of the wrong template being used. There is a limit to the degree to which a commercial organisation can standardise its purchase and supply contracts. The considerations applicable to, say, a building or works contract are very different to those applicable to a supply of goods contract. The contracts for consultancy services will be very different to those for catering services, which will differ again from those for provision of software as a service.

If organisations have a bank of standard contract forms for use in different circumstances, it may be necessary to create a 'decision tree' or flow-chart to guide personnel to the appropriate form in each case.

Case study

The limits of standardisation

When a public sector organisation set out to standardise its contract terms, it discovered that this was not as simple as having one form for works, one for goods and one for services. Industry standards in various aspects of its work had to be taken into account. A first analysis of the types of contract that might be required suggested that 12 types might be needed, as follows.

- Works contract for self-contained projects (designed in-house or by appointed designers)
- Works contract for self-contained projects (on a design-and-build basis)
- **Term contract** for works (with frequent low-to-medium value call offs)
- Standard supply of services contract
- Short-form services contract (low value/low risk)
- Technical consultancy appointments (in relation to building contracts)
- Management and other consultancy appointments (low value/low risk)

Term contracts
Contracts written to last a period of time and include agreed terms

- Software as a service
- Catering and other concession contracts
- Standard supply-of-goods contract
- Equipment hire contracts
- General terms and conditions for use with low value one-off purchase orders

The organisation could have simplified the list, but it discovered that its suppliers were reluctant to accept overly generic forms which strayed too far from what they were used to.

Key sections of the contractual terms document

Many contracts (though not all) follow an established format which is summarised in table 1.6.

1. The ARTICLES. These comprise the very basic agreement: a summary. They state that Party A (e.g., the purchaser) is entering into a contract with Party B (e.g., the supplier). Party B agrees to provide the goods or services and Party A agrees to pay it for them. They set out exactly who the parties are by reference to their full legal entity names – usually registered company names and registration numbers where applicable – and their registered office addresses.

   In each case they will also give the term by which each party is known throughout the rest of the contract. This will either be by a generic function ('the Purchaser', 'the Client', 'the Supplier', 'the Service Provider', etc.,) or (less helpfully) by a shortened form of the company's full name (e.g., 'Bloggs' for Bloggs Commercial and Industrial Cleaning Company Ltd).

   This clarifies the purpose of the contract and who the parties are, while at the same time making the drafting of the clauses slightly simpler, by not having to ensure that the party names are inserted repeatedly.

2. The RECITALS. These provide the context. They set out the facts that surround the situation in which the contract happens. In some agreements it is a very simple re-statement of the facts that the purchaser wants to acquire X and the supplier has agreed to provide it. In some contracts (particularly building contracts) there will be a number of other factual statements covering who will perform other roles necessary for the contract to work.

   By convention they start with the word 'whereas' (which means 'given this ...') and are followed by 'it is now hereby agreed' (or something similar). If anything in the recitals is wrong, it could undermine the whole contract. If the recitals said: 'Whereas ABC Property Company is seeking to build 20 bungalows on the site known as Dogs Lane...' when what they actually wanted was a 100-flat tower block at Cats Road, then regardless of what the rest of the contract said, the courts would have a basis for taking the view that the whole premise was undermined and there was fundamental ground for disagreement.

3. Some forms of contract, particularly industry standard forms, will also have a CONTRACT PARTICULARS section. This sets out some of the specific variables, such as the required date of completion and any specific insurance requirements. It is a mechanism for writing terms and conditions without having to amend clause by clause. It works by creating a schedule of common variables which can be filled in, and to which the detailed terms refer back.
4. The full TERMS AND CONDITIONS are the detail. These cover the ifs, buts, maybes and what will happen in respect of X if ABC happens to Y. Normally they will be in standard wording, with specific meanings set out in a DEFINITIONS AND INTERPRETATION clause for avoidance of doubt. They will cross-refer to the contract particulars and the schedules.
5. The SCHEDULES. These set out project-specific detail either as designed by the purchaser (e.g., KPIs) or as submitted by the supplier (e.g., pricing).

Table 1.6 Common contract sections

How contract terms are established

The process for establishing the contract terms in a formal contract is shown in figure 1.2.

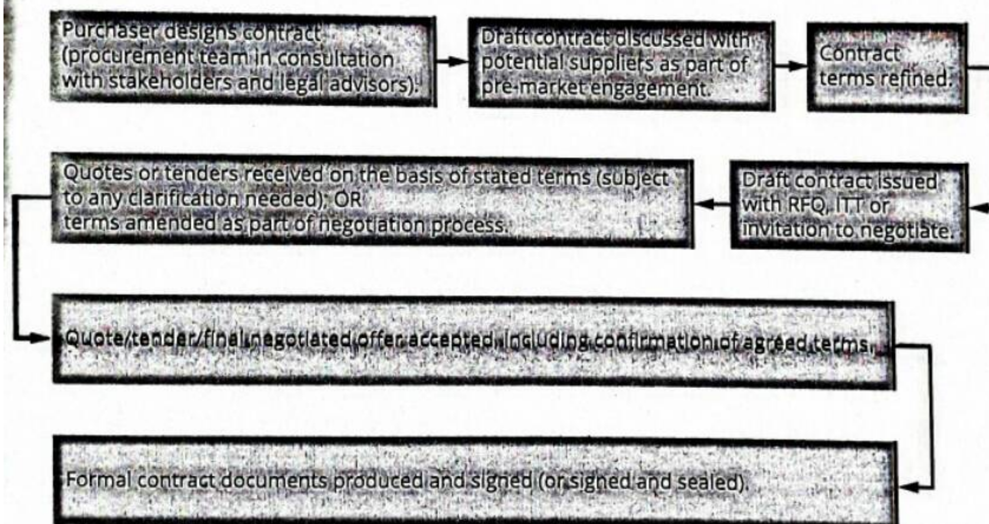


Figure 1.2 Finalising contract terms

It is good procurement practice that the purchaser takes the lead role in establishing the contracting terms, that the Terms and Conditions are part of the RfQ/ITT, and that bidders are required to agree to these or be excluded. The degree to which these can be imposed, however, will depend on the professionalism of the procurement team, the robustness of the procurement process, the relative buying power of the purchaser in the target market, the competitiveness of that market, and the sourcing process.

Be aware of the following.

- The lower the purchaser's **market leverage**, the easier it may be for the supplier to negotiate changes to the terms, either as part of the tender process

Market leverage
Another term for buying power, the ability of a purchaser to strongly influence the outcome of commercial negotiations

or even after the contract has been signed. Both purchaser and supplier must be aware of the opportunities and threats that this creates.

- In regulated procurement (e.g., public sector), once the opportunity has been advertised it is difficult to persuade purchasers that the terms can be changed. Some public sector purchasers might insist that this cannot be done at all once the process has commenced. This is not true. Provided that all potential suppliers are aware of the changes and, where appropriate, periods for responding to invitations to tender are extended, there is no reason why a purchaser cannot take on board rational comments from potential suppliers and review or change the proposed terms of contract.

It is crucial, therefore, that procurement personnel fully understand the proposed form of contract and why each of the terms exists. Every contract term is designed to do **one** of the following.

- Protect the supplier
- Protect the purchaser
- Balance the protection between them

Key terms would cover pricing, payment terms, risk allocation, insurance requirements, timescales, health and safety, and actions and remedies in the event that one party defaults. A certain balance will be achieved across the contract as a whole between the purchaser's interests and those of the supplier. This may not necessarily be an equitable balance: one party may be favoured more than the other. What is important is the agreed distribution of benefit and cost, protection and risk.

A change to any single clause will shift that balance to a greater or lesser degree. It is part of the procurement and supply professional's role to understand exactly how that shift might play out in practice in their business environment and whether it matters on a case-by-case basis. This can only be done by fully understanding the contract, both on a clause-by-clause basis and by understanding how the clauses relate to each other and to the contract-specific schedules.

Remember
Contracts should protect both parties, but the degree to which they do so will reflect the relative bargaining positions of the purchaser and the supplier and their ability to influence the contract terms.

Informal contracts

There are well-established legal rules that determine whether, in the absence of a formal set of contract documents, a contract exists.

If a quotation has been requested and then provided, and an order has been issued on the basis of it, there is an intention to create a legal relationship. The purchaser clearly expects the goods or services to be provided on the terms set out in the RFQ and/or the order issued (although remember that these might not agree with each other). The supplier also clearly expects to provide the goods or services on the basis of the quotation (which might not agree with either the request information or the order). There is a significant risk of divergence between what the purchaser thinks they are buying and what the supplier believes they are to supply.

If disputes over such matters reach the courts, it is likely to be found that a contract does indeed exist, even if nothing was written down (e.g., if the whole discussion had been by telephone). The difficulty is in establishing what the terms of the agreement are.

There might be ways of establishing these on a balance of probabilities.

- If the parties had contracted previously, the terms of those agreements might be assumed to apply again.
- If there are normal sector expectations about certain aspects of the delivery, they might be assumed to apply.
- Either of the above could be discounted if there were any evidence suggesting that either party had indicated that other circumstances should apply in this particular case.

Clearly this is not a very satisfactory way to proceed. Both purchaser and supplier are exposed to unconsidered risks in the event of the arrangement not being successful. Those risks could far outweigh the time and cost of putting in place at least a simple formal contract.

Apply

Consider situations with which you are familiar where formal contracts are not used. What potential risks can you see for the purchaser? And for the supplier?

Case study

When is a contract not a contract?

As part of its social responsibility programme, a commercial organisation had a small team of people engaged in funding and facilitating projects in the local community. The financial values were relatively small and none of the team had been trained in procurement and supply. They came to the procurement team seeking advice on two opposite issues.

- A specific project was not demonstrating any social return on investment. There was no evidence of progress, but even worse, the partner organisation had not provided any evidence that it was actually carrying out the activities for which it had received funding. The team wanted to know how they could enforce the terms of the agreement. This proved difficult because of a particular clause which said: 'this agreement is not intended to be legally binding'. You cannot try to enforce an agreement which you have formally agreed you will not enforce. Under common legal rules, 'intention to be legally bound' is required in order for a contract to exist. This was no more than an informal agreement.
- The team also wanted to provide funding to a partner organisation but did not want to comply with the rules around tendering and contracting.

They tried to argue that they were not entering into a services contract, but were merely providing a grant with conditions attached to it. Legally, a 'grant' is a gift which does not create a legal relationship between the giver and the recipient. There may be conditions attached to a donation which include a requirement to repay the money in certain circumstances, but as this is not a contractual relationship, there is no clear route to remedy if the recipient defaults. Given that the team wanted to be able to enforce the conditions, a contract rather than a grant agreement would be a better way of proceeding.

The lesson in both cases is that properly documented contracts may be necessary even where the parties are not looking to make a profit.

Pricing and other schedules

A schedule to a contract is simply an appendix to the body of the contract form. Schedules are used as a way of making it easier to incorporate project-specific information in a contract without having to amend the wording of the main body of the document clause by clause. It allows for the standardisation of terms and conditions, which then simply cross-refer to the detail in the schedules.

The benefits of this approach are as follows.

- Drafting the contract is simplified, and therefore quicker and more cost effective.
- Within the purchasing organisation, clauses for similar contracts have identical wording, avoiding the risk of different approaches across the organisation.
- Contract managers become familiar with the forms that they use regularly and, in the event that they need to refer back to the contract, they can do so with ease, knowing where to find relevant information. This is true for both purchasers and suppliers.
- The contract and the procurement documents can be drawn up in such a way as to allow direct incorporation of a supplier's tendered offer, reducing the risks of misinterpretation.

Pricing schedules

Any contract that does not involve a single fixed-fee payment on completion will have a pricing schedule. This will effectively set out how the price is to be calculated for each invoice. It may include various rates or simply confirm the total fee and the proportions payable at key stages. The degree of complexity in the pricing schedule will vary hugely depending on the nature of the contract.

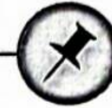
We will look at pricing schedules and pricing arrangements in more detail in section 3.3.

Other schedules

There is no limit to the number of other schedules that might be included in a contract.

Where template or standard forms of contract are used, they will be supplemented by a standard list of schedules. Not all schedules will be applicable to all contracts, but building the full list into the template document acts as a reminder at the drafting stage to consider the specific nature of the purchase.

> *Remember*
> A schedule attached to a contract has no force unless it is referred to within the terms and conditions. The schedules provide detail to explain, amplify and/or limit the areas covered by the terms and conditions.



The most common types of schedules are described in table 1.7.

Schedule	Key features
Specification	The most important schedule to any contract is the specification, setting out **exactly** what is to be delivered. It might be a conformance/technical specification or a performance specification, but it must be clear and unambiguous. It enables the supplier to cost, and therefore price, delivery properly. It provides the purchaser with a 'checklist' to ensure it gets what is being paid for. It should ensure that any compatibility or interface issues are catered for at source.
Preliminaries or contractual/ operational matters	The expression 'preliminaries' is often used in the construction industry, particularly in the UK, and is often abbreviated to 'prelims'. Other forms of service contract might refer to 'contractual' or 'operational' matters. They explain the context in which the contract has to be performed. They can be an over-arching schedule which encompasses all those indicated as separate schedules in this table. Usually included in tender documents, so that a single line on the pricing schedule can be used to cover all associated overheads and risks.
Performance management framework	The full framework including KPIs and targets, the assessment scheme and incentives, disincentives, bonuses and penalties. Unless clearly linked to clauses in the body of the contract that enable penalties, service credits, bonus payments or other consequences, it will serve very little positive purpose. In term contracts, this should include a mechanism for enabling adjustment of the targets and/or changes to the actual indicators to be measured.

Geographic information system (GIS) mapping
A means of storing, retrieving, managing, displaying and analysing data in relation to its geographic or spatial context. It can be used for any kind of data (qualitative or quantitative) mapped in layers which can range from global/international down to precise locations within buildings, depending on the parameters set and the needs of the data users

Schedule	Key features
Site lists, maps and plans	Factual information in list or map form to assist in the clarity of identified points of delivery. If a very precise place of delivery is critical, even a full postal address may not be sufficient. A plan can assist in avoidance of doubt (e.g., **GIS mapping**). Particularly relevant in facilities management where external areas are involved, or where only parts of buildings come under the purchaser's jurisdiction (e.g., if they only lease a single wing of a building).
Health and safety	For construction, this may include specific pre-construction information required to be provided by law (e.g., under Construction (Design and Management) (CDM) regulations in the UK). In the absence of regulation, good practice would still require providing a risk assessment of known hazards of working in a particular area, such as potential for asbestos, hazardous chemicals, and physical issues such as heat, noise or fumes. Risk assessment forms in respect of the delivery of the contract itself may be included, such as use of chemicals, working at height, lone working, etc. These schedules may be 'live' contract documents (i.e. completed prior to signing the contract but required to be updated at regular intervals as part of the normal contract management).
Method statements	Describe how the desired result is to be achieved. Particularly important where performance specifications are used. May be included as a separate schedule or incorporated into the specification. The contract needs to be clear as to whether the method statement provided is 'approved' or merely 'accepted'. Approving or embedding a supplier's method statement in the specification shifts some of the liability for the method from the supplier to the purchaser and unnecessarily fixes on one potential method as a contractual requirement, whereas flexibility during the contract might be useful.
Supply chain	Can include subcontractors and/or approved manufacturers of components, but might equally simply set out the process for agreeing and/or approving the supply chain. This could be to purchase buying power to be leveraged down the supply chain, or to control ethical issues in the supply chain (e.g., source of materials, labour rights or payment terms). Increasingly, large organisations are subject to public and governmental scrutiny of what occurs within their supply chains. Getting this wrong can have reputational and financial impacts.

Schedule	Key features
Supply chain	The contract needs to make provision for sanctions, remedies or other actions if these schedules lay down minimum requirements. Supplier development might be a more appropriate response than supplier sanction, but the contract needs to allow for worst-case scenarios.
Alliancing agreements	A contractual mechanism, e.g., for requiring subcontractors or co-contractors to work with a main contractor or the purchaser in setting up joint supply chains. More common in framework agreements than term contracts. Useful if the combined buying power is greater than the sum of the parts. Risks undermining any existing arrangements that any of the parties already have in place. Possibly only of use in very high-value contracts.
Core list or exclusions list	Where **schedules of rates** are based on national schedules of rates or catalogue prices, they are often quoted on the basis of a percentage discount against the schedule or catalogue price. The discount may not apply to all possible call-off items. In these cases it is necessary to specify one of the following. • Which items it does apply to, which are normally those most frequently purchased (known as the core list or core items) • Which items it does not apply to, such as unusual or specialist items (known as non-core or excluded items) The price schedule should cross-refer to any core items or an excluded items schedule, or the two should be combined. The price schedule should indicate how non-core items are to be priced. This ensures that the pricing mechanism for all potential call offs is clear.
Supplier's staff	Where the provision of services is specifically dependent on the skills and qualities of individuals, there may be a requirement to set out key personnel who are material to the contract, such that the contract may be terminated without their continued participation – or at least without their replacement by personnel of proportionately similar skill and experience. That skill and experience may need to be set out in detail if it is to have any force. Where the services involve contact with children or vulnera adults, or where there are defence or security implicatio there may be a need to set out specific staff-vetting pro and means of evidencing clearance to work on the p
Codes of conduct	If not covered in preliminaries, these can be used norms of behaviour for supplier's staff working particularly in respect of working on the clien Normally such codes cover issues of respe property, cultural sensitivity, and so on.

Schedule of rates An itemised list of component parts within a lump-sum contract, or a list of individual products, giving a price for each unit

General Data Protection Regulation (GDPR)
European regulation which sets out how personal data must be managed, applying to any data relating to any person in the EU, whether they are a European citizen or not, and to all organisations doing business in Europe, regardless of the nationality of the business ownership

Schedule	Key features
Data management	If not included within the body of the contract, there may be a need for any or all of the following. • Non-disclosure requirements to protect intellectual property or commercially sensitive information • Commercially confidential information in general – contracts may have generic clauses relating to this, but for avoidance of doubt a schedule can set out precisely what information is deemed to fall under this generic heading • Minimum cyber-security standards • Rules regarding processing, management and storage of any personal data which may need to be shared in the context of the contract (e.g., the European Union (EU) has recently updated its data protection rules under the **General Data Protection Regulation (GDPR)**, which applies to data relating to any person within the EU, even if not a citizen of the EU)

Table 1.7 Common contract schedules

Contract variations

There is a tendency to think of a contract as a fixed and finite thing, but many purchase and supply contracts have to allow for change. Changes may occur as a result of unforeseen circumstances such as a change in regulations, or a foreseeable need for change such as price adjustments over time. Change may be necessary because of external events or be requested by one or other party to the contract and might be to the benefit of both parties.

Simple matters such as KPIs can become obsolete if they are so easy to achieve that measuring them ceases to add value, while other areas which have become more important are not being monitored. Technology also changes rapidly: without the ability to adjust a specification (by agreement) within a contract, both parties could become locked into out-dated products or services with no alternative other than to terminate the contract.

If the contract does not have a change mechanism, at best it risks stagnation, and at worst it risks ineffective delivery or early termination.

The change process should therefore be set out within the contract and should include the following.

- Who can request a change
- Who can authorise a change
- Who can accept a change
- The mechanism for agreeing price adjustments in respect of such a change (if possible with reference to the existing price framework)
- The implications for the contract if a variation order (also known as change order) is rejected

Ideally, the format for a variation order will be set out as a schedule or appendix to the contract. A sample format is set out in figure 1.3.

VARIATION ORDER Number: Issue Date:

This Variation Order is issued pursuant the Contract in place between XXXXXX and XXXXX

1 Details of the Contract

Title	
Form	
Client	
Contractor	
Contract date	

The above contract is varied as set out below:

Ref:	Item	$
Price Change:		$

Signed: .... Date ....
On behalf of [insert name of Client]

Print Name
& Job Title: ....

Accepted: .... Date ....
On behalf of [insert name of Service Provider]

Print Name
& Job Title: ....

Figure 1.3 Sample variation order

The variation order must include a statement of any price impact on the contract value. Where the nature of the change is such that it requires a change to the timescales for delivery, these should also be noted, confirming any changes to the date for completion of the contract, or amendments to standard timescales laid down within the contract.

All change orders should reference both the clause allowing for the change, and any clauses or schedules which it changes.

Copies of all change orders should be held with the original contract documents. The orders themselves do not need to be signed and sealed: authority for them to be valid is delegated under the terms of the contract, provided that they are issued in accordance with those terms (e.g., signed by someone with the relevant authority such as the contract manager or contract administrator). But they do have the impact of actually changing the agreement.

Where contract registers are used, those changes may need to be reflected in the register, especially with regard to price and/or timescales.

Remember

Contracts can be amended during their lifespan. Any contract expected to last for more than a very short period of time should include a mechanism for variation which sets out who can authorise changes and any limits to those changes.

1.2 Analyse the legal issues that relate to the creation of commercial agreements with customers or suppliers

This section looks at the law surrounding contracts. Much of what follows has been developed through the UK legal system, but the principles are generally accepted elsewhere.

The basic rules of contract formation

In order for a contract to come into being, there are five conditions.

- Offer
- Acceptance
- Consideration
- Intention to create legal relations or intention to be legally bound
- Capacity to contract

In this section, a number of legal cases are described. They are headed by the names under which they are normally known and their dates, such as *Fisher v. Bell* (1961).[2] Many of them are very old, often dating back to the 1800s. This is the way the law evolves in countries with a common law legal system, such as the UK, the USA and Australia. Each of the cases demonstrates how the rule was established or clarified. When reading them, think about how the scenario might apply in the modern world.

Countries with a civil law system (e.g., Austria, Poland) do not rely on case law, but only on what is actually written down in statutes and regulations. Other countries such as South Africa have a mixed system which is partly civil law and partly common law.

The civil law countries are more likely to have updated regulations to take account of modern communication methods than those still basing rules of contract on case law. Case law is only updated in two situations.

- When a relevant case comes to trial
- When the governing authorities specifically decide to change the law by statute, officially terminating the rules which have previously evolved

Check
What are the **five** minimum preconditions for there to be a contract?

Rules relating to offer and acceptance, consideration, intention to create legal relations and capacity to contract

Offeror
Person making an offer

Offer

An **offer** is a full statement of what the **offeror** is willing to provide and the terms by which they are willing to provide it.

Understanding what an offer **is**, requires a good understanding of what it is **not**.

If something is **not** an offer then by definition it cannot be accepted, so even if someone appears to accept it, no contract is created.

Definitions of actions which are **not** offers have evolved through case law. Table 1.8 sets out things which are **not** offers in the legal sense. The case law establishing the principles is old but still holds.

Remember these rules have been established under English case law. They will only definitively apply where the relevant law is that of England and Wales. However, the principles are very similar in many other jurisdictions. The buyer should always check which jurisdiction the contract is agreed in.

Not an offer	Relevant case law
Invitation to treat (or invitation to negotiate). This states that a person or organisation is willing to enter into discussions about the possibility of a deal, but does not confirm a willingness to be bound by any terms mentioned. **Catalogues and goods on display are** invitations to treat: invitations to a buyer to offer to buy, but the seller can always refuse to sell. Similarly, ITTs – even though they set out the proposed contract terms in finite detail – are still only invitations to treat. The offer is made by the firms submitting the bid. In this case, the buyer can decline to buy. Indeed, where there is more than one tender, they will have to decline most of the offers received.	*Fisher v. Bell* (1961)[3] A flick-knife was displayed in a shop window. The shopkeeper was charged with offering an offensive weapon for sale (a criminal offence). He was acquitted on the basis that the display was not an offer, but only an invitation to treat, which at the time was not an offence. *Pharmaceutical Society of Great Britain v. Boots Cash Chemists* (1953)[4] The Pharmaceutical Society of Great Britain alleged that the supermarket-style operation breached rules on the sale of controlled pharmacy products. It was held that the display of the products on the shelves was an invitation to treat, and the offer to buy was made when the purchaser took the products to the cash desk to pay. Provided there was a pharmacist present at the cash desk, the rules were complied with.

Plaintiff
The person bringing a legal claim

Not an offer	Relevant case law
Declaration of intention. This is defined as an aim or a plan. By its nature it is not definite and cannot therefore be seen as an offer.	*Harris v. Nickerson* (1872)[5] An auction sale was advertised, but then cancelled. The **plaintiff** had travelled to the sale and tried to claim his expenses. It was held that the advertisement was not an offer that he could accept by making the journey.
A 'mere puff' (or boast). This is anything which is not intended to be taken literally or too seriously, such as many advertising slogans. There is a questionable line, however, between what is merely a boast and what a reasonable person might expect to take seriously.	*Carlill v. Carbolic Smoke Ball Company* (1892)[6] The Carbolic Smoke Ball company placed an advertisement stating that they would pay £100 to anyone who caught influenza after using their smoke balls, and as evidence of good faith they had placed £1000 on deposit at a named bank. Mrs Carlill used the product but still caught influenza. She claimed her £100, which the company declined to pay. One of the defences put forward was that the advertisement did not constitute an offer. It was held that a reasonable person would take the promise seriously and therefore it was indeed an offer which bound the company.
Provision of information	*Harvey v. Facey* (1893)[7] The plaintiff sent a telegraph asking 'Will you sell us Bumper Hall Pen? Telegraph lowest price.' The reply was 'Lowest price for Bumper Hall Pen £900'. It was held that this was merely an answer to a request for information and not an offer to actually sell at that price. In essence, it was an indication simply that they would definitely not sell for any less – they could still seek to get more.

Table 1.8 Actions which are ***not*** *offers*

Remember
These four actions are not offers.

- Invitation to treat
- Declaration of intention
- A 'mere puff'
- Provision of information

Communication of an offer

An offer can only exist if it is communicated to the other party. The nature of an offer is that it is capable of being accepted or declined. Clearly a party cannot make that choice if they are unaware of the offer.

In the case of *Taylor v. Laird* (1856),[8] a sea captain resigned in a foreign port and his employers were duly notified. He later worked on the ship on its return home, but the company declined to pay him. It was held that they were entitled to withhold pay, since his offer to assist had not been communicated and they had not had the option of declining.

Duration of an offer

There are six ways in which an offer will end, i.e. cease to be capable of being accepted.

- **Withdrawal** (or revocation). The offeror can simply decide not to proceed and withdraw the offer. An offer can be withdrawn at any time up to the point of acceptance, even if there has been a promise to keep it open for a specific length of time.

  If the agreement to hold the offer open for a given time period is a contract in its own right (i.e. there has been consideration paid for it, as happens when an option is purchased), it is still possible to withdraw the offer, but in this case doing so would be a breach of contract. It is unlikely that an action for **specific performance** would succeed, but damages may be awarded.

  For example, in *Routledge v. Grant* (1828),[9] Grant offered to buy Routledge's house and gave him six weeks in which to accept. Before the period elapsed he withdrew the offer. It was held that he was entitled to do so. Like the offer itself, withdrawal must be communicated. However, that communication does not have to be direct. The communication can be by virtue of an action such as selling to someone else. It can be communicated by any reliable source.

  During another prospective house sale (*Dickinson v. Dodds* (1876)[10]), the **defendant** had offered to sell the house, but before the plaintiff had accepted, he sold it to another party. The plaintiff heard of this from a friend. It was held that because the source of information was reliable, the offer had been revoked and could not now be accepted.

- **Lapse**. If a time limit is set for acceptance and the offer is not accepted within that time it will lapse: that is, cease to be valid. For example, if an ITT states that offers must be held open for three months and the purchaser takes longer than that to complete the evaluation and internal authorisation processes, strictly speaking the tenders are no longer available for acceptance.

  In practice, what would happen in these circumstances is that the purchaser would, as the expiry date approached, seek an extension to the validity period (which the tenderers could decline), or they would choose to accept the offer anyway. If the seller agreed to go ahead in the latter case, it would not mean that the contract would be invalid, but simply that the offer and its acceptance had switched direction. Rather than the seller offering to provide the goods or services and the purchaser accepting that offer, it would create a situation where the purchaser was offering to buy and the seller was accepting that offer.

  Where no express expiry limit is stated, an offer will lapse after a reasonable time. What constitutes 'reasonable' will depend on the circumstances.

  In *Ramsgate Victoria Hotel v. Montefiore* (1866),[11] Montefiore offered to buy shares in the company in June. He had no response to his offer until November, by which time he was no longer interested. It was held that the offer had lapsed and he was not obliged to purchase the shares.

Specific performance
This is where a court orders a party in breach of contract to perform exactly what it is required to do under the contract. Specific performance might be ordered in addition to damages. The remedy exists so that parties to a contract cannot simply get out of their obligations by accepting the financial cost of damages

Defendant
The person defending a claim brought against them

- **Death.** The death of either party before acceptance will terminate the offer. By analogy it is probably also true, though not actually tested in the courts, that the winding up of a company would have the same effect.
- **Rejection.** Once a party has rejected an offer, they cannot later decide to accept it. A counter offer is a rejection. If Company A offers to provide services at $90 an hour and Company B states that it will accept but only at a fee of $85 an hour, it has rejected the original offer and made a counter offer. Company A is no longer obliged to hold its original offer open.

  This was precisely the scenario in *Hyde v. Wrench* (1840).[12] There was an offer to sell a farm at £1000. A counter offer of £950 was made but it was rejected. The buyer tried to revert to the original offer of £1000 but it was held that the seller could reject this since the original offer had itself been rejected.

  Any acceptance made subject to conditions other than those originally offered is also a rejection. In a sense, this is actually a counter offer being disguised as an acceptance.

  In *Neale v. Merrett* (1930),[13] the defendant offered to sell a parcel of land for £280. The plaintiff accepted the offer and paid £80, promising to pay the rest in £50 instalments. It was held that there was no contract because the offer did not include such credit terms.

  Like an offer and a withdrawal, rejection must also be communicated. If a rejection was sent in writing, but then the party changed its mind and telephoned to accept, provided the phone call was made prior to the letter arriving, the acceptance would stand. However, it is hard to see any practical impact of this in modern commercial dealings and electronic communications.

Express terms
Contractual terms which are specifically stated in contract documents

Implied terms
Contractual terms that exist but are not written within the contractual documentation, i.e. the law of the land

- **Failure of conditionality.** If an offer is subject to certain conditions and those conditions are not fulfilled, the offer will lapse. The conditions may be **express terms** or **implied terms.**

  In *Financings Ltd v. Stimson* (1962),[14] Stimson offered to take a car on a hire purchase agreement. Before the offer was accepted, the car was stolen and damaged. Financings accepted the offer, but it was held that it could no longer do so, because there was an implied condition that the car being hired would be in substantially the same condition at the point of acceptance as it was when the offer was made.
- **Acceptance.** Once an offer has been accepted it comes to an end. This may appear obvious, but an offer may be made to a group of people but only be capable of being accepted by one of them (e.g., because it relates to a single item). Once one person has accepted the offer, it ceases to be available to the others. By extrapolation, if a liquidator is selling the stock of a bankrupt company, any fixed offer it makes to do so may be communicated to a number of interested parties, but their ability to accept the offer will lapse once all of the stock has been sold.

Remember
The **six** ways in which an offer ceases to exist: withdrawal (sometimes called revocation), lapse, death of the person making the offer, rejection (including counter offer), failure of conditions, and acceptance.

Acceptance

As already discussed, acceptance is subject to the following conditions.

- Acceptance can only occur while the offer is open.
- It must be absolute and unconditional.
- It cannot be made by someone with **diminished capacity.**

This raises the question of the validity of things which look like an acceptance, but are headed **subject to contract** – in particular, **letters of intent**, which are often conditional acceptance letters.

Subject-to-contract letters, which are often used in the purchase of land, are clearly intended to indicate that there is not yet a contract being created.

Letters of intent have been the subject of much debate, particularly in the construction industry where they are common. The current view is that they have the same status as subject-to-contract letters (i.e. they are a clear statement of intention), but if – as shown above – a declaration of intention is not sufficient to create an offer, it logically follows that it is not sufficient to form an acceptance.

A further principle of acceptance is that, logically, it **creates** the contract. Therefore the place of acceptance may be important in determining which jurisdiction the contract falls under, in the event of any dispute. With the growth of global trade and electronic communications, including the increasing use of electronic contracts, this concept of 'place' in contractual terms becomes somewhat unclear. It is important, therefore, to avoid any unintended implications of this by categorically stating within the contract terms which legal and judicial system shall apply by reference to the relevant country's courts.

Acceptance does not need to be explicit. It can be implied by actions – this is known as **acceptance by performance.** If a purchaser uses the goods supplied, it can (and will) be implied that it has accepted the terms on which they were offered. However, if the purchaser does not use, or otherwise interfere with, goods that it has not ordered, then its silence on the fact of the delivery cannot imply that it has accepted them. No payment can be demanded.

Likewise, a buyer cannot assume **title to goods** (i.e. treat them as their own) if the seller is silent about an offer made, even if the buyer has made a payment – particularly if that payment did not require action on the part of the seller (e.g., if the payment was made direct to the seller's bank account). It would be different if the buyer had sent a cheque and the seller had paid it in. In that latter case, it could be argued that the seller's actions in banking the cheque amounted to acceptance.

In *Felthouse v. Bindley* (1862),[15] after some ongoing negotiations regarding the sale of a racehorse, the plaintiff eventually wrote: 'If I hear no more about him, I consider the horse mine at £30 15s.' As it turned out, he did indeed hear 'no more'. Nevertheless, and despite the fact that the seller had actually fully intended to sell at that price, it was held that there was no sale completed.

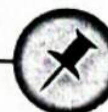
Diminished capacity
A person's inability to enter a contract, e.g., because they are a minor, are suffering from mental health issues, or are under the influence of drugs

Subject to contract
Heading used on letters, particularly in land transactions, to indicate that matters are still being discussed and that the letter must not be taken as a formal offer or an acceptance of any terms referred to within it

Letter of intent
Letter issued by a purchaser indicating that they intend to accept a tender, usually subject to certain preconditions having been met, such as obtaining any legal or financial consents

Title to goods
Legally recognised ownership

Remember
An offer can only be accepted if it is still open. The acceptance must be unconditional.



Exceptions to acceptance rules regarding communication

There are two rules which override the need for acceptance to be communicated.

- The person making the offer can simply dispense with the need for a formal acceptance (decide they do not require it). In many call-off contracts, there will be a written requirement for the supplier to acknowledge call-off orders, but in many others there is no such requirement. All that is required is for the seller to fulfil the order.
  - There is little real difference between this and acceptance by performance as outlined on the previous page. The seller is accepting the offer by their action in fulfilling the order.
- There is a specific legal rule known as the **mailbox rule**. This principle holds that if a letter accepting an offer has been properly posted (i.e. stamped and handed in to the postal authorities), then it will be effective from the date of posting, even if it never arrives.

  There are two conditions for this rule to apply.
  - It must have been obvious to both parties that the acceptance would be sent in this way.
  - There must be evidence of posting.

Note that the mailbox rule **only** applies to acceptance. It does **not** apply to offers or withdrawal of offers. This creates a potential problem in itself.

The case of *Byrne & Co v. Leon Van Tien Hoven & Co* (1880)[16] involved a firm in Cardiff selling tin plate to a company in New York. The negotiations were all done by letter. Having made the offer to sell, the seller then sent another letter withdrawing it. While the second letter was in transit, the purchaser sent a letter accepting the offer. It was held that the acceptance was valid because it was sent before the withdrawal was received.

> *Apply*
> Review the 'postal rule' in the context of tender processes with which you are familiar and explain why its importance is diminishing.

Mailbox rule regarding electronic communications

Strangely, the postal rule was never applied to the use of telephone or telex (an early electronic form of communication). In both of those scenarios, where the communication is virtually instantaneous, it is usually held that it is not effective until it is received.

In *Entores v. Miles Far East Corporation* (1955),[17] an acceptance sent by telex from Amsterdam was held to be effective only when it arrived in London. A cynical view might be that this departure from the accepted rule – that an acceptance was valid when sent – was the result of a desire to have the acceptance take effect in London, which would bring the contract within the jurisdiction of the English courts.

Does the mailbox rule apply in respect of e-mails? Or is the rule in *Entores*[18] more relevant? The courts have not yet ruled on this. Arguably, they may never need to do so. The growth of international trade and the near-instant modes of communication available mean that the two main problems of when and where acceptance is effective are pre-empted within the normal operation of business. This is due to two main reasons.

- The problem of withdrawals and acceptances crossing in the post (i.e. one being sent before the other is received) is now very remote. Business transactions happen much more rapidly. In the context of e-mail being used, the circumstance in *Byrne v. van Tien Hoven*[19] would require both e-mails to have been sent at the very same moment, and/or for one or other of them to have been delayed in the electronic system. For this to happen at the crucial point is not impossible, but it is rare.
- Familiarity with international trade has led to the now near-universal practice of stating within the contract itself which courts shall have jurisdiction. Thus a contract between a company in London and one in New York will state whether it is subject to the English legal system or the American one.

Mailbox rule in civil law jurisdictions

The mailbox rule does **not** apply in countries with civil law codes. These take a more logical view that acceptance, like offer and withdrawal, can only be effective when communicated, although some (Germany and the Netherlands) soften this by adding a proviso that the lack of communication must not have been the fault of the person making the offer. This means that one party cannot revoke an offer if the only reason it did not receive the acceptance was because (either deliberately or unintentionally) it prevented itself from receiving it.

The Vienna Convention on the mailbox rule

Vienna Convention
The United Nations Convention on the International Sale of Goods

The United Nations Convention on Contracts for the International Sale of Goods (CISG), often known as the **Vienna Convention**, complicates matters. It states that the postal rule does not generally apply (as a means of establishing when and where the contract was concluded) but it does retain the part of the rule which says an offer cannot be withdrawn after an acceptance has been sent, whether or not the acceptance is received.

Ability to agree rules between the parties

Given the potential for different legal rules to apply, depending where the parties are located and how the communication between them is being conducted, particularly when dealing internationally, it would seem sensible for the parties at the outset of negotiations (in invitation letters) to be very clear on how acceptance of offers will be communicated. This could be done by setting out **deemed receipt** protocols. An example might be as follows.

- The **tender** will be accepted by an e-mail copy of a letter duly signed by the authorised signatory.
- The **acceptance** will be effective on receipt and, in the absence of evidence of receipt, shall be deemed to have been received within one hour of being sent, unless a non-deliverable message has been received by the sender.
- The **original of the letter** will be sent by registered mail, but for avoidance of doubt, the e-mail acceptance shall be effective irrespective of receipt or otherwise of the hard copy.

> *Remember*
> The rules regarding when offers and acceptance become effective are complex and can be different depending on which legal system applies. It is sensible to be explicit in stating which country's system has jurisdiction and to include precise terms regarding receipt and acceptance of tenders when inviting offers.

Check

The rules on acceptance are complicated. Work through the text slowly and answer the following questions.

- Can an offer be accepted after it has lapsed?
- Does acceptance have to be explicit (in words or in writing)?
- Can silence signify acceptance?
- Describe the mailbox rule and explain the problems it might create.

Consideration

In legal terms, contracts are bargains: one thing given in exchange for another. The thing given in exchange is known as **consideration**.

In commercial contracts, consideration can be thought of as the payment for the goods or services being provided. It will normally be a financial payment, but in legal terms it does not have to be. Payment in kind (i.e. in goods or services) can be consideration. This barter type of exchange – one service for another – had gone out of fashion but with the ability of the Internet to connect people, it is making something of a comeback in contracts between individuals. It is, however, rare in commercial contracts, where the consideration is almost invariably money.

For a contract to exist, there must be consideration and it must have value. No consideration means no contract.

As with offers (see table 1.8), consideration is another concept where to understand what it **is**, you need to understand what it is **not**. Again, the definitions have been established through case law. Table 1.9 sets out things which are **not** consideration in the legal sense, with warnings about some exceptions which **are** consideration.

Consideration or not?	Relevant case law
Past consideration. Something which has already been done or given **cannot** act as consideration. Suppose a local council's decorators paint fences belonging to a private property company by mistake, and the private company then agrees to pay for the work. If the private company defaults on that payment, the council has no legal claim. Because the private company already has the benefit of the freshly painted fences before promising to pay, they gain nothing in exchange for that promise to pay. The benefit would remain in the absence of the promise. If, instead of painting the fences, the council had planted trees in the garden and agreed that they could remain if the private company paid (but in the absence of payment they would be removed), there would be consideration because the benefit can be retracted.	*Eastwood v. Kenyon* (1840)[20] Eastwood had been the guardian of a young girl, spending money on her education and general wellbeing. When she came of age, she promised to repay her guardian. When she married Mr Kenyon, he repeated the promise. No repayment was made. It was held that Eastwood could not recover the costs because the consideration for them was in the past. Mrs Kenyon had been brought up and educated without any promise of recompense. *Roscorla v. Thomas* (1842)[21] Roscorla bought a horse from Thomas. **After** the purchase, Thomas promised that it was 'sound and free from vice'. It turned out that the horse was vicious. Roscorla sued. He lost the case because no additional consideration had been given in exchange for the warranty that the horse was well-behaved. He had already completed the purchase in the absence of that assurance.

Consideration or not?	Relevant case law
Implied consideration. If the detail of a promise to pay is expressed after the provision of goods or services, but there is an implication that such a promise would be forthcoming, this may (depending on the facts) be valid consideration. If, to use the previous example, the private company had asked the decorators to paint the fences while they were working in the area, there could be an implied promise that the council (or the decorators themselves) would be paid a reasonable sum for doing so.	*Stewart v. Casey* (1892)[22] Stewart was joint owner of some patents. He asked Casey to promote them, which he successfully did. After the work was done, Stewart promised Casey a share in the patents in payment. It was held that this was enforceable, because the original request for the work carried an implied promise to pay for it, and a letter indicating that payment would be solely by way of shares set the detail on the payment. (It is worth noting that not all legal commentators agree that the approach taken was correct in this case, which is why the text here says only that there **may** be implied consideration. Commercially, it is not an assumption to be relied on.)
A promise to perform an existing obligation. If the existing obligation is a legal one, it must be performed whether or not the goods or services at issue are delivered, so it cannot be said to be in exchange for them. The standard case quoted (see right) does not make this very clear, but the argument is that Rees was under an obligation to pay the full amount. In effect, he promised to pay some of it if the builders stopped chasing him. In making that payment, he was only performing part of what he was already obliged to do, so had given nothing in exchange for the builders ceasing to pursue the debt. They could continue to do so.	*D & C Builders v. Rees* (1966)[23] Rees owed £482 to D&C for building works, which he was refusing to pay. Eventually the builders agreed to take £300 in full payment. The courts held that they were still entitled to sue for the remaining £182 because there had been no consideration for the promise to settle for less.
A promise to perform over and above an existing obligation. This is consideration (see right). A modern analogy would be police presence inside football grounds before, during and after matches, which has to be paid for by the football clubs. Conversely, any police presence outside the ground is at the discretion of the force and comes under its existing public order duties.	*Glasbrook Bros v. Glamorgan County Council* (1925)[24] Glamorgan police were offered £2200 to provide a special guard for a coal mine during a strike. Glasbrook Brothers (the mine owners) then refused to pay. It was held that payment was due because the guard was over and above the police force's normal duties to protect property.
A promise given to a third party. This is not **normally** consideration, and is based on a concept known as **privity of contract**, namely that a contract is a private arrangement between the parties to it. Anyone who is not a party to the contract, even if they are a beneficiary of it, cannot sue if the terms of the contract are breached. We have used the word 'normally' in this case because most lawyers are uncomfortable with the idea that someone who is intended from the outset to be the beneficiary of a contract cannot enforce its terms.	*Tweddle v. Atkinson* (1861)[25] John Tweddle's son, William, was engaged to Mr Guy's daughter. Both fathers agreed in writing between them to pay sums of money to William Tweddle. Mr Guy died before payment was made and his executors refused to pay. William Tweddle sued. It was held that because he was a third party to the original contract (between his father and Mr Guy) he had no rights to enforce it.

Table 1.9 Legal consideration summary

Apply
Look back at the case of *D&C Builders v. Rees*[26] in table 1.9. Think about what implications this might have for contracts with stage payments. It is common practice for final accounts on such contracts to be signed as being 'in full and final settlement'. Do you think this could be overruled on the basis of the D&C Builders case?

There is no fixed answer here. It would depend on the facts of the case, and underlines a need for contracts to set out clear rules around the agreement of variation orders and any cost adjustments (up or down) associated with them.

Adequacy and sufficiency of consideration

The law makes a distinction between **sufficient consideration** and **adequate consideration**.

Sufficient consideration means that consideration is capable of having a monetary value and does not fall into any of the categories in table 1.9 that are defined as being 'not' consideration. Consideration is therefore sufficient to meet the test of law if it meets the following requirements.

- It must be present or future consideration (not past).
- It must be something which the provider is not already obliged to perform or provide.
- It must be provided from one of the contract parties to the other.
- It must have (or be capable of having) monetary value.
- It must be more than a vague promise.

Adequate consideration relates to whether or not the payment is a reasonable or fair amount to be given in exchange. Generally in commercial contracts, the law will not intervene in this area. If there is a reasonable balance of power between the parties, they are free to make a bad bargain.

Governmental and legal authorities may seek to intervene where the balance of power is clearly not equal, particularly in contracts between large companies and individual consumers. In the UK, recent examples of this include caps on price rises by public transport companies and energy companies.

Remember
Consideration must be given directly in exchange. It cannot be something already done, or something that is already an existing duty (unless it goes above and beyond that duty). It cannot be a vague promise and it must be given from one party to the contract to the other party (not to a third party). It must be specific and it must have (usually monetary) value. It does not, in legal terms, have to give good value for the exchange.

Rights of third parties

Concern about the inability of beneficiaries to enforce contracts that they are not party to have been partly addressed in England and Wales by the Contract (Rights

of Third Parties) Act 1999. This gives third parties the right to enforce a contract, if the contract itself does either of the following.

- Gives them the right to do so
- States that it is intended to confer a benefit on them

There is similar legislation in New Zealand (now incorporated into the Contract and Commercial Law Act 2017).

Other countries have not followed this lead. This is not surprising because the overriding commercial response, in the UK at least, has been to ensure contracts include terms which stipulate that the contract is specifically **not** intended to confer any rights on third parties.

Collateral warranty

A **collateral warranty** is an agreement under which a subcontractor guarantees to a third party that it will fulfil its obligations under a contract. It is only legally binding if executed as a deed (see the following page).

Let us look at an example without collateral warranty. Figure 1.4 shows a contract between a building company (A) and a structural engineer (B). The purchaser (C) of the completed building, a factory for a manufacturing company, also has a separate contract with the building company.

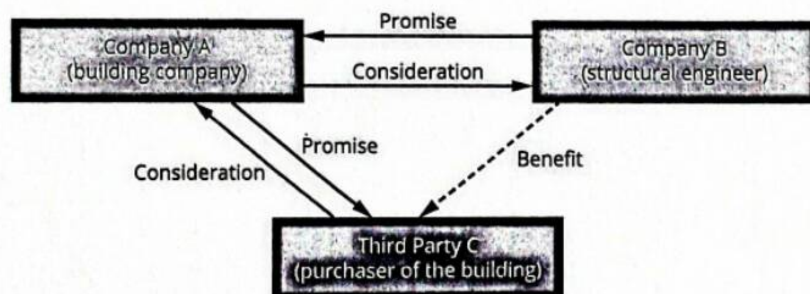


Figure 1.4 Third-party relationship without collateral warranty

The contract between Company A and Company B states the following.

- Company B (the structural engineer) promises to design the foundations and key structural elements of the factory in accordance with all laws, regulations, good practice, etc.
- Company A (the building company) provides consideration by way of fees (i.e. monetary payment).
- Company C (the eventual owner) benefits from the work of the structural engineer but cannot enforce any of the terms of the engineer's contract with the building company.

If there is a problem with the engineering design, such as faulty foundations, and the building collapses, Company C may be able to claim against A under **its** separate contract, but can it also or as an alternative claim directly against Company B?

In the normal course of events this might not matter. Company C could claim against Company A, which in turn could claim against Company B. But what if Company A had become bankrupt in the meantime and had been wound up? Company C could no longer claim against it because it no longer exists. It would then **want** to be able to claim against Company B. Could it do so? The answer is complicated.

- Under the promises to third party/privity of contract doctrine, the answer is **no.** Company C cannot claim against Company B because there is no consideration from Company C to Company B for Company B carrying out its duties effectively.
- Under the Contracts (Rights of Third Parties) Act and similar legislation, the answer might be **yes**, if the contract listed it as being able to do so.
- If a deed of collateral warranty exists (with the appropriate terms), the answer would also be **yes**, because this type of deed creates a direct legal relationship designed expressly for that purpose. This is illustrated in figure 1.5.

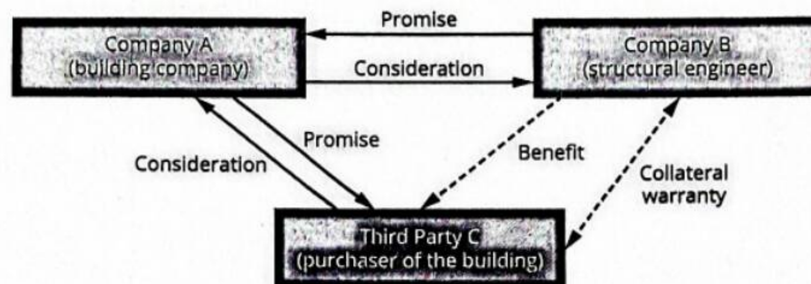


Figure 1.5 Third-party relationship with collateral warranty

Where consideration is not required

The major exception when consideration is not required to form a contract is where the promise is made by way of a **deed**. There used to be a rule that a deed needed to be sealed, but more recently it is generally accepted that a document is a deed if it says it is, and has been signed by the parties and witnesses to their signature. In the commercial world, if an organisation has a company seal, it will be required to attach it to deeds. Some forms of organisations, such as partnerships, will not have a seal, but this does not prevent them from entering into deeds.

As shown here, collateral warranties generally do not involve consideration, therefore they are only effective if executed as deeds.

Some warranties will introduce a minimum consideration (e.g., a very small amount of money) to avoid the need for them to be deeds. The reason for this is that most contracts have a liability period of six years, but those executed as deeds carry 12 years' liability.

Remember
When the promise is made by way of a 'deed' rather than a 'contract', consideration is not required. A document is a 'deed' if it explicitly says it is.

Intention to create legal relations

Intention to create legal relations/to be legally bound
Intending that an agreement should be capable of being enforced via the courts

A further requirement for a contract to exist is that it is **intended to be a contract**. There has to be a mutually agreed intention that the agreements set out are to be enforceable. It seems extreme to say that a contract is intended 'to have the force of law' but that is essentially what an intention to create legal relations means: that the promises made (i.e. the contract) are legally binding and legally enforceable – through the courts if necessary. The expressions **intention to create legal relations** and **intention to be legally bound** mean the same thing and are used interchangeably.

Commercial arrangements are generally assumed to be intended to be enforceable, while purely domestic agreements are thought not to be. The following two cases are commonly used to illustrate the difference in a largely domestic setting.

In *Balfour v. Balfour* (1919),[27] Mr Balfour promised his wife an allowance when he left to work abroad. After a while, the payments stopped. The courts held that this was not a contract and Mrs Balfour could not insist that they be continued.

In *Simpkins v. Pays* (1955),[28] three people shared a house: the owner, her grand-daughter and a paying lodger. Every week they entered a newspaper competition. Although the entries were in the name of the house owner, all three contributed to the entries, and it was understood that they would share any winnings. When an entry did win, the house owner refused to share. The courts held that this was in the nature of a contract that was intended to be binding.

In the commercial setting, it is assumed that there is an intention to be bound, unless there is strong evidence to the contrary.

The case of *Rose and Frank v. JR Crompton and Bros Ltd* (1925)[29] was an agreement for an English company to use a New York firm to market its carbon paper in America. The agreement included the wording: 'This arrangement is not entered into... as a formal or legal agreement, and shall not be subject to the legal jurisdiction in the Law Courts'. When the English firm withdrew, the American company found that it could not enforce the contract.

In *Appleson v. H Littlewood Ltd* (1939),[30] Appleson claimed to have won on the football pools (a form of betting on the outcome of football matches) and sued to recover his money. The courts held that Littlewood Ltd did not have to pay because the entry form included the words 'binding in honour only'. This meant it had a strong moral obligation to pay, but no legal obligation.

Apply

It is easy to think that cases from 75 or 100 years ago have no relevance to the modern world. Read the information above on *Rose and Frank v. Crompton*[31] and *Appleson v. H Littlewood Ltd*[32] and then revisit the case study 'When is a contract not a contract?' in section 1.1.

Apply

On reflection, do you think that the judgment in *Simpkins v. Pays*[33] would have been the same if all three people had been family members, rather than one of them being a paying guest? Would it have made a difference if only one of them had paid all of the entry fee?

Is there intention to be bound and rules of consideration? There will always be grey areas and 'what if...' questions when applying case law. When answering exam questions that relate to rules from case law, always pause to think about how similar the exam scenario is to the one on which the rule is based, but also how different it is, and whether that difference is enough to mean that the rule does not apply.

You will need to look at both sides of the argument – but you will also need to make a decision as to which side you think has the stronger position. This is what contract lawyers and judges do every day, and it is also part of the skillset of the procurement and supply professional. As such, there is no definitive answer here.

Capacity to contract

A person has the **capacity to contract**, which is sometimes referred to as 'legal capacity' or 'legal competency', if there is no legal reason why they cannot enter into a contract. The following categories of people do not have capacity to contract.

- Infants/minors (those under the age of maturity, which is 18 years old in most countries)
- People suffering from mental health issues
- People under the influence of drugs

If a person without capacity enters into a contract, it will not be legally binding on them. It may, however, be binding on the other party. The reason for this is that the purpose of the rules on capacity are to protect those who may not be capable of making an informed assessment of the agreement being entered into.

Some countries make exceptions to the rules on consent. For example, contracts in respect of housing, food and other life essentials are more likely to be considered binding, if it can be shown that the person entering the contract fully understood it.

Note that all of these rules apply to natural persons (i.e. human beings). They do not apply to companies or public authorities. All commercial entities are deemed to have a capacity to contract.

Ultra vires

There is a similar provision in the commercial world – applying to public sector bodies – where the organisation may only legally be able to contract to do certain things. These are known as the **ultra vires** rules, a Latin term meaning 'beyond powers'.

Public sector organisations often have the limits of their duties and obligations set out in law. Acts of parliament, or the equivalent, will describe the following.

- What the body is intended to do
- What the body is required to do
- What the body is able to do in order to meet the needs of the two points above.

These rules may limit the areas in which the organisation can and cannot contract. Any contract which the organisation enters into to do something beyond these limits will not be capable of being enforced against it.

Remember
People without the capacity to contract are individuals (young people or those with limited mental capability) who are deemed not to fully understand the nature of contracting. Ultra vires relates to companies or public bodies acting outside the legal limits of what they are permitted to do.

Articles of incorporation
The legal document creating a commercial company and setting out its purpose

The equivalent in commercial companies is that they are not permitted to do anything beyond what is set out in their **articles of incorporation**.

The problem with the ultra vires rule is that the second party to the contract (i.e. not the one acting beyond their powers) will not necessarily know that the breach is occurring.

Case study

Credit Suisse v. Allerdale Borough Council (1997)
Allerdale Borough Council, a public authority, wanted to build a swimming pool for the local residents. It was unable to borrow the funds to do so. It set up a separate company to build and run the facility, and take out the necessary loan for the project. Allerdale guaranteed the loan (i.e. if the new company defaulted, the council would pay). The company collapsed. Allerdale was able to escape having to repay the loan by arguing that its own actions in guaranteeing it were unlawful. The courts agreed, stating that the council had no power to set up the company in the first place, and that even if it had had that power, it would still not have had the power to guarantee any loans taken out by said company.

(Source: Credit Suisse v. Allerdale Borough Council (1997) QB 306.)

The problem which is immediately evident from the *Allerdale* case is that the council could enter into a contract knowing full well that it could not be held to it.

For this reason, the ultra vires rules have slowly been eradicated in the UK, firstly in the commercial sector during the 1980s, and more recently in the public sector, giving both commercial organisations and public sector bodies full capacity to contract in line with natural persons. This process is generally similar in many countries but there may be local variations.

Apply
Research the rules on ultra vires in a country other than the UK.

The battle of the forms and precedence of contract terms

The battle of the forms

Under the rules relating to the duration of an offer (discussed earlier in the chapter), a counter offer is a rejection of the original offer. In many cases, companies are not even aware that they are making offers and counter offers. This is particularly the case where they are operating on standard terms.

Every company has its own standard terms and conditions. These are the baseline terms on which they buy or sell. The theory is that these are the terms which will apply in the absence of a more substantial contract.

They will often be printed on the back of the standard documents used in the buying and selling process, which may include some or all of the following.

- RFQs
- Quotations submitted
- Order forms
- Delivery notes
- Goods received notes
- Invoices

You can very quickly see that some of these documents are issued by the purchaser and others by the supplier. Logically, therefore, some will have the purchaser's standard terms printed on them; others will have the supplier's standard terms on them.

Battle of the forms
A series of forms such as orders, delivery notes, etc., issued in sequence by purchaser and supplier, each containing terms that appear to override those on the previous document

Equally logically, those two sets of terms will be different. The purchaser's terms will seek to limit the purchaser's risk; the supplier's terms will seek to limit the supplier's risk.

The to-and-fro of these different sets of terms is known as the **battle of the forms**. Each set of terms is fighting to take precedence over (or overrule) the other. How is it possible to determine whose terms actually apply, or which contract terms take precedence?

Each issue of a set of terms is in effect a counter offer, which rejects the previously issued terms. So the sequence might be as follows in figure 1.6, and at some point in the chain, an acceptance will be issued.

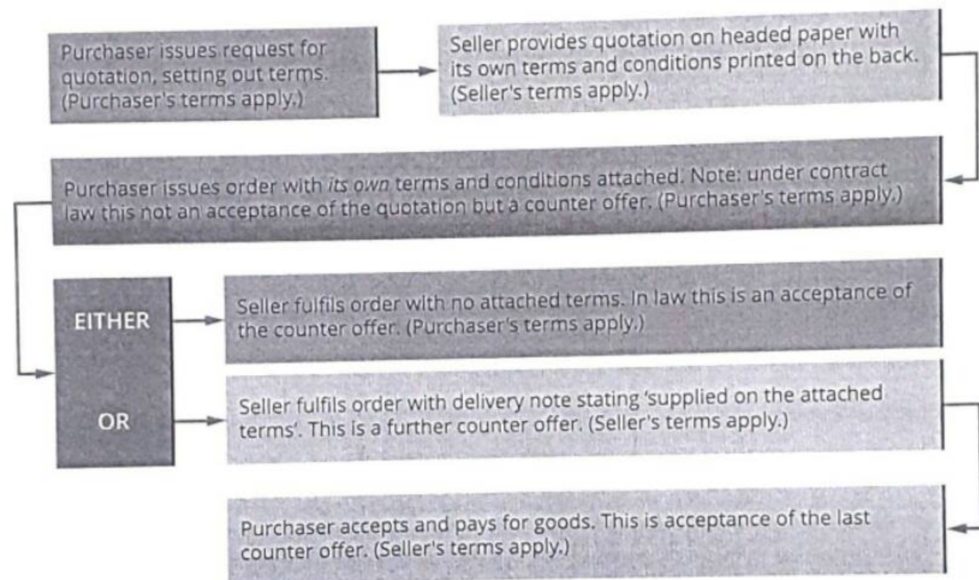


Figure 1.6 Offers and counter offers

In *Butler Machine Tool Co Ltd v. Ex-Cell-O Corporation* (1979),[34] Butler offered to sell using its own standard terms. Ex-Cell-O placed an order using its terms (which were different from Butler's). That order form had a tear-off slip which the supplier had to return. That slip acknowledged the terms of the order. The courts held that the return of this slip was an acceptance of the terms and created the contract.

In this case, even if Butler had then included its own terms on the delivery note and required a signature for Ex-Cell-O accepting those terms when receiving the goods, it would have had no impact because the contract had already been formed.

It is often said that the battle of the forms is won by the person who 'fires the last shot'. Clearly from this examination of the *Butler* case that is not so. Shots can continue to be fired after the battle has already been won and lost.

Remember
In the battle of the forms, it is usually the most recently issued set of terms and conditions that will take precedence.

Precedence of contract terms

Commercial agreements are rarely simple. They can consist of numerous documents and schedules. At the very least, they will be made up of a number of different sections. Each of these deals with specific aspects of the contract and may therefore be drafted by different specialists. As a result it is easy for mistakes to occur so that not all of the terms, clauses and schedules agree with each other. Also, things may have been agreed prior to signing the contract which, for some reason, are not reflected by the wording of the contract itself.

It is important to understand how the law deals with these anomalies and inconsistencies. Typically, anything explicit in a contract overrides anything implicit or previously agreed. Usually, anything explicitly set out in a contract will override anything implicit or previously agreed. The one exception to this is where terms are implied into a contract by statute law or legal regulation.

Matters not reflected in the contract

Most contracts will have a 'full agreement' clause. This explicitly states that anything discussed prior to the final drafting and signature of the contract shall be ignored and that the contract itself represents the full agreement of the parties.

In the event of a dispute, this clause will be followed to the greatest extent possible. If it is possible for the courts to determine exactly what the written contract says and what (using the normal **rules of interpretation**) that must mean, then the courts will uphold that. However, if what the parties were trying to say cannot be determined from a reasonable interpretation of the contract, then the courts will look at the pre-contract context to try to establish the intentions of the parties.

Rules of interpretation
In a legal context, a set of principles which have evolved over several hundred years, which define how law courts will interpret contracts. One of the primary rules is that words will have their normal everyday meaning, unless there is a specific definition provided within the contract itself. In commercial contracts where a level of legal and/or professional knowledge can be assumed (rather than between a business and a private individual), the courts may infer what a reasonably well-informed person of a given status in a given profession would have understood by the wording

Standard forms and attached schedules

Many market sectors use standard documents with general clauses, which are made more specific by amendment or attachment of schedules. Some organisations will also have similar standard templates.

It is obvious that direct amendment of clause wording overrides the pre-printed standard format, but what happens when something in one of the schedules appears to contradict the standard wording without specifically stating that it is an amendment to it?

The first thing the courts will do is check whether there really is an inconsistency or ambiguity. If they can come to an interpretation of the various clauses which makes all of them valid, then they will assume that such an interpretation is what was intended.

If they cannot find such a position, there is a general rule that specific clauses override general ones. The logic is clear: if the people drafting the contract have taken the trouble to write detailed requirements, then these must be more important than those to which they have paid less attention.

Hierarchy of clauses or order of precedence clauses

Many contracts will have a hierarchy of clauses or order of precedence clause which explicitly sets out which terms take the lead. For example, it might say that in interpreting the contract, anything in the contract clauses (i.e. the main document) shall take precedence over anything on drawings or schedules attached to it.

Case study

RWE Npower Renewables Ltd v. J N Bentley Ltd (2014)
This court of appeal case shows how the courts will try to find a way of reconciling all of the clauses before moving to use the order of precedence clause. Bentley had been appointed by RWE to carry out civil engineering works. The contract form (NEC3 Engineering & Construction Contract) included a short agreement document which set out the order of precedence of the remaining contract documents as follows.

- Contract Data Part One
- Z clauses (a set of optional clauses issued as part of the standard NEC suite)
- NEC3 conditions of contract
- Post-tender clarifications
- Works information
- Site information
- Contract Data Part Two
- The tender

There were delays on the project and a dispute arose as to whether Bentley had done sufficient work to claim completion of section 2 of the works information and thus avoid having to pay liquidated damages.

Bentley argued that there was a conflict between the works information and Contract Data Part One and that the order of precedence should apply. RWE argued that the contract should be understood as a whole and that it was unnecessary to rely on the order of precedence clause. In their view, the Contract Data Part One and the works information could both be interpreted in a way in which the combination made sense (so there was no conflict).

The court agreed with RWE, a decision which was upheld on appeal, underlining that if any 'commercially sensible' interpretation can be put on the whole, that will be held to be the case.

(Source: RWE Npower Renewables Ltd v. J N Bentley Ltd (2014) EWCA Civ 1679.)

Only where the discrepancy is blatant – such as one section requiring something to be painted white and another section requiring it to be painted black – would the order of precedence clause be taken into account. This suggests that it will only be used in rare cases.

This does **not** mean, however, that order of precedence clauses should not be included, but it does mean that procurement personnel drafting contracts and contract managers operating them should not rely on such a clause as a 'get out of jail free' card. Potential problems could include the following.

- Failing to ensure placement of the clause in the right contract document, so that it does not itself become subject to a different document.
- Using industry standard forms that already have such clauses which might not agree with what the parties want on this particular contract.

Example of a precedence clause being used

When there is a definite conflict that cannot be resolved by any sensible reading of the contract, the courts will rely on the order of precedence clause.

Case study

CLP Holding v. Singh and Kaur (2014)

In this case, the contract related to the sale of a commercial property. The price was listed as £130,000 in the special conditions.

The standard conditions, however, stated that all figures were exclusive of VAT and that the buyer must also pay any chargeable VAT. The contract included an 'order of precedence' clause that clearly stated that the special conditions took precedence.

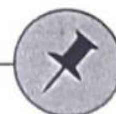
It was held that the buyer was only required to pay the £130,000. Lord Justice Kitchin reasoned that the £130,000 could not be interpreted as being exclusive of VAT, when (taking background knowledge into account) it was clear that the buyer was not aware that the price would be subject to VAT.

This case is useful in that it illustrates the multi-strand approach of the courts in coming to a conclusion. They have used the precedence clause to allow the special conditions to override the general conditions, but they have also used the more general rule of looking to see what the intention of the parties was.

(Source: CLP Holding v. Singh and Kaur (2014) EWCA Civ 1103.)

Remember

- Generally, a term drafted for a specific contract will take precedence over a standard term.
- Express terms will override implied terms, unless the implied term is created by a statutory regulation.
- The fairness of holding parties to the written contract will be considered; that is, it will be assumed, unless there is very strong evidence to the contrary, that the parties knew what they were agreeing to. (Note that this is not a judgment on whether the contract itself is fair – parties are free to make a bad bargain – merely that, having made the agreement, it is fair that it be upheld.)
- All of the contract documents will be reviewed and an attempt made to determine the true intentions of the parties, but it will be difficult to override a very precise express term.



Risks presented by contracting on suppliers' terms or through oral contracts

A fairly drafted contract will protect both the supplier and the purchaser. Where the bargaining power of the two parties is roughly equal, it will do so in equal measure. Otherwise it will reflect the relative bargaining strengths of the parties.

Where the purchaser has significant market influence or the better negotiators, they will be able to dictate terms. The power of the major supermarkets over farm-produce suppliers is a clear example of this.

Conversely, where the sellers have the upper hand (e.g., in monopoly or limited supplier markets such as energy supply), purchasers will struggle to achieve their preferred terms of trading.

Nevertheless, this does not mean that the effort should not be made. Simply accepting the supplier's terms means wasting even what little influence there is. In many circumstances, it means that those terms have not even been read so that the risks they create have not been understood, let alone mitigated or managed.

Accepting the supplier's terms means accepting a contract that is drafted entirely in the supplier's favour. This could include the following.

- No warranty of quality or fitness for purpose
- A specification that reflects what the supplier wishes to sell, rather than what the purchaser wishes to buy
- All risks of damage in transit resting with the purchaser
- Payment terms which might result in cash flow issues for the purchaser
- Exclusion of all liability (to the extent permitted by law) for any damage or injury caused by the goods being purchased or as a result of the services provided
- Lack of protection against time and/or budget overruns
- Inability to change the original specification without extra costs (possibly disproportionate)
- Lack of protection of any of the purchaser's intellectual property, which might need to be deployed to make the contract function
- Inability to control any shared data, which apart from the personal impacts of a data breach, could result in significant legal penalties, particularly within the EU under new GDPR

Apply
Consider how your organisation or one with which you are familiar places orders for low-value goods. Does it create a situation which might give rise to a battle of the forms? How might this risk be avoided?

Risks presented by relying on oral contracts

In principle, oral contracts are enforceable. The problem is that if the contract terms have not been written down, it can be very difficult to prove what they were. There is unlikely to be any record of the transaction, unless it has been made by telephone and the call has been recorded. Even in that scenario, the conversation

is likely to have been quite short and limited. Most likely, the purchaser has telephoned the supplier, outlined the nature of the goods or service they wish to purchase, may or may not have asked for an estimated price, and then simply placed the order.

It is, however, not possible to say what each party thought it had agreed to, in terms of the following.

- Warranty
- Specification
- Timescales
- Cost
- Liabilities

The purchaser may believe it is contracting on **its** normal terms. The supplier will believe it is contracting on **its** terms. What is most likely to happen is that at some point in the process, formal documentation will creep in (e.g., a confirmation order, or a delivery note) which will then result in a battle of the forms commencing (discussed earlier in the chapter). Therefore procurement and supply personnel should be very careful to avoid oral contracts.

Case study

Oral contracts have been enforced

In 1984, Getty Oil was 'sold' to Pennzoil on a handshake. Texaco made a better offer and the company was sold to it. The court upheld a claim by Pennzoil that its oral contract had been undermined and it was awarded over $9bn in damages.

In the 1990s, when actress Kim Basinger backed out of an oral agreement to star in the film *Boxing Helena*, she was found to have breached a contract and was bankrupted by trying to settle the millions of dollars in damages.

The Vienna Convention on Contracts for the International Sale of Goods (CISG)

CISG
The Vienna Convention on Contracts for the International Sale of Goods, a United Nations treaty seeking to harmonise contract terms for the sale of goods between different countries

Contracting State
A country which has signed the Vienna Convention on CISG

The Vienna Convention on **CISG** is a voluntary treaty under the auspices of the United Nations Commission on International Trade Law (UNCITRAL). In the language of the CISG, countries that have signed the treaty are known as **Contracting States**.

At the time of writing, the latest figures (December 2017) indicated that 89 countries had signed up to the treaty. Countries that were **not** yet party to the treaty included India, South Africa, Taiwan and the UK. Taiwan is not permitted to become a signatory as it is not fully recognised by the United Nations. The UK's position is less easy to understand. Possible reasons that the UK has not signed the treaty include the following.

- A lack of parliamentary time to debate adoption and other legislative priorities
- A lack of interest in the business community
- A concern that London might lose its position in international litigation

The purpose of the Vienna Convention is to set out a framework for international transactions based on a uniform approach. It tries to get around the problems created by differences in local laws.

The Vienna Convention is only applicable in specific situations.

- It only applies to goods (not services or works), but does include goods to be manufactured to the specifications of the buyer.
- It only applies to private commercial (business-to-business) transactions, not to public sector contracts or sales to consumers.
- It only applies where the parties to the contract have their place of business in different Contracting States.

At state level, countries signing up to the treaty can exclude parts of it.

- They can exclude some of its provisions in respect of all goods.
- Alternatively, they can exclude the whole of the treaty from some part of their territory (e.g., China is a signatory to the convention but does not apply it to Hong Kong).

At contract level, the parties to the contract can exclude or alter the provisions as they see fit on a case-by-case basis.

Where the sale of goods is between two businesses in different Contracting States, then it is international and the CISG rules of law automatically apply **unless** they have been excluded. A contract clause stating that the contract is subject to the legal systems and courts of a particular country overrides or excludes the CISG rules, since the local rules of that country would apply instead.

Where only one (or neither) of the businesses is located in a Contracting State, the rules may still be applied if the legal rules of that country (or those countries) permit the businesses to choose which legal system is to apply to their international contracts. In this case, the CISG rules will only apply if the contract explicitly says they do.

The interpretation of the Convention continues to evolve through case law. There have been some 4500 cases so far. UNCITRAL reports details on these and periodically issues a digest of them, which can be found on the UNCITRAL website.[35]

> *Remember*
> The Vienna Convention (CISG) applies to goods where the contract is between two commercial organisations whose place of business is in different Contracting States, only if those countries have not excluded the rules in respect of the goods in question or the territorial areas where the businesses are based. The companies themselves can agree terms different to the CISG rules. Explicit terms in the contract will override CISG rules.

What type of goods fall under CISG rules?

The current interpretation indicates that CISG does **not** apply to the following.

- Distribution agreements, since these are about the organisation or transport of the goods, not the transfer of ownership
- Goods bartered for other goods or services – that is, anything where the payment is not money

- Framework agreements, which are generally accepted not to be actual contracts, merely a mechanism for pre-agreeing the terms of a contract should one be created
- Franchise agreements
- The sale of ships or aircraft
- The sale of electricity. The position on the sale of gas has yet to be finalised, although one court (the Austrian Supreme Court) has accepted that the rules do apply to the sale of propane gas.
- Anything sold at auction. This has been related to traditional auctions which tend to be for one-off goods, and it is not clear how the rules might apply for larger scale contracts which are let via electronic reverse auctions.

Computer hardware is definitely 'goods' within the interpretation of the Convention, but the position regarding software is less clear. Some courts indicate that only standard software (what might be called out-of-the-box software) is covered; others have taken the view that non-standard bespoke software also falls within the remit. This would be logical following the general rule on goods to be manufactured to purchaser specification. All other types of goods are covered.

Apply
Use the Internet to research the CISG rules. Do they cover the organisation, sector and country in which you work or wish to work in future?

Application to contracts

The Convention covers the formation of contracts, including the following.

- Offer
- Acceptance
- Consideration

Under the CISG, the offer must be addressed to a person, definitively describe the goods, quantity and price, and indicate an intention to be legally bound on acceptance. An offer may be revoked, provided that the withdrawal is received before an acceptance is sent.

Acceptance must be explicit. Silence cannot be taken to mean an offer has been accepted. Any proposed acceptance which changes the terms of the original offer is a counter offer and therefore a rejection of the original offer.

The CISG does **not** cover validity or enforceability of the contract (or parts of the contract). Therefore the following matters are determined by national laws.

- Capacity
- Illegality
- Mistake, duress or fraud
- Damages and penalty clauses
- Validity of assignments or settlements
- Retentions or deposits
- Liability for death or personal injury caused by the goods

This may mean that there is still a need to specify in a contract which country's laws will apply to areas not covered by the CISG. Such a clause will need to be carefully worded to make sure that it only refers to non-CISG matters and does not accidentally exclude the whole of the CISG rules.

There is a general requirement to act in good faith. This has been put forward as one reason for the UK's reluctance to sign up to the treaty since – it is argued – good faith cannot be adequately defined or measured.

The Convention does not require contracts to be made (or amended) in writing. As already mentioned, there are serious risks in not fully documenting contracts in writing. These risks apply equally to amending contracts. Procurement and supply professionals should carefully consider how they manage this within contracts. Good practice requires all amendments to be in writing and any contract relying on CISG rules would benefit from this being explicitly stated as an exclusion to those rules.

Remember
The CISG does not require contracts or amendments to contracts to be in writing. If the contract is relying on CISG rules, it is wise to exclude this particular feature of those rules and explicitly state that all variations must be in writing.

Incoterms®
Series of commercial terms published by the International Chamber of Commerce, covering the allocation of costs and transfer of risks between buyer and seller. The various options are abbreviated to three-letter codes

Force majeure
An exclusion clause that relates to things which are not only outside the control of the parties, but which by their nature are unforeseeable. The term normally includes such events as natural disasters, civil unrest and war – but where these things are frequent occurrences and/or could arguably be foreseeable, they may not be covered in a particular contract for that very reason

Rules relating to the sale of goods

The seller's duty is to deliver the goods, provide any documents relating to them, and transfer ownership to the buyer.

The quality, quantity and specification of the goods must be in accordance with the contract. They must be suitably packaged. They must be fit for purpose and free of any third-party claims (e.g., for infringement of intellectual property rights).

The buyer's duty is to take all reasonable steps to take delivery of the goods, to examine them promptly, advise of any non-conformity within a reasonable time, and to make payment.

Although the CISG has provisions for when the risk passes from buyer to seller, this is generally excluded in favour of the use of standard **Incoterms®**.

Remedies for breach of contract include damages, specific performance or adjustment of price, and will depend on the facts of the case and the nature of the breach. Liability for breach is avoided if the failure to perform is due to something beyond the party's control and could not reasonably have been foreseen. This is equivalent to **force majeure**.

If the seller has to refund the price of goods (e.g., where the breach of contract is not sufficient to warrant an award of damages), the refund must also include interest from the original date of payment. It is unclear whether the interest rate is based on that of the seller's state or the buyer's.

Similarly, if the buyer is required to return goods, they must also make a payment representative of any value or benefit derived while they were in possession of them. Again, it is not clear how such value would be calculated.

Misrepresentations made pre-contract award

Misrepresentation is a false statement of fact made by one of the contracting parties before, or at the time of, entering into the contract which led or encouraged the other party to contract. Table 1.10 shows several examples of necessary conditions for misrepresentation.

Necessary condition for misrepresentation	Commentary and case law
There must be a statement made.	Statement can be taken literally to mean something said, but it can also be implied by conduct. Silence will not normally be considered misrepresentation, except in the following cases. • In contracts 'of utmost good faith' (e.g., insurance contracts) where only one party has access to information crucial to understanding the advisability of the contract • Where what is not said deliberately creates a misleading impression (e.g., in *Nottingham Patent Brick & Tile Co v. Butler* (1886),[36] a house purchaser asked if there were any restrictive covenants and the solicitor replied that he 'was not aware of any'; this was true, but omitted the fact that he had not done the normal searches which would have revealed that there were indeed such covenants; this was held to be misrepresentation because of its context) • If a party makes a true statement and the circumstances change, causing it to become false, there is a duty to update the original statement (e.g., in *With v. O'Flanagan* (1936),[37] O'Flanagan told With that his medical practice earned £2000 p.a., which was true, but by the time the sale of it to With went ahead, it had been neglected for months because O'Flanagan had himself been ill and was now worthless; the failure to correct the previous statement was held to be misrepresentation)
The statement must relate to fact.	A statement of law is not misrepresentation, nor is an honestly held opinion (however misguided). Stating you hold an opinion when you do not is not a statement of fact. This rule also applies to statements of intention (e.g., in *Edgington v. Fitzmaurice* (1885),[38] a statement that funds raised by loans were to improve the business when the real intention was simply to pay off existing debt was held to be misrepresentation).

Necessary condition for misrepresentation	Commentary and case law
The statement must be false.	False is read widely as meaning that the statement must be untrue, or have become untrue (see *With v. O'Flanagan*[39] on the previous page) or be misleading in context (see *Nottingham Patent Brick v. Butler*[40] on the previous page).
The statement must be made by the contracting party.	Statements made by the contracting party's agent are treated as if made by the contracting party. A statement does not necessarily have to be made directly to the other contracting party.
The statement must induce the contract.	The statement must have direct influence on the other party's willingness to contract. Any statement made once the contract is entered into clearly cannot have affected the desire to enter into it, so cannot be misrepresentation. The innocent party cannot avoid the contract under the following circumstances. • If they knew about the falsehood (since they had the opportunity not to contract given that knowledge) • If they did not know about the statement that was a misrepresentation (since they could not have acted on the basis of something they did not know) • If they did not rely on the statement but carried out their own investigations Note that the misrepresentation need not be the only inducement to contract (e.g., in *Edgington v. Fitzmaurice*[41] on the previous page, part of the reason for entering into the contract was the plaintiff's own mistake, but it was held that was nevertheless able to revoke the contract because of the misrepresentation).

Table 1.10 Defining misrepresentation

Types of misrepresentation

Misrepresentation can be fraudulent, negligent or innocent.

Fraudulent misrepresentation is where the person making the statement does so knowing it to be false or is reckless in using information without taking any steps to see if it is true or not. Information which is inaccurate but was believed to be true (provided that belief is reasonable) will not be fraudulent.

Negligent misrepresentation occurs where the person making the statement has a duty of care and fails to take such reasonable care as to the accuracy of the statements. This will apply in the case of experts acting in their professional capacity. In the UK under the Misrepresentation Act 1967, in a claim for negligent misrepresentation it is for the defendant to prove that they have not acted negligently.

Innocent misrepresentation is where the misleading statement is neither fraudulent nor negligent, because it is genuinely and reasonably held to be true by the person making it.

These are the remedies for misrepresentation.

- **Rescission of contract**
- Damages

In the case of fraudulent or negligent misrepresentation, the court may award both rescission and damages, but in the case of innocent misrepresentation it can only award one or the other.

Rescission is not always an option. It will not be possible in the following instances.

- Where the innocent party has affirmed the contract; that is, acted in a way confirming that they wish it to continue
- Where the claim has not been brought within a reasonable time (this is a point of general law)
- Where restitution (returning to the pre-contractual position) is impossible (e.g., because the goods have been consumed or have deteriorated)
- Where there has been intervention of innocent third-party rights (e.g., if the goods have been sold on)

In these cases, the courts may still choose to award damages.

Rescission of contract
An equitable remedy that seeks to place both parties in their pre-contractual position, as though the contract had never existed

1.3 Compare types of contractual agreements made between customers and suppliers

This section looks at different types of contractual arrangements between purchasers and suppliers. This is specifically about the contracts, not the procurement procedures which lead to them. Most contractual arrangements can be arrived at through a process of direct negotiation or through a process of competitive tender. The differences between these activities are beyond the scope of this section.

One-off purchases

One-off purchase contracts can be used for goods, services or works. The key element of a one-off contract is that it relates to a single purchase. Note that this is not the same as a single item.

When buying goods, the one-off purchase might literally be for a single thing (e.g., a computer or a vehicle), but it could equally be for a batch of things (e.g., 100 computers or a fleet of vehicles). It can be something as simple as a desk or (in theory at least) as complicated as an aircraft carrier. In practice, the more complicated the item being purchased, the less likely it is that a one-off contract will be used.

When buying services, the one-off purchase is most likely to be for a single engagement. Examples might include a single training course, the valuation of a specific piece of land, or the auditing of one set of accounts.

Innocent misrepresentation is where the misleading statement is neither fraudulent nor negligent, because it is genuinely and reasonably held to be true by the person making it.

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In the purchasing of works, the one-off contract will relate to a very specifically defined project. It may be a single building, but it could also be a whole estate.

Simple one-off purchases

The simplest one-off purchase may not have a formal contract at all. An example might be that the marketing team need some advertising leaflets for an event: they have produced a mock-up of what they want, phone the local printing company to ask for a price, e-mail across the draft and agree a delivery date. That is as complex as it gets. The goods are delivered, the invoice is attached (or follows) and gets paid.

From sections 1.1 and 1.2 of this chapter, it should be clear what potential problems might exist with this approach. Some of those will be avoided if there is a formal purchase ordering system linked to standard terms and conditions, but there is still the potential for a battle of the forms.

Check
Remind yourself what the battle of the forms is, and consider why it might arise in this context.

Complex one-off purchases

There is a distinction between the spot-purchase of simple items and the commissioning of a major project such as building a housing estate or buying an aircraft carrier.

In one sense, these are potentially one-off purchases. A national government may well commission more than one aircraft carrier at a time, but it equally may not envisage a strategic need for more than one. Similarly, even if it would prefer to have a five-year construction programme, a local authority or housing management company may only have funds to develop one estate at a time. If funds and strategy allow, more efficient procurement options exist through strategic alliances or framework agreements, but the political and financial reality is that procurement efficiency is not always top of the agenda when major capital investment is considered.

However, that does not mean that all good procurement practice is ignored when it comes to complex one-off purchases. This is not a case of picking up the phone book or searching on the Internet to find a supplier. The sourcing process is likely to be competitive – either through formal tenders or via parallel negotiation with potential suppliers.

The contracts tend to be very carefully considered to reflect the complex nature of what is being purchased. Specifications are detailed. Change procedures are well-documented because the more complex the project, the more likely it is that variations will be required.

Remember
A one-off purchase contract can be simple or complex. It may or may not have been tendered.

Reasons for using one-off purchase contracts

The reasons for using a one-off contract depend mainly on whether it is for a simple or a complex purchase. In the case of simple items or services, the usual reasons for

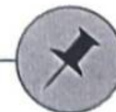
using a one-off contract (and often an accompanying spot-purchase, untendered approach) are low-value spend, urgent need and a lack of planning. Usually such purchases are for immediate use, but if stock-holding is an option, they could also be used to take advantage of special offers (e.g., bankruptcy sales, sell-off of spares for products reaching the end of their support life). In the case of more complex purchases (e.g., works, complex goods or services), the most common reasons for a one-off approach are either lack of a fully developed strategy for the spend area and/or the inability to predict future funding. The lack of strategy may itself be a result of an inability to predict funding, but equally the inability to negotiate forward funding can be because strategy is ill-defined. It can be hard to define what is cause and what is effect. This is particularly true in the public sector where national and international politics have an impact, but it can also be the case within private sector organisations as different departments or divisions compete for budget.

Nature of the contract

The complexity of the contract will reflect the complexity of the purchase. For simple, low-value purchases, standard terms and conditions may be all that is required, but do not assume that just because the purchase is a one-off, the contract will be simple. It may still need to cover the following areas.

- **Warranties and guarantees** if the one-off purchase has a considerable life-span and is business-critical (e.g., a back-up generator for the office which houses the national computer servers).
- **Insurance requirements**, including professional indemnity, public/products liability, employer's liability, and cover for any specific risks such as pollution or working at height.
- **Specification requirements** on quality, timing and delivery.
- **Minimum quality standards** on the business operation (e.g., a catering provider might only be providing sandwiches for a team meeting lunch, but you still need to know its hygiene practices).
- **Built-in change process** for any goods or services that are beyond very simple (e.g., works contracts always have variations procedures because of the unpredictable nature of such projects).
- **Ability to extend the scope of the contract** should be minimal or none, and restrained to the single requirement.
- **Ability to extend the duration of the contract** should be limited to the ability to accommodate unexpected time overruns (which itself should be subject to a damages/penalty provision where they are attributable to the supplier, and an extension to overheads costs where they are attributable to the purchaser).
- **Data security protocols** need to be considered if personal data is being shared.

> *Remember*
> The complexity of the one-off purchase contract will need to reflect the complexity of the product, service or works being purchased.



Benefits of one-off contracts

The one-off contract **does** have a valid place in the tool-box of the procurement and supply professional.

Benefits for the purchaser include the following.

- On simple, low-value purchases, the potential for speedy delivery, particularly if purchased on standard terms from suppliers who are known, approved and (possibly) local
- The ability to tap into falling market prices and/or time-limited special offers
- On complex projects, the ability to narrow down the terms to one deliverable, which can simplify the contract, covering only the risks associated with that one product, service or works package

Benefits for the supplier include the following.

- If the one-off contract is on a spot-purchase basis, there may not be any competition, enabling the supplier to set its own price
- If purchasers regularly use one-off contracts, the total spend may be significant even if individual order values are low

Naturally, advantages for the purchaser can be seen as disadvantages for the supplier and the other way around.

Risks of one-off contracts

As already stated, purchaser benefits are supplier risks and vice versa, but there are also other risks.

Risks for the purchaser include the following.

- If the one-off contract is tied into on-the-day pricing, it is not possible to demonstrate value for money because there is no market investigation and limited, if any, competition; be aware, however, that this is a function of the sourcing process and not directly attributable to the nature of the contract.
- The contract (if properly drafted for a one-off purchase) will not allow for extensions should the situation change such that 'more of the same' is required. This can create a situation where a supplier may become 'embedded' and thereby gain additional leverage over price and/or contract terms. Embedded in this context means that its product or service dictates what other products or services are purchased and who from, because of the need for consistency or technical compatibility.
- There is only a limited ability to develop a relationship with the supplier, so opportunities for joint working and/or innovation will not be captured.
- Where procurement is regulated, such as in the public sector, the use of one-off contracts may be viewed as a mechanism for avoiding the regulations by keeping values below financial thresholds. This is non-compliant and may lead to legal challenges, financial penalties and reputational damage.

Ad-hoc purchase
An item bought for a single and non-recurring use or purpose

Risks for the supplier include the following.

- Low-value **ad-hoc purchases** make production planning difficult.
- A failure to perform on this one contract could lose a potential client for ever, as there is no readily available opportunity to demonstrate performance improvement.

Check
Summarise the risks and benefits of using one-off purchase contracts for the purchaser and for the supplier.

Framework arrangements and agreements

It is useful to start by understanding the difference between a framework arrangement and a framework agreement.

Informal framework arrangements

A framework **arrangement** is a rather loose set-up, without any legal standing. It usually occurs when an organisation has decided for itself to limit the number of suppliers it is willing to work with and, through a purely internal process, sets up an approved list of such suppliers. There are no commonly agreed terms for working with any one of those suppliers. The purchasing organisation has simply carried out the necessary due diligence on the viability and suitability of the suppliers and approved their use.

Such a process would normally restrict purchasers within the organisation to using only such approved suppliers. This kind of arrangement may also be called an approved supplier list, an approved contractor list or (more often in the case of consultants or professional advisors such as lawyers or accountants) an approved panel.

Contractually, such an arrangement has no legal standing at all. Approved suppliers are not guaranteed any work, nor are they guaranteed any terms or conditions if such work is offered to them. Nevertheless, there are advantages to operating such a system.

The advantages and disadvantages for both purchasers and suppliers are set out in table 1.11.

Feature	Good for purchaser?	Good for supplier?
Quick access to a market of reliable and vetted suppliers for either direct purchasing or limited tendering among a small number of firms.	Yes – reduces tender process costs and speed to supply. No – limits number of potential providers so could miss the best or most appropriate provider.	Yes – better chance of winning tenders when low number able to bid. Yes – potential for high turnover of low-value orders for known client. No – no access if not on the list/framework.
Familiarity – using a known client/supplier.	Yes – ability to build trust through regular work.	Yes – ability to build trust through regular work.
Keeping list up to date with complete, current and accurate information on supplier status (e.g., financial standing, health and safety policies, procedures and declarations, data management protocols, insurances, environmental policies and actions, equality and diversity matters, changes in structure and ownership, licences and industry accreditations).	No – this can be resource intensive as all documentation needs to be checked.	No – this can be resource intensive as documentation may need to be provided separately for many databases.

Feature	Good for purchaser?	Good for supplier?
Open access to the list whereby suppliers can apply for inclusion at any time or at regular intervals, not just in response to a single advert (unlike formal framework agreement).	Yes – ability to include newly discovered potential providers. No – resource requirement for vetting new suppliers. No – risk of the lists becoming large and unmanageable.	Yes – ability to target potential customers without constraints of tender timescales. No – risk of lists becoming large and reducing likelihood of winning work.

Table 1.11 Advantages and disadvantages of informal framework arrangements and approved lists

Remember
An informal framework arrangement has no legal standing. It is essentially an 'approved list' of suppliers or service providers. It can provide a quick and easy route to pre-qualified suppliers but is resource intensive to maintain and there is a risk that good suppliers who are not on the list will be 'missed'.

Formal framework agreements

Mini-competition
A limited tender exercise, usually only on price, under the rules set out in a framework agreement; only suppliers appointed to the framework are able to take part

Direct call off
The act of placing an order under a framework agreement without having further competition

Closed system
A system or process that, once started, does not allow new entrants. A framework agreement might have multiple buyers and multiple suppliers, but once set up, no additional buyers or suppliers can be added to it

A formal framework **agreement** differs from an informal framework arrangement in that it does have some legal standing. It is **not** a contract, primarily because there is no consideration involved, but it is an overarching (or umbrella) agreement under which contracts can be created. It is intended to be legally binding on the parties from the point in time when the contract under the framework is created.

The framework agreement does not commit either party to actually enter into a contract, but it does set out the terms and conditions which will apply **if** a contract is created. **It is not itself the contract**.

Usually, there will be some terms and conditions which are not specified in a framework agreement, which need to be included in a contract created under it. The framework agreement should include a mechanism for determining price, but it will not be as detailed or definitive as a schedule of rates in a contract. Also, a framework agreement is likely to make allowance for the size of the order or location of delivery, with different rates applying in different circumstances.

At the beginning, a framework agreement is set up in exactly the same way as a contract. There will be a tender process or a series of negotiations to select which supplier or suppliers will be appointed to the framework.

The agreement will set out the following.

- How call offs can be made – whether a **mini-competition** is required or a **direct call off** can be made
- How price is calculated
- The specification – this may have various options to cater for different needs
- The duration of the agreement
- Who can access the agreement – a true framework agreement is a **closed system**

- Any limitations, such as how long past the end of the framework agreement a contract established under it can run
- The main terms to be included in the contract or the form of contract to be used, where this is intended to be a standard form

When the purchaser wishes to use the framework agreement it will issue a call-off order or call-off contract, using the terms set out in the framework agreement. This might be a direct call off or may require a mini-competition (see the section on the use of mini-competitions on the next page).

Types of framework agreements

Framework agreements can be: one-to-one, one-to-many, many-to-one or many-to-many, as shown in figure 1.7. (In this instance, 'many' means two or more.)

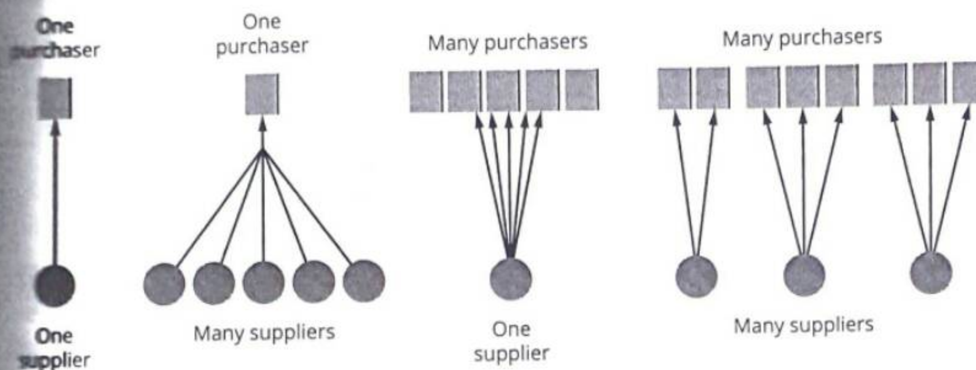


Figure 1.7 Types of framework agreement

> *Apply*
> Choose a product or service with which you are familiar. Compare the advantages and disadvantages of using a one-off purchase contract as opposed to a formal or informal framework arrangement.

Where there is only one supplier appointed to the framework, a contract can be placed directly with them as soon as the remaining terms are agreed.

Where there is more than one supplier, the framework agreement itself will describe how the call off is to be made and how the supplier is to be selected from among those available.

Direct call off

Where a framework with multiple suppliers permits a direct call off to be made (i.e. a contract placed without further competition), it should set out exactly how the supplier may be selected. Within regulated procurement, this should strictly be the supplier with the highest ranking when the original evaluations for appointment to the framework were made. That supplier should receive all call-offs until they reach capacity or unless they are not interested in a particular job. At that point, the second-ranked supplier should be approached.

In practice, this does not usually occur. It is more likely that suppliers will either be used in rotation, or that there will be preferred suppliers for particular projects which might be determined by their experience, recent performance or other

factors. There is an arguable case that this is a better use of frameworks since it makes it more likely that all suppliers appointed are likely to receive a reasonable share of the available opportunities and potentially retains an element of competition among them. If the first-placed supplier is to receive most or possibly all of the work, suppliers may be reluctant to tender unless they are confident of being in that top slot.

The counter-argument is that this would be no different to tendering for an individual contract. However, the whole point about the framework approach is that it is not intended to tie the purchaser to a single supplier for the duration of the period. If that were desired, then a term contract could be used rather than a framework agreement.

Remember
Under a formal framework agreement, direct call off is only permissible if the agreement itself says it is. The framework will also set out how the supplier to be used is to be selected.

The use of mini-competitions

A mini-competition is a tender process run under a framework agreement. The framework agreement will set out the process to be followed. It is only open to suppliers on the framework. All framework suppliers should be invited to participate, but they are not obliged to do so.

The tender will normally include price and may include limited aspects of quality. Often it will be price-only.

These are the purposes of the mini-competition.

- To allow for price to be calculated on the basis of the precise requirements
- To allow contract-specific terms to be refined
- To maintain an element of competition among the framework suppliers

The advantage of mini-competitions under frameworks as opposed to full tender processes is that they are quicker and take fewer resources. The due diligence work which will normally be included in a full tender is carried out at framework level and not repeated for each call off.

There is a risk, however, that if the framework itself is not properly managed, the due diligence checks may become out of date and purchasers may be relying on information that is no longer valid.

Contracts created under framework agreements

The only limitation on the nature of contracts that can be created under a framework agreement is what the agreement itself lays down. In principle, it could be any standard or bespoke form of contract. Equally it could be a single purchase contract or a term contract.

Remember
A mini-competition is a tender carried out using only the suppliers on a framework agreement. It is used to clarify contract-specific terms and encourage competition (particularly price competition).

Call offs

A call off or a term contract is one which exists for a fixed period of time, rather than for a specific purchase. They are used where the purchaser has a regular requirement for goods or services of similar nature which they want to be provided by a single supplier. Examples include the following.

- Servicing and maintaining equipment in buildings, like fire alarms or lifts
- Services which cannot be carried out on site (e.g., laundry for hotels)
- Supply of goods which are regularly required but where the purchaser can only stock a limited amount (e.g., stationery)

Unlike a single supplier framework agreement, all of the terms of the contract are agreed at the outset, including price.

- For repetitive services which do not vary, price may be expressed as an annual or quarterly fee.
- For goods or services which might be different from order to order, price will normally be described in a schedule of rates. There may be different unit prices for the same thing, depending on the size of the order, to reflect the efficiency of production and/or the transport costs in delivery.

A call off is the actual order placed under the contract. Typically, this will only need to state item, quantity and place of delivery. All other aspects are fixed by the contract.

Unlike the framework agreement where the supplier is not obliged to enter into a given call-off contract, under the term contract they are committed to meeting all orders placed. The key benefits and risks for both parties are summarised in table 1.12. If the contract documents are well-written and the contract period is not too long, most of the disadvantages can be avoided. The contract itself will allow for changes to be agreed which accommodate movements in market conditions or technology, or for early termination if agreement cannot be reached.

Benefits for the purchaser	Benefits for the supplier
Guaranteed delivery for the length of the contract. Agreed prices, either fixed for the duration of the contract or with a pre-agreed mechanism for price adjustments (e.g., in line with the government's officially reported rate of inflation). This helps with setting and controlling budgets. Simple order mechanisms at the point of need. As all of the contractual terms are agreed, individual orders can be quick and easy. Schedule of rates pricing enables electronic procure-to-pay systems, which gives greater control and visibility of spend.	Reasonable certainty of future demand makes it easier to plan resources and production and to predict cash flow. Simple order and payment systems reduce administration costs. Agreed specifications can reduce the costs of short-order runs. This is particularly true if the supplier can influence the specification and can produce the same product for different customers. Even with a single customer it may be more economic for the supplier to produce more than is required by a single order and hold stock for future orders.

Benefits for the purchaser	Benefits for the supplier
The value of spend and length of contract justify the costs of proper market engagement and tender or negotiation processes resulting in better value for money (see section 3.1). The longer the contract, the greater the opportunities for aligning working practices to create joint efficiencies.	The longer the contract, the greater the opportunities for aligning working practices to create joint efficiencies.
Risks for the purchaser	**Risks for the supplier**
If prices generally fall, the purchaser may be locked into a higher rate. In sectors where technology changes rapidly (e.g., computing, medicine, aeronautics), a term contract risks tying down the specification in a way that prevents innovation.	If costs of raw materials are rising but the sale price is fixed, the contract may make a loss. In long-term contracts, the ability to move production on to newer models or designs may be hampered by a need to continue serving a client with an older specification.

Table 1.12 Advantages of term call-off contracts for both purchaser and supplier

Remember
It is better to refer to contracts for a specified period as 'term contracts' rather than 'call-off contracts' to avoid confusing them with the contracts created under framework agreements.

Services contracts

As well as classifying contracts by the contract type (e.g., one-off purchase or term contract), they can also be split down by their subject matter into whether they are contracts for goods, services or works.

- **Goods** are what would normally be thought of as products, things or stuff: tangible items or materials that can be touched, stored and moved. They might be raw materials, component parts or finished articles.
- **Services** are intangible. They cannot be touched or stored. A service is something done or provided by a person or a group of people.
- **Works** can be thought of as a special type of services contract. Works contracts relate specifically to construction works, buildings, civil engineering and the like. In some contexts, works contracts can also cover the repair and maintenance of buildings and structures, but this is a complex area which varies depending on which particular set of legislation or regulations is being applied (e.g., in the UK some types of supply might count as works under the service charge regulations, but be services under the public procurement regulations). There is no short cut for the procurement and supply professional in this area. Categories simply have to be checked on a case-by-case basis. It is important to be aware that these discrepancies may exist even within a single legal jurisdiction, so matters can become even more complex when dealing with international contracts.

Implications of the difference between goods, services and works

In many areas it will **not** matter at all whether the contract under consideration is for goods, services or works. The general principles regarding offer, acceptance, consideration, misrepresentation, and so on, all remain the same for all types of contract.

The methodology for designing and drafting the contract is also very similar. The key terms and schedules discussed in the previous sections will all need to be thought about in much the same way.

Contracts can equally be for one-off purchases or for periods of time with call-off contracts. Informal framework or panel arrangements and formal framework agreements can also be used.

There are, however, a few differences that are worth consideration, as shown in table 1.13.

Aspects of a contract for services	Things to think about
Regulated procurement (public procurement)	Where procurement is regulated (normally public sector and similar nonprofit areas) the financial threshold at which the full regulated procedures apply for services will usually be the same as that for goods, but tends to be much lower than that for works. This can affect the selection of the tender procedure for those caught by the rules.
International trade	Under the World Trade Organization (WTO) rules, there are similar requirements for the trade in services as there are for the trade in goods, but they are not identical (e.g., the rules on equal treatment of suppliers applies to all goods traded by signatories to the **GATT** (goods), but signatories to the **GATS** (services) can select which services they will apply the principles to). The Vienna Convention relates specifically to goods. There is no equivalent in respect of services. It is even more important, therefore, that services contracts stipulate which legal jurisdiction will be used in the event of contractual disputes.
Key personnel	There may be key personnel (e.g., contract managers) in respect of all contracts, but for service contracts the personnel deployed on the project may be even more key. Where delivery is of a personal nature (e.g., consultancy, legal services, training delivery), the selection of the supplier may have been based entirely on the skills and experience of the individuals or team members put forward as being the delivery team. Should these personnel cease to work for the supplier, for whatever reason, then the supplier may not be able to deliver the contract to the expected standard. Contracts should make allowance for this by including terms which allow for the contract to be terminated if the replacement personnel do not meet the expected quality.

GATT
General Agreement on Tariffs and Trade, an international agreement regulating barriers to international trade, such as quotas and tariffs (a payment on goods being imported). Only applies to the trade in goods, with the purpose of encouraging international trade in goods

GATS
General Agreement on the Trade in Services, an international agreement regulating barriers to the provision of services between different countries. Similar to GATT, but only applies to services, with the purpose of encouraging international trade in services

Developing economy
A national economy which is generally held to be still developing its industrial base, financial institutions and economic infrastructure

Transitional economy
A national economy which is moving from being a state-controlled economy to a full market economy (e.g., ex-Soviet Union countries)

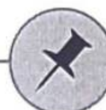
Aspects of a contract for services	Things to think about
Local knowledge	It is a legal requirement of most regulated procurement that suppliers cannot be selected purely on the basis of their location. Preference cannot be given to local suppliers. Local in this sense may mean national as opposed to international. There are exceptions to this rule in some **developing** and **transitional economies** where preference may be given for a limited period while local industry and infrastructure are developed. In the private, non-regulated sector, a wider view may be taken of the benefit, or otherwise, conferred by the location of a particular supplier. In the case of service provision, it is easier to see why location might be more important than it is for goods. Costs of transportation or travel aside, service delivery might require very specific local knowledge. This could be in respect of national laws and customs for legal, financial or other consultancy or training; it could be about local political or planning policies for anything regarding construction or infrastructure development. Some of this knowledge might be easy to obtain, but much of it may be the result of the experience of the practitioner in the field. While contractually it is undoubtedly poor practice and potentially unlawful to say that the delivery personnel must be from a certain locality, there may be good reasons to devise terms within the contract or the specification to ensure that they must be familiar with relevant legislation, policy and practice. Consideration should be given to how liable the supplier should be if they fail to do this.
Data sharing	The nature of services contracts is such that there is likely to be more sharing of data, including personal data. The data sharing protocols within the contract must reflect this. Within Europe, new data protection regulations (the GDPR) strengthen requirements in this area, as noted earlier in the chapter.
Insurance	Specific thought should be given to the type of service being provided and whether professional indemnity insurance is required.
Conflicts of interest	Conflicts of interest can arise in any contract, but they may be more likely in some types of service contracts (professional services) because of the more direct involvement of individuals in the delivery of the service. Contract clauses covering requirements in this area need to be robust and the supporting administration (e.g., regular checking of declaration of interests) is important.

Aspects of a contract for services	Things to think about
Codes of conduct	Many service contracts will involve the supplier interacting directly with the purchaser's staff and/or its customers. In doing so, it affects the perception of the purchaser's organisation and should therefore be required to act in a way that reflects the values of that organisation. A code of conduct is one way of establishing what those actions and behaviours are. To give the code real force, it should be included as a contract schedule so that breaching it becomes a breach of contract.

Table *1.13 Aspects of services contracts*

Apply
Think about a company that manufactures any kind of product and consider the variety of things it must purchase. Which of those are goods and which are services? What might the procurement officer need to know?

Remember
The difference between goods, services and works can be important if the procurement is subject to regulation and/or trade agreements as different rules or financial thresholds may apply.



Contracts for the hiring and leasing of assets

Acquiring the use of assets does not necessarily mean that they have to be purchased. Often there is also the option of hiring or leasing them.

The words **hire** and **lease** are used interchangeably. Hire is more usually used for short-term arrangements and lease for longer-term contracts. For example, you would hire a room for a meeting, but lease an office building. In legal texts, you might also find reference to a contract of bailment. Again, this is the same thing.

When goods are hired, the ownership of them is not transferred. The person or firm hiring simply acquires the use of them for a specific period of time. Because there is no transfer of ownership, there is no 'sale'. Therefore any regulations or agreements relating specifically to the sale of goods, such as the UK Sale of Goods Act or the Vienna Convention, do not apply.

The process of forming a contract for hire is the same as that for a contract for sale. There must still be an offer, acceptance, consideration, intention, and capacity to contract, in order to be legally bound.

Many of the key terms of a service contract might also apply in a contract for hire (e.g., payment terms, health and safety issues, insurance requirements), but there are also specific areas to be thought about. Key things to consider in hire or lease contracts are set out in table 1.14.

Aspects of a contract for hire or lease	Things to think about
Why hire/lease rather than buy?	If the asset is very expensive but will only be used intermittently, it is more cost effective to hire (e.g., agricultural harvesters which cost hundreds of thousands of dollars but are only used for a few days each year). Payment of regular monthly amounts might be preferable from a budget perspective to a single capital outlay. However, this has to be set against the fact that the total cost will be higher, often significantly so.
Hire the asset or buy the service?	As in the previous example, you would need to consider whether you would actually hire the harvesting equipment or whether you would contract for the service (e.g., equipment, driver, delivery to specified storage point).
Transfer of risk	Although ownership does not transfer in a contract for hire, some of the risks of ownership do. The contract must be clear on which risks do transfer to the hirer and which remain with the owner (e.g., it is normal that the hirer will be required to insure the asset).
Maintenance	Some equipment which may be leased will require regular servicing or maintenance. The hire contract may make provision for this to be part of the hire package, as is often the case with company vehicles. Equally there may be a separate contract for this either with the owners of the equipment, which is often the case for photocopiers and printers, or with an entirely different company if servicing and maintenance are risks which the contract places with the hirer. When comparing offers of contracts for hire of assets, it is important to understand what is included in each offer to ensure you are comparing like with like.
Period of hire and arrangements at the end of the period	The contract will set out how long the hire period is. It should also state what will happen to the asset at the end of that period. Is it to be returned to the owner? If so, at whose cost? Alternatively, the hirer may decide to keep the asset.

Aspects of a contract for hire or lease	Things to think about
Extending the scope of the contract	Consider a contract for the hire of multi-functional devices (e.g., a printer/copier/scanner). When the contract is put in place there might be a need for eight machines in various offices, but then the company might open a new office and require another two machines. The hire contract needs to set out not only whether it is possible to add these new machines to the existing contract, but also what happens to the period of hire if that happens. The first part of this issue is normally clear, but the risks associated with the second can be overlooked. If the original contract was for a period of five years (at which point most of the original machines would be reaching the end of their lifespan), how is this affected by adding the new machines? There are the following options. 1. The new machines are only hired for the remaining period on the original contract. 2. The new machines are also hired for five years, but the contract expires in respect of the existing machines. 3. A new five-year period commences in respect of all machines (old and new). It is very common that suppliers wish to see option 3 implemented because this can lock a purchaser into a contract for longer than they would prefer, particularly as the first batch of machines may need to be replaced at the end of the original five-year period, which might then create yet another extension to the time period. There is a danger of creating a rolling contract. Option 1 might not be viable for the supplier if the remaining period on the contract is quite short. Option 2 would seem to be the best compromise, but this could result in the hirer having different machines which could present problems in linking them to electronic print-management programmes that monitor spend across departments. Whichever option is preferred, it must be consciously chosen and clearly spelt out in the contract.
Reducing the scope of the contract	Rather than opening another office, our hirer of print machines might close one and therefore need fewer machines. The contract needs to make provision for early return or disposal of those no longer needed.

Table 1.14 Hire/lease contracts

Remember
In addition to normal considerations, the key areas to consider in contracts for hire are: the reason for that approach, which risks are to be transferred to the hirer and which will remain with the owner, who is responsible for maintenance of the asset, what happens to the asset at the end of the hire period, and what happens to the hire period if the scope of the contract has to be increased or reduced.

Case study

Lease of laundry equipment
A company managing accommodation for the elderly had a number of communal laundry facilities for use by the residents. The costs of the machines and running costs were all re-charged to the residents. The machines were leased and the re-charge to residents worked out at about $2 a week. The contract had been renewed several times, with new machines only being required and provided when the existing ones were beyond economical repair. It was calculated that a $2000 machine had cost upwards of $9000.

When the procurement team looked at renewing the machines by outright purchase, the management department declined on the basis that the residents would prefer the smaller regular outgoings to the one-off cost.

Hire purchase agreements

Hire purchase agreements are less common than they once were but do still exist. A hire purchase agreement exists where the asset is hired for a period of time but at the end of that period the intention is that there will be a transfer of ownership.

The transfer may be automatic on the payment of the final instalment of the hire charge, or it may be an option which the hirer has to exercise by paying a further consideration.

In legal terms, the contract is a contract for hire for the full duration until the final payment or the option payment (whichever applies) is made. Only at that point does it become a purchase contract.

Apply
Compare the advantages and disadvantages of a hire/lease contract as opposed to a purchase contract. Imagine you are instructed to procure new photocopiers for your company. Why might you prefer to lease them rather than purchase outright? Are there any reasons why you might prefer to purchase outright?

Chapter Summary

- There is a difference between an estimate, a quotation (or quote) and a tender. An estimate is a 'best guess' of likely cost and has no legal standing. A quotation is a fixed price that must be adhered to, it will normally only cover price (and not any possible variations or options with regard to quality) and it may be submitted via a formal or informal process. A tender is a detailed quotation submitted via a formal process. A tender may cover price only, but usually it also covers aspects of quality.
- When deciding whether to seek quotations or tenders, the costs of administering the process, along with any need for urgency and speed of process, must be considered. The process should be proportionate to the cost and risk of the purchase; there should be a robust audit trail; the process should be transparent and equitable. Estimates should be avoided.
- Key things to consider when drafting specifications include purpose, type, perspective, relevance, scope, performance, innovation, clarity, compliance with regulations, and the environment in which the contract is to be delivered. Specifications can be conformance (technical), i.e. based on inputs, or performance, i.e. based on outputs. Most are a combination of the two, setting minimum technical standards but allowing scope for suppliers to determine how best to meet the requirement above and beyond the absolute minimum.
- KPIs, the way in which they will be measured and the consequences of not meeting them should be embedded in the contract terms so that they can be enforced.
- A contract is a total agreement between the parties, not just a document. Key terms in the contract set out the rights and responsibilities of each party (what it can do and what it must do) and the remedies available to it if the other party does not meet its responsibilities. They include the specification and the pricing schedule as key parts of the agreement.
- Contracts may need to be amended during their life. It is important that they contain terms that explain when this is permitted and the process for ensuring that changes are contractually binding.
- For a contract to exist there must be an offer, acceptance, consideration, intention to be legally bound, and capacity to contract. These are complex issues which have been determined by extensive case law.
- The 'battle of the forms' is a situation where the terms and conditions of the purchaser and the supplier are sequentially superseded one by the other, as requests for quotations, orders, delivery notes, etc., are passed between the parties, each one declaring that it operates on the terms of the party issuing it. It is best managed by having formal contracts.
- Express contract terms are those which are written down and explicitly agreed between the parties. Implied terms are not written within the contract but are implied either by case law, custom and practice, or through statute law. Unless an implied term is created by statute and the statute makes it clear that it cannot be overridden, then parties are free to contract in a way that excludes implied terms.

- The Vienna Convention is a United Nations convention relating to the international sale of goods that seeks to establish a common legal framework within which to interpret contracts. It only applies to international contracts and to goods (not services). The Convention allows for the states signing up to it to exclude some of its application, either in terms of which goods it covers or by excluding certain geographical areas. The Convention includes provisions on when risk passes from buyer to seller, but these are generally excluded in favour of the Incoterms® produced by the International Chamber of Commerce, which are more flexible. The UK is not a signatory to the Convention. Any explicit terms in individual contracts will override anything implied by the Vienna Convention.
- Misrepresentation is a false statement of fact made by one of the contracting parties before, or at the time of, entering into the contract, which led or encouraged the other party to contract. It can be fraudulent, negligent or innocent. In the case of fraudulent or negligent misrepresentation the remedies are rescission of contract or damages or both. For innocent misrepresentation the remedy is rescission of contract or damages but not both.
- The differences between one-off purchase contracts, informal panels and approved lists, formal framework agreements and term (or call-off) contracts can be summarised as follows.
    - A one-off contract is for a single specific deliverable. It may be simple (a piece of machinery) or complex (a housing development), but it is self-contained.
    - An informal panel or approved list is not a contract, it is merely a list of suppliers who have been checked and deemed appropriate to contract with. The process of checking is known as qualification, pre-qualification or due diligence. Such panels are generally open for suppliers to apply for inclusion either at any time or at periodic intervals.
    - A formal framework agreement is a closed list of approved suppliers arrived at by means of a tender process. The agreement includes the terms on which any contracts under the framework with those suppliers will be awarded, including a mechanism for determining price.
    - A term (or call-off) contract is a contract with a specific supplier for a specified period of time under which a number of orders (call offs) may be placed. It is used for periodic purchases where the nature of the individual call off varies but the terms applying to all of them can be agreed. It will normally include a schedule of rates for pricing individual call offs.
    - The term 'call off' can be confusing. A 'call off' under a framework agreement will result in a contract. That contract may be a one-off purchase contract or it may be a term contract. A 'call off' under a term contract is a specific order which does not create a new contract.
- A hire contract (often called a lease contract) is one where the ownership of the goods involved does not transfer: the purchaser merely pays for the ability to make use of the goods for a period of time. Common applications are vehicle fleets and photocopiers.

End of Chapter Assessment

1. Describe the key sections in a standard contract for the supply of goods or services and appraise the relative advantages and disadvantages of using separate schedules for some elements rather than embedding all aspects in a single continuous document. **DESCRIBE**
2. Explain the 'mailbox rule' on acceptance of an offer and analyse the extent to which it still makes sense in the context of modern communication. Suggest how parties might mitigate any risks associated with this. **EXPLAIN**
3. Appraise the usefulness of the Vienna Convention on Contracts for the International Sale of Goods, paying attention to what the rules do and do not cover. **APPRAISE**
4. Compare and contrast framework agreements with term contracts, showing the relative merits of each. **COMPARE**

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CHAPTER 2

Specifications and key performance indicators

Learning outcome

By the end of this chapter you will understand the fundamentals of specifications and key performance indicators that are included in contractual arrangements made with suppliers.

Chapter overview

2.1 Analyse the content of specifications for procurements

You will understand:

- Drafting specifications and developing market dialogue with suppliers
- The use of standards in specifications
- Typical sections of a specification
- Standardisation of requirements versus increasing the range of products
- Including social and environmental criteria in specifications
- The role of information assurance in developing specifications

2.2 Appraise examples of key performance indicators (KPIs) in contractual agreements

You will understand:

- Defining contractual performance measures or key performance indicators (KPIs)
- The use of service level agreements (SLAs)
- Typical KPI measures to assess quality performance, timeliness, cost management, resources and delivery

Introduction

Specifications and key performance indicators were introduced in section 1.1, which set out how these concepts become embedded in the contract documents. In this chapter, each of them is considered in more detail from the perspective of what needs to be included and how procurement and supply professionals design and/or negotiate that content.

Throughout the chapter, whenever something is considered from the purchaser side, you are encouraged to question what that might mean from the supplier side. In some scenarios purchasers have a free hand in designing their specifications and KPIs. In many others they are the result of negotiations between purchaser and supplier. In some cases they can be dictated by suppliers, particularly where the supplier's bargaining power exceeds that of the purchaser.

2.1 Analyse the content of specifications for procurements

Five Rights
The original 'Five Rights' of procurement are traditionally: the right **quantity**, the right **quality**, at the right **time**, from the right **place**, at the right **price**

Section 1.1 showed that the specification was the most important document or section within a procurement contract. Any ambiguity, misunderstanding, lack of clarity or confusion about the specification will result in a failure against one or more of the **Five Rights** of purchasing.

1. Quantity
2. Quality
3. Time
4. Place
5. Price

This section looks at how to design specifications to ensure that each of those 'Rights' is covered.

Note that the concept of the original Five Rights is a very basic, transactional approach to purchasing, which could easily be extended into further 'Rights' to cover the source, approach to ethics, and environmental and social impact, to name a few. Modern professional procurement and supply is much more about operational risk management, stakeholder engagement, supplier relationship management and regulatory compliance, than it is about the transactional aspects of individual purchases or contracts. These aspects also need to be taken into account when drafting specifications.

Drafting specifications and developing market dialogue with suppliers

Section 1.1 looked at the ten key things to think about when designing specifications.

Check
What are the ten key areas to think about when designing a specification? Review figure 1.1 in section 1.1 if you are unsure.

Project management
Initiation, planning, execution and control of inter-related pieces of work, normally carried out by a team of people, to achieve a specified aim by a specified time

The information in figure 1.1 of section 1.1 provides a checklist against which the emerging design of the specification can be monitored, but it offers little help in how to go about it. For example, where should the procurement professional start?

Any well-run procurement exercise should be run along **project management** lines. These may be formal or informal depending on the size, value and complexity of the procurement itself, as well as on the size and complexity of the procuring organisation. The principles should apply even if they are informally applied.

One key aspect of a project management approach is that it includes a scoping stage. This sets out (among other things) the objectives of the exercise (in our

case, the procurement); the limits and constraints (e.g., anything which is not included, any budget limits or legal requirements); possible and/or preferred processes; and the roles and responsibilities of the project team. The project team can be thought of as those people directly involved in the procurement exercise at any stage, whether or not they are formally identified as a team.

The scoping stage will normally be managed by the procurement professional and should cover a number of basic questions regarding the specification.

Scoping stage questions about the specification

1. Who is responsible for producing the first draft of the specification? This could be the procurement department, the commissioning department or ongoing contract manager, or an external expert. Factors which influence this decision include the following.

    a. The structure of the organisation

    b. The level of skill and knowledge within the relevant departments

    c. Whether this is a re-procurement (i.e. replacing an existing contract) or something completely new

    d. Current workloads

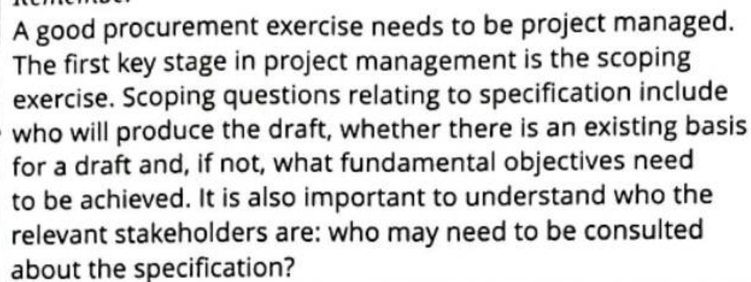
    e. Timescales

    It is important to remember here that the question relates purely to the first draft. All relevant stakeholders should have an input into the specification design. Ultimately, it needs to be approved and owned by the department responsible for managing the contract.

    The expression 'department' (as in procurement department or commissioning department) is used in a loose sense here. It could be a formal department or division of the organisation, but equally it could be a small team of people or business unit.

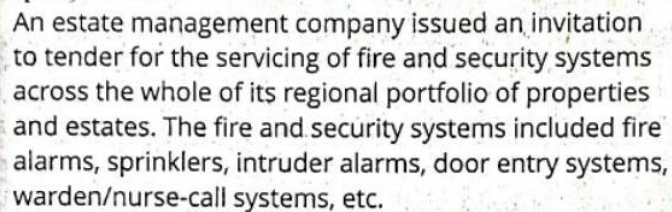
2. Is there an existing specification?
3. If so, how well does it achieve what is needed?
4. What are its identified shortcomings?
5. If there is no existing specification, what are the broad objectives to be achieved?
6. Is there an already defined minimum quality standard? What is it?
7. Are there quality aspirations above that standard?
8. Are there any technical constraints (e.g., physical constraints on where equipment has to be located, technology constraints requiring electronic systems to be able to 'talk' to each other, input factors such as availability of power or water)?
9. Are there any environmental and/or social requirements or aspirations?
10. Who are the stakeholders that need to be consulted? Note that these stakeholders will have views on questions 1 to 9 above, as well as the first draft of the specification, so be prepared to bring them in at as early a stage as possible.

With this basic information in hand, it should be possible to start designing the specification.



Remember

A good procurement exercise needs to be project managed. The first key stage in project management is the scoping exercise. Scoping questions relating to specification include who will produce the draft, whether there is an existing basis for a draft and, if not, what fundamental objectives need to be achieved. It is also important to understand who the relevant stakeholders are: who may need to be consulted about the specification?



Case study

The importance of stakeholder consultation in scoping specifications

An estate management company issued an invitation to tender for the servicing of fire and security systems across the whole of its regional portfolio of properties and estates. The fire and security systems included fire alarms, sprinklers, intruder alarms, door entry systems, warden/nurse-call systems, etc.

Many of these systems were already interlinked, for example, fire alarms and door entry systems operated on a common electronic interface. In many cases the fire alarms were also linked to emergency lighting systems.

However, there were also a number of developments, with a total of 2000 properties, where the only relevant installations were security lighting with motion sensors. These had never previously been included on a 'fire and security' contract and so were overlooked. They were not included in the tender. The relevant service charge consultation exercise was not carried out, so they could not be included at a later stage.

Arrangements were put in place to resolve the issue, but at extra cost and with a significant amount of extra administration. This could have been avoided if all of the relevant stakeholders had been involved in the scoping exercise and all of the right questions had been asked.

Writing the first draft of a specification

Specifications rarely start from a blank piece of paper. The vast majority of goods and services purchased commercially already exist in the marketplace, which means that someone somewhere is already buying them and therefore specifications already exist. A good place to start is by assembling a number of comparable specifications from different sources.

These should naturally include those already used within the organisation itself, but also variants used by other companies in the same sector and other companies in different sectors.

The ease or difficulty of obtaining sample specifications will vary from **sector** to sector and **category** to category. The more competitive the sector in a given category, the less likely it is that purchasing organisations will be willing to share. Public companies and third-sector charities are more likely to share, but arguably, in many cases they are less likely to be at the forefront of specification development.

Suppliers will always be willing to assist in specification development, as this is one way in which they can seek to influence the design to favour their own products.

In all cases, purchasers need to be aware of intellectual property issues. A **non-disclosure agreement** will certainly be requested by most of those willing to share specifications.

Any specification acquired, whether from within the purchasing organisation or outside it, must be treated as a starting point only. It should then be subject to a robust analysis and challenge by stakeholders. If several variants are being used as the starting point, the pros and cons of each of them must be identified. This will be an iterative process. At all points in the process, the ten key aspects of specification design should act as a guide to ensure that the options are considered in the light of the following points.

- What you are trying to achieve
- Any preference for conformance or performance specification
- Varying perspectives of different stakeholders
- Relevance and avoiding the inclusion of anything not actually needed
- The limits and constraints of the scope of the procurement
- Performance standards to be achieved
- Improvements sought
- Ensuring that there is no ambiguity
- Compliance with regulations and standards
- The expected operating environment

Remember that the starting-point specification will have been designed for situations where one or more of these key aspects is very different from yours. It is useful to know what those differences are. This can help those reviewing the options form opinions regarding anything in the sample specifications which is unexpected (either additional requirements or requirements not included). For example, if a specification includes provisions for machinery to operate in extreme temperatures, but the purchasing organisation will never need it to do so, there may be scope for adjustment of those requirements.

Similarly, business environments create different priorities in different companies. For example, a high-tech company committed to innovation might be willing to make a high initial outlay on the basis that they expect to replace equipment after a short life as new technology emerges. In this case, at the contracting stage, it may wish to add an equipment buy-back agreement to the specification. On the other hand, a different company may require its equipment to last much longer and wish to spread outlay over the expected long life of the machinery. In this case, when contracting, it may wish to add a long equipment warranty to the specification. It is important, even at the earliest specification stages, to consider the whole-life cost of your acquisition, and what should happen at the end of the contract or product life.

Sector
A division of the national or international economy (e.g., manufacturing sector, health sector, financial services sector)

Category
A group of goods or services that have shared characteristics

Non-disclosure agreement
A promise not to share information that could be useful to competitors and therefore harmful to the company that owns it. Also called a confidentiality agreement or memorandum of understanding

2.1

Unfortunately, a lot of the information will not be directly available. Procurement personnel will need to challenge the sample specification by relating it directly to their business scenario and seeking to understand the different scenarios that might account for things which do not appear to fit. Simply changing anything which does not appear to fit is a dangerous approach. The features may have been included for reasons which do in fact apply within the purchasing organisation but have not yet been specifically identified.

Remember

A previously used specification must always be robustly challenged to see how well it fits the proposed circumstances. Aspects which appear not to fit should be analysed to understand why they were included in the sample specification and whether this changes the view on whether or not they should be omitted or changed.

Advantages and disadvantages of starting from a pre-written specification

There are a number of advantages but also a number of disadvantages or risks of starting with a pre-existing draft specification. These are listed in table 2.1.

Advantages	Disadvantages
It is always easier to critique than it is to create. A blank page is never a good starting point for a discussion.	Time can be wasted discussing irrelevant aspects. Good project management skills are needed to close out these areas quickly.
Most of the necessary elements will be covered, acting as a prompt to ensure they are considered and a conscious decision made to include or omit.	Some elements relevant to your organisation may not be included and could be missed if the sample is totally relied on.
Using more than one sample provides ideas and options regarding different potential solutions.	Trying to combine aspects from different sample specifications can create inconsistency and ambiguity, especially if different terminology is used in different parts of the specification for the same thing.
Using more than one sample specification is a good way of understanding the quality variations available. Remember: the 'gold standard' is rarely required and there is always a trade-off between quality and price. If you are able to obtain price brackets for the various quality levels, a more intelligent conversation can be had about the specification in a full-business context (taking into account budgets, cash flows, likely lifespan, etc.).	The sample specification(s) may require a higher quality than your organisation either needs or can afford. The sample specification(s) may be aimed at a lower quality than your minimum threshold and therefore be incapable of delivering your desired outcome. It can be difficult to understand why the sample specification is the way it is, and therefore the degree to which its operating environment matches your own environment.
Cross-references to legislation, international standards or codes of practice act as prompts to check what you need to comply with.	References to legislation, international standards or codes of practice may be outdated or obsolete.

Advantages	Disadvantages
The sample specification(s) may suggest ways in which innovation can be promoted or captured during the life of the contract.	The difference in the length and format of the contracts can either lead to the inclusion of things you do not need or may suggest that items which are potentially value-adding are not possible in your scenario. There is a risk that if the specification is looked at in isolation (i.e. on the basis of an assumed form of contract) then such opportunities may simply be disregarded. The procurement role is not only to challenge the specification. It should also raise the possibility that if such innovation would add real value to the organisation, then it should not be automatically omitted from the contract, even if it will only be acceptable under a different contractual approach. Instead, the whole contractual approach should be reviewed in that light.
The sample may be drafted to align with a standard form of contract, ensuring consistency of format and terminology.	Changing the specification to align to a different form of contract may create inconsistencies.

Table 2.1 Advantages and disadvantages of using pre-written specifications

The specification must not be drafted in isolation from the rest of the contract documents. The whole package has to mesh together. It could be that discussions about the specification mean that the proposed contractual approach needs to be changed.

Shortcuts to the specification

There are a number of shortcuts that can be taken when drafting the specification. These include the following.

- **The use of brand names**. In regulated procurement, this is generally prohibited unless an alternative equivalent is permitted or the branded product has already been sourced in a compliant fashion.
- **The use of recognised standards**. (This is considered further later in this chapter.)
- **The use of samples**. Relatively rare in large commercial contracts, this could be useful if either the product or the supplier is new to the market and the contract is a short pilot programme with a view to the supplier proving it is sustainable over a longer period (e.g., in the context of textiles or agriculture).

> *Check*
> Compare the benefits and risks of writing a specification from scratch with those of using sample specifications obtained from suppliers or other purchasers.

Apply
Assume that you are working for an events company or a government or local authority with responsibility for tourism. You are required to source a supplier to provide sound and lighting for a major event. How would you go about designing the specification?

Developing market dialogue with suppliers

Remember
One of the starting points for developing a specification to meet an identified need is to use sample versions already in existence.

While sample specifications may be accessible through other purchasers in the same sector, suppliers will be much more willing to share. It is therefore important that the procurement officers open and maintain a dialogue with suppliers in the relevant market. For some procurement professionals this will become a category specialism. In many other organisations, particularly in smaller ones, procurers are expected to be generalists without this luxury of becoming subject experts, but they still need to understand the areas of supply in which they work.

The only way for procurers to understand what is happening on the supply side of the market is to talk to suppliers. Happily the reverse is also true. Supply professionals are just as keen to talk to purchasers to understand what is happening in their customer marketplace.

From the procurement side, this market dialogue should not be a time-limited conversation which is tied to a specific procurement exercise, but must be an ongoing exchange of views and ideas, so that both parties gain insight into how the relevant industries or sectors are developing. Both parties gain from this dialogue. Procurers gain insight into product development road maps and potential supply opportunities, but as trust builds between the parties they will also be able to access knowledge relating to supply-side risks. In exchange, suppliers receive knowledge of the client road map which might need to influence their own future plans.

How to develop dialogue

There is nothing complicated about opening a conversation with a potential supplier. It is as simple as finding a telephone number and name, and making a call. Before you do that, however, you need to be very clear about the following.

- What you wish to achieve through the conversation
- What you are willing to divulge about your own plans in order to get the information you want
- Any conflicts of interest that might exist and how you protect against them
- Any intellectual property issues and how you protect intellectual property
- Whether the conversation is a procurement-led conversation or a technical/operations-led conversation

Ideally, meetings with suppliers and potential suppliers should involve both procurement and technical/operational personnel. These two key perspectives will cover most of the issues that wider stakeholders will be interested in. Bringing other stakeholders into supplier/purchaser meetings can broaden the discussion and may provide additional insight, but this makes the meetings harder to arrange and more costly to run, because more people are involved. There is also a greater risk of commercial confidentiality being breached: again, because there are more people involved, but also because not all stakeholders will understand the constraints of the discussions.

There are a number of approaches which can be taken to engage with suppliers, as shown in table 2.2.

Approach to dialogue	Advantages	Disadvantages
General networking (e.g., talking to suppliers at events or via social media)	Establishes a personal connection, useful as a starting point. Can provide the basis for more in-depth conversations.	Unlikely to deliver very specific information. Risk of creating the perception of 'too close' a relationship which might raise suspicion of conflicts of interest.
One-to-one meetings	Most likely to deliver the following. • Supplier-specific product development information • An insider's view on risks to the supply chain • Direct input into specification development	The supplier may favour its own product or service. The supplier may be silent on or understate features where it is behind its competitors. There is a risk of only getting part of the story depending on which officers from each side are meeting (e.g., procurement, sales or operations). There is a tendency in some organisations for the outcomes of such conversations not to be adequately shared across departments.
Group visits (i.e. either supplier to buyer, or buyer to supplier)	Allows for people from different teams to meet their counterparts and understand the challenges from the other side of the fence.	May involve personnel not accustomed to such engagement and therefore unskilled in managing the information flow (how much to disclose or not disclose).

Approach to dialogue	Advantages	Disadvantages
Meet-the-buyer events (group events where suppliers can talk to purchasers about future programmes or specific upcoming contracts)	Useful for ensuring suppliers understand the purchaser's requirements. If held as general (rather than project-specific) events, could help inform the supply market as to the product/service development being sought by purchasers.	Often held too late to influence specification development. Traditionally focus more on process. Holding such events outside of the planning of specific procurement exercises could be more useful.
Formal negotiations or competitive dialogues on a contract-specific basis	Useful for refining a draft specification or schedule of requirements into a fully agreed and jointly developed contract specification.	Time-consuming and can be resource intensive. Usually only permits a limited number of participants.

Table 2.2 Advantages and disadvantages of different approaches to market dialogue

What kind of dialogue?

In any commercial exchange it is important to be clear on what the objectives of the conversation are. Are you looking to find out about a particular supplier's ability to meet your needs, or is it a general conversation about developments in the sector? Is it related to a particular contract due to be tendered or negotiated in the near future, or are you just keeping your knowledge up to date?

Knowing what you are trying to achieve helps to keep the conversation professional and productive for both parties.

It also ensures that the relationship is not soured as a result of, say, the supplier thinking it was potentially being offered a contract when all the purchaser was doing was establishing market capacity.

How do you manage market dialogue?

Being clear on your objectives helps you to design the best approach to the dialogue (see table 2.2).

All meetings should be documented. A note should be made of who was present, the areas discussed, the insights gained, and any follow-up action that might be useful as a result, such as revisiting proposed specifications, reviewing the timeline for procurement exercises, or checking the latest risk register in that category. Market dialogue is not purely about specification, but also about contract terms, buyer–supplier interactions generally, learning from mistakes and preparing for the future. A conversation with one supplier can inform the questions you ask of another.

Respect commercial confidentiality. Although insights gained from one conversation lead to questions in another, you must be very careful not to allow this to happen in a way that breaches the confidentiality of the first conversation. Many market dialogue conversations will happen on the basis of trust between the individuals. Many others will require a memorandum of understanding/

non-disclosure agreement, which formally binds the parties not to use the information in a way that undermines the commercial interests of the party providing the information. These agreements are generally mutual, so that the supplier undertakes not to disclose the purchaser's information, just as the purchaser agrees not to disclose the supplier's information.

Market dialogue in regulated procurement

There has long been a false belief that market dialogue cannot occur in areas where procurement is regulated. Generally, the only restriction in regulated procurement is that such dialogue must halt once a specific procurement process (i.e. the tender exercise) has commenced, unless that exercise is itself based on formal dialogue or a competitive negotiation procedure authorised by the regulations.

Outside of a specific exercise, procurement professionals working in the public sector or other regulated environments should be engaging in market dialogue to the same extent as their private sector colleagues. Arguably, because they often cannot do so once a contract opportunity has been advertised, it is more important that they do so on an ongoing basis outside of that precise scenario.

> *Remember*
> Market dialogue is an ongoing conversation between suppliers and purchasers. It can be used (among other things) to assist in developing current and future specifications. Care must be taken to ensure that supplier bias does not creep in as a result of using a single supplier to produce a specification. All information must be treated as confidential.

The use of standards in specifications

Standard
A document which sets out agreed minimum technical parameters for a product or service

Code of practice (CoP)
A set of written rules explaining how people working in a particular profession should behave. Sometimes related to particular professions, they may equally relate to anyone working in a given environment or carrying out a particular function

ISO
International Organization for Standardization (www.iso.org)

One of the shortcuts used in writing specifications is quoting recognised **standards** and **codes of practice.**

A code of practice is a recommended way of acting in order to achieve a given aim but recognises that there may be other approaches that are equally acceptable. It is therefore less prescriptive than a standard, and normally addresses modes of behaviour rather than specific outcomes to be achieved.

A standard is much more definitive. Examples include the following.

- **Company-specific standards.** Written by the purchasing organisation to specify exactly what is to be achieved.
- **Association or trade-body standards.** Often minimum compliance requirements to maintain accreditation or licensing by the relevant body (common in areas of high risk such as asbestos management, gas installations, windows and other glass products, fire protection and management).
- **National standards.** Most countries have their own national agencies covering standards in various sectors (e.g., British Standards Institute, Hellenic Organization for Standardization in Switzerland, Standards Australia, Kenya Bureau of Standards).
- **International standards.** The **International Organization for Standardization (ISO)** is, as its name suggests, a multi-national organisation

that works to produce standards which can be understood and used across the world. It was founded by the Institute for Civil Engineers in London in 1948 with delegates from 25 countries. In 2016, there were 162 countries whose national standards bodies were full members.

The ISO defines a standard as a document that provides:

> ***"requirements, specifications, guidelines or characteristics that can be used consistently to ensure that materials, products, processes and services are fit for their purpose."***
>
> *(International Organization for Standardization[1])*

At the time of writing, the ISO had published over 22,000 international standards covering a vast range of aspects of product or service quality. Some of these relate to the products and services themselves, while others relate to the general operation of the business.

Table 2.3 shows some common ISO standards that you are likely to have come across.

Business management	
ISO 9001	Quality management systems
ISO 27001	Information security management
ISO 5001	Energy management
ISO 14001	Environmental management
Product specification	
ISO 90-1	Light gauge metal containers – Definitions and determination of dimensions and capacities – Part 1: Open-top cans
ISO 3630-1	Dentistry – Root-canal instruments – Part 1: General requirements and test methods
ISO 18890:2018	Clothing – Standard method of garment measurement
ISO 5790:1979	Furniture – Chairs and tables for educational institutions – Functional sizes

Table 2.3 Examples of ISO standards

Apply

Visit the ISO website and search for standards that apply to your own industry or sector (or one in which you wish to work). Consider how you would incorporate the standard into a specification.

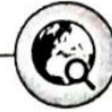
Note also that some standards might be both sector-specific and international. One example is the Institute of Electrical and Electronics Engineers Standards Association (IEEE-SA), which seeks to agree standards within its own areas of

interest. Unlike the ISO, its members are not necessarily government-sponsored agencies but are what the organisation itself calls a 'community of interested parties'. Like the ISO, however, its work in developing the standards is based on impartiality and consensus.

Case study

IEE-SA standard

The following information is an example of the highly technical nature of standards issued by some bodies. You are not required to understand the detail of this, the important point is to grasp how standards are set within a language that relates to the relevant technical specialism.



P802.3ch – Standard for Ethernet Physical Layer Specifications and Management Parameters for Greater Than 1 Gb/s Automotive Ethernet

This standard defines Ethernet local area, access and metropolitan area networks. Ethernet is specified at selected speeds of operation; and uses a common media access control (MAC) specification and management information base (MIB). The Carrier Sense Multiple Access with Collision Detection (CSMA/CD) MAC protocol specifies shared medium (half duplex) operation, as well as full duplex operation. Speed specific Media Independent Interfaces (MIIs) provide an architectural and optional implementation interface to selected Physical Layer entities (PHY). The Physical Layer encodes frames for transmission and decodes received frames with the modulation specified for the speed of operation, transmission medium and supported link length. Other specified capabilities include: control and management protocols, and the provision of power over selected twisted pair PHY types.'

(Source: standards.ieee.org/standard/802_3bv-2017.html)

How standards are used in specifications

Standards are incorporated into specifications by simply cross-referring to the relevant standard by its number and date of publication. It is important to include the date of publication. All standards are reviewed from time to time and their content changes. The absence of the publication date will lead to disputes over which version of the standard actually applies to the contract. Is it the current version or the one in place when the contract was signed?

There are two possible approaches to this.

- Fix the date of publication of the standard at the date of contract.
- State the publication date as the standard to apply at the commencement of the contract, but include wording that requires compliance with subsequent editions.

The second approach is common when referring to legal requirements in contracts, but it might not be the best approach when referencing standards.

Compliance with the law is not optional. Adherence to a standard is. While there can be additional costs involved when the law changes, it is still a fact that it must be complied with. This is not the case with updated standards.

- When a standard is updated, the differences might or might not be significant in the context of a specific contract.
- The costs associated with meeting an updated standard might outweigh the benefits of doing so.

Before deciding to include a reference to a standard in a specification at all, the standard must be reviewed in detail to ensure that it really does set out what the buying organisation is trying to achieve. If there are any aspects of the standard which conflict with the intended outcomes, or are unnecessary (i.e. they add cost but no value), then the specification must clearly indicate how these issues are to be addressed. It must be clear that in this area the written requirements of the specification supersede the standard.

The next step is then to consider what might change in the standard and whether or not that will add cost or value or both. If the market dialogue with suppliers is in place, you should benefit from the suppliers' specialised knowledge of any changes to standards under discussion. Equally, there may be hints in the general press. Processes and standards are sometimes called into question and discussions begin about possible future controls concerning areas of specification that can affect personal safety (e.g., if there is a factory fire or some other high profile disaster).

However, the fact that there is a certain amount of uncertainty and guesswork involved, especially for long contracts, cannot be ignored. The solution, therefore, is to formulate the contract in such a way as to achieve the following.

- Allow the purchaser to take a view on whether updates to a standard are to be incorporated or not.
- Provide a mechanism to incorporate – or confirm non-incorporation of – the changes by way of a contract variation or contract clarification order.
- Provide a mechanism for assessing and agreeing the cost impacts of such changes and who will bear the cost (purchaser or supplier or split).
- Set out the consequences for the contract if agreement cannot be reached in respect of the change.

> *Remember*
> Standards are published at a point in time and often go beyond what is required in the specific project being tendered. Invitations to tender and contracts should be very specific in stating whether the standard applies at the point of publication or whether there is an automatic requirement to comply with any updates. The contract must also specify the order of precedence if an update to the standard conflicts with the contract specification.

Benefits and risks of using standards in specifications

Standards set by individuals or individual companies have little to recommend them – they are in effect no more than a company- or contract-specific description of requirements. However, there are significant benefits in the use of national and international standards when specifying goods and services. As is always the case, such benefits come with attendant risks. Table 2.4 sets out both the benefits and the risks.

Benefits of using published standards	Risks of using published standards
Specifications are shorter – there is no need to repeat all of the detail included in the standard. Suppliers can understand specifications more quickly – they will know the extent to which their offer meets or does not meet the standard indicated. Where international standards are used it removes a barrier to trade, in that cross-border suppliers do not have to understand local or national rules but can rely on international definitions and parameters with which they are already familiar. Use of the standard allows for different approaches to be offered, all of which will meet the desired outcome, without procurers having to second-guess what such approaches might be. Use of the most up to date international standard should ensure that all recent influences (up to a point in time) have been considered.	In-house staff (procurement and/or operations) may not be familiar with which standards do or could apply, so simplification opportunities are missed. Staff may not fully understand the implication of the standards that they quote, and inadvertently create conflicts within the specification by drafting precise requirements that do not agree with the standard – without allowing for a precedence of terms facility. Staff may not fully understand either the quoted standard or their own operating environment and, as a result, use standards in situations for which they are not designed, thereby possibly adding cost without value. Insufficient thought can be given to what needs to happen when the standard is updated. **SMEs** may not be as familiar with international standards as larger companies, while still being capable of doing what is actually required. This can be a disincentive for such firms to respond to advertised opportunities.

Table 2.4 Benefits and risks of using published standards in specifications

SME
Small- to medium-sized enterprise, normally defined by turnover or number of staff. For example, the EU definition is a firm with fewer than 250 employees and an annual turnover less than €50 million and/or a balance sheet of less than €43 million. A quick online search will reveal the parameters that apply in other parts of the world

> *Apply*
> Section 1.2 looked at 'precedence of contract terms' clauses. Appraise the usefulness of such clauses in the context of using published standards in specifications. Why might they be needed? How would they be used?

Typical sections of a specification

At the simplest level, specifications for goods, works and services can be very different in style and structure, not least because goods are more likely to be **off-the-shelf**, whereas works and services are generally much more **bespoke**.

It is clear that a specification for office furniture will be very different in style and structure to the specification for the building of the offices in which the furniture will be placed. Both will also be very different from the specification for the legal services that the organisation occupying the building will need to run its business.

Good procurement practice should only make specifications absolutely definitive to the extent that they truly need to be so. Allowing suppliers to achieve the end result by variant means can increase competition and stimulate innovation. The

Off-the-shelf
A product or service which has been designed by the supplier and is delivered in standard form, with the purchaser unable to influence or change any aspect of the design or quality. Sometimes also called **out-of-the-box** solutions

Bespoke
Made or provided especially for a specific end user

risk for purchasers is that this may lead to a reduction of standardisation within their organisation, resulting in increased operating costs.

Table 2.5 sets out the key sections which will appear in most specifications and some of the main things to think about in each area. These are derived from a British standard (BS 7373), produced by the British Standards Institution (BSI). They are common to many specifications which may never have had reference to that standard, although the information may be provided within a different format or structure.

Version control table
List of dates of publication or agreement of each version of a specified document, together with the key changes since the previous edition

Specification section	Factors to consider
Title	Be very precise in the title. It needs to be succinct, but it should also reflect not only what is being specified, but the context of the specification. Is it for a specific tender exercise or for wider use? Your organisation might want a common specification for a particular good or service in all areas of operation, or it might need different specifications for factories in different parts of the world with different operating conditions. Think also about whether you are writing the specification as a purchaser setting out what you **need** to be delivered, or as a supplier setting out what you **promise** to deliver.
Version control/issue reference	Specifications evolve over time. Readers of the specification need to be sure they are all using the same version. Project management systems require a **version control table**, setting out version number, date, changes since the last issue and so on. Is this level of detail necessary? That will depend on the complexity of the specification. For simpler projects it will add work with no value. The minimum requirement is a unique identifier to the current edition. This simply needs to be a version number and a date of issue. This can be added as a footnote on the document or embedded in the document title.
List of contents	It is possible that the document will be used by a number of different people in different contexts. Ease of finding the relevant section is key to clarity. In a well-constructed specification there will be no repetition of requirements under different headings. If for any reason this is unavoidable, ensure that any cross-references are also noted in the contents list.
Foreword (or background)	Set out the context for the specification. Consider the comments against the title above. A good explanation of context will help the supplier (or maybe the purchaser) understand any assumptions that underlie descriptions. Understanding the viewpoint of the author can highlight possible misunderstandings at an early stage, so that they can be removed during the tender/negotiation phase and do not become locked into the contract.

Specification section	Factors to consider
Scope	Setting the limits of the requirement ensures that time and money are not wasted on areas which are simply not wanted. The more detail that can be given here, the better, as it enables suppliers to draw on similar experiences on other contracts which were either very successful or not at all successful, seeking to replicate the former and learn from the mistakes of the latter.
Definitions	As with any contract document, terms with precise meanings must be defined to avoid the potential for later disputes. • **Terminology** – words or phrases that could have more than one meaning should be defined. • **Abbreviations** should be defined, no matter how common they are. • **Units of measurement** should be defined, especially if some units have different meanings in different countries. • **Time** such as calendar days or working days, four weeks or a calendar month, etc., should be defined.
Consultation requirements	If the supplier (or conversely the purchaser) is responsible for ensuring that the requirement (or the offer) is compliant with any national or local legal requirements, this must be explicitly stated. Failure to do so could create an implied term that the provider of the specification has already checked and confirmed this aspect.
References to other documents, standards or CoPs	Any documents referred to within the specification must be clearly referenced by their full title and date of publication. Information on where they can be obtained must also be included. It must be clear whether compliance with these documents is mandatory or desirable. There should also be either a hierarchy of compliance in the event of discrepancy between various quoted documents, or a procedure to be followed to determine what approach will be taken in this event on a case-by-case basis.
Substantive requirements	This is the bulk of the specification and sets out exactly what the requirement is (where the purchaser is providing the specification) or what the offer is (where the supplier is doing so). The following should be included. • **Characteristics** – design, dimensions, ability to interface with other systems or processes, materials (to be used or prohibited), labelling requirements (e.g., eco-certifications, safety tested)

	• **Timescales** – delivery dates or time-from-order • **Response times** – on failures, defects or repairs • **Performance/reliability** – KPIs, operating conditions to be assumed, testing methods and any independent inspection regimes that apply, margins of tolerance against test or KPI criteria, reporting requirements • **Lifespan/durability** – required (or offered) useful life in normal use, and a definition of what 'normal use' shall mean • **Packaging** – in the supply of goods, protection of goods in transit, removal of waste packaging; may consider environmental consequences of different types of packaging and/or waste disposal • **Information requirements** – user manuals, operating and maintenance instructions, availability of support or replacement components • **Implementation** – will there be a need to train staff to use the equipment? Are there integration requirements with other systems or processes? How will this work? What are the timescales? Are detailed method statements required? • **Guarantees and warranties** – what guarantees are available? Are there any restrictions to ensure they are not invalidated?

Table 2.5 Key sections of a specification and factors to consider

Apply
The information in table 2.5 on the typical sections of a specification is only provided by way of example. Seek out real-life specifications – either from your own organisation, from the Internet, or through other routes such as local businesses who might be willing to share information for purely academic use. This exercise will demonstrate the number of different approaches which might be taken.

Remember
The key substantive elements to be included in a specification are: characteristics of the product or service; timescales for delivery; response times for defects; KPIs relating to performance and reliability; lifespan and durability expectations; documentary requirements for training/user manuals and/or management information; and any specific requirements regarding implementation.

Standardisation of requirements versus increasing the range of products

The standardisation of requirements is nothing new. It started with the Industrial Revolution in the late 1700s and has continued ever since. As technology and trade increase, so does standardisation. This does not mean that standardisation should be automatically assumed to be a wholly good thing. There are a number of advantages associated with standardisation, but there is also the disadvantage that it reduces the range of products available.

Advantages of standardisation

The advantages include the following.

- **Clarity of specification**. Both the purchaser and the supplier are clear as to what is required.
- **Economies of scale**. Producing standard goods enables greater automation of production processes and more rapid production, both of which increase efficiency and reduce costs.
- **Reliability**. The continuous production of goods to a standard specification enables flaws in materials or production processes to be eliminated, leading to more reliable products.
- **Service enhancement**. In both the production of goods and the delivery of services, the personnel involved become familiar with the standard product and more adept at delivering or producing it. Skill comes with practice.
- **Time-saving in the procurement process**. Using standards reduces the amount of time purchasers needed to write specifications and also the time needed by potential suppliers to understand and respond to them.
- **Accuracy of quotations**. Suppliers will make fewer errors in quoting for a standard product; their familiarity with the standard also reduces the element of **pricing for risk**.
- **Wider supply market**. Using standard products means more suppliers are able to provide them, leading to increased competition and less reliance on a few specialist suppliers for each item.
- **Narrower supply base**. Although there are more potential providers for a standard product, the number of suppliers actually used can be reduced, by reducing the variety of things purchased. This can improve the bargaining position of the purchaser, as the value of orders per supplier increases. It reduces the costs of managing suppliers (e.g., in ensuring accreditations and insurances are kept up to date, monitoring their financial standing and compliance with ethical and environmental standards). Successful suppliers receive higher value orders.
- **Inventory savings**. The smaller the range of products, the less warehousing space is required; this applies in relation to goods being produced, but also to spare parts for machinery or vehicles.
- **Reduced risk**. In the event of one supplier ceasing to trade, it is easier to switch to an alternative.

Pricing for risk
Increasing the price quoted for goods or services to include an element of insurance against having to remedy errors

Supply market
All potential suppliers capable of delivering a requirement

Supply base
The group of suppliers that a purchaser actually contracts with

Advantages of increasing the range of products

Increased standardisation **reduces** the range of products available, but there might be cases where **increasing** that range is a better option. Advantages of doing so include the following.

- **Breadth.** The more products an organisation offers, the more segments of the market it will appeal to, and the more revenue it will generate.
- **Innovation**. Reliance on existing standards does not allow for the creation of new products. A new technology or new product can have significant benefits to the firm that is first to bring it to market. Apple is the most familiar example of this, creating products which simply did not previously exist and then developing a market for them.
- **Product differentiation**. There is only so much demand for any given product. Once that level is reached, the market is said to be saturated. At that point, the only way suppliers can increase their share of the demand is to differentiate their products from those of their competitors. This may mean producing non-standard products. It is worth noting, however, that increasingly product differentiation is being achieved more through branding and marketing than it is through real differences in the product itself. This can be seen most clearly in the clothing industry, where some brands are deemed more desirable than others even though there is no real difference between the items.
- **Cultural differences**. Increasing the range of products allows access to different markets or improves success within those markets. Differences in local customs, associations and tastes may need to influence the product itself, or at least its packaging (see the case study 'Cultural differences affect product range').
- **Economic factors**. Customer wealth varies around the globe. From a supplier's perspective, this can argue in favour of producing simpler, cheaper versions of a product aimed at less affluent markets, and more complex, more expensive versions for the wealthier consumers.
- **Flexibility**. From a purchaser's perspective, increasing the range of products used may help their company to be better able to respond to changes in the market. These changes could be limiting factors (e.g., where legislative change or economic shifts affect the price of one product more than another) or the change could be positive (e.g., already being in a relationship with a supplier who is bringing an innovation to market).

Case study

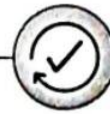
Cultural differences affect product range
In looking to create a standard mayonnaise, Heinz carried out research[2] across Europe and discovered huge variations in customer preferences with Germans preferring a sweeter version, Belgians liking something slightly more sour, and the French wanting a mustard flavour. The purpose of this research in Heinz's case was to come up with a blend that would satisfy all tastes, but it highlights an opportunity for smaller producers to capture the niche markets for those precise preferences.

Alternatively, the difference may only be in the packaging. The drinks manufacturer Red Bull uses the colours red, silver and blue on its cans in North America because of the associations of those colours in the USA (red for

courage and blue for youth), while in China the cans are red and gold (the Chinese colours for wealth and luck).[3]

Check

Compare the relative advantages and disadvantages of standardisation over having an increased range of products in an economic sector or product/service category with which you are familiar.



Including social and environmental criteria in specifications

Social and environmental criteria are increasingly being included in specifications. It is important for the procurement and supply professional to understand why this is happening in a general sense, why it is worthwhile in a business sense, what kind of criteria might be appropriate, and how to go about including them in a specification.

Increase in the use of social and environmental criteria

There are a number of driving forces for the increased use of such criteria. Some are based on ethical considerations which are commonly accepted, some are consumer driven, some are driven by the demands and policies of other influential stakeholders (such as funders, regulators or governments) and finally, some are driven by direct economic pressures. Table 2.6 sets out some examples under each heading.

Reasons for including social or environmental criteria	Examples of criteria
Ethics Labour conditions (including modern slavery, child labour, etc.) Bribery and corruption	Compliance with international labour standards Support for education programmes aimed at reducing child labour Adult education programmes aimed at ensuring workers understand their rights
Consumer-led Changing demands Willingness to pay premium prices Brand reputation Boycotts and protests in response to damage or injury to property, the environment or people	Organic production Ethical trading labels (e.g., Fair Trade) Environmental labelling (e.g., Forest Stewardship Council; Marine Stewardship Council; **GHS** labelling) Avoidance of certain inputs, ability to trace raw materials (e.g., conflict minerals)
Stakeholder pressures International agreements Government policies	Waste reduction Waste separation and recycling Energy use/carbon footprint measures

Globally harmonized system for the classification and labelling of chemicals (GHS)
An international standard for labelling hazardous substances

Reasons for including social or environmental criteria	Examples of criteria
Proposed regulations (not yet implemented) Internal policies and marketing strategies Funding agreements	Water conservation Community initiatives Training and employment initiatives Use of local and/or SME firms in the supply chain
Economic incentives Cash savings Process efficiencies Skills shortages/talent management	Waste reduction Energy and water use reduction Training and apprenticeships

Table 2.6 Reasons for increased use of social and environmental quality criteria

Apply
Review table 2.6 and think about your own industry or sector (or one in which you wish to work). Consider how the criteria listed might be used. Can you identify any others? If so, which of the motivation factors apply?

Remember
Social, environmental and ethical criteria are becoming increasingly important. Driving forces include regulation, consumer and other stakeholder pressure, more informed stakeholders, and cost savings from waste reduction.

When to define social and environmental criteria

Although the precise detail of the criteria will need to evolve or be defined alongside the refinement of individual specifications, this must not be done in an ad hoc manner. The organisation should have an overarching strategy or policy which sets out the social and environmental objectives to be pursued via procurement and the supply chain generally. Some of these will be about the specification, but that must be tied into other aspects of the sourcing strategy.

Particular thought needs to be given to supplier selection and monitoring processes and to the normal scope of contracts. For example, a supplier management strategy which favours smaller suppliers will not work well with an environmental approach that requires significant capital investment by suppliers. Very short-term contracts do not easily support apprenticeships and other training programmes.

It is important therefore that, at a strategic level, all internal stakeholders understand how the various organisation aspirations, strategies and policies impact on the procurement decisions and potential outcomes. Naturally, it is equally important that the personnel designing the specifications and procurement processes fully understand those policies and strategies.

Good procurement should involve ongoing study of the supply market (and the reverse is true for suppliers who should be keeping a watch on their customer base) and for large, high-value or high-risk contracts there should be contract-specific 'market warming' or pre-market engagement activity.

All of these should include analysis of what is feasible and, more importantly, what is effective and efficient in terms of delivering social and environmental gains. Feasible means that it can technically be achieved; effective means that it can deliver the objective; and efficient means it is technically able to deliver the objective at an acceptable cost.

Can you really get something for nothing?

Particularly in the public sector, there is a tendency to think about social and environmental aspects of a contract as being an add-on. The term '**social value**' is often used to cover such criteria.

Social value
The output from a contract that benefits society at large, rather than the purchaser or end user (sometimes also called community investment or corporate social responsibility)

The concept of added value suggests a belief that you are getting something for nothing. This is naive. Every item in the specification has a cost attached to it. However, it may not necessarily be clear whether that cost is higher or lower than the alternative. For example, if your specification states that 80% of production waste must be reused or recycled, there are costs of collection, sorting and either feedback into use or the recycling process itself. However, that cost might actually be less than the combined cost of simply disposing of the waste to landfill and using virgin input materials. In this case, the net cost to the supplier of that specification requirement could be neutral if it is something they are already doing – or, it could be a saving if this specification is the one that prompts them to do it for the first time.

Other criteria may have additional costs attached. This might be true for all suppliers or only for some suppliers. If the requirement will disproportionately affect some potential suppliers, purchasers may want to consider whether that matters. It could simply be a reflection of the efficiency of the marketplace, with competition doing what it is intended to do: allowing the most cost effective suppliers a competitive advantage over the less-able ones.

However, there may be reasons for wanting to **level the playing field** by allowing a price adjustment in evaluation for some providers. Such circumstances could include wanting to ensure national supply for reasons of national security or defence, maintaining security of supply for purely commercial reasons, or alternatively simply wanting to spread the risk across a number of providers.

Level the playing field
Take action to remove an advantage or disadvantage that only applies to some parties

Note that the use of such price premiums is not permitted in most public-sector procurement regimes, although it is allowed in some circumstances in developing countries.

The impact on price

Where there is an additional cost associated with the social or environmental criteria, a supplier has three ways of covering this.

- Treating it as a general business cost and increasing the overheads element of price
- Increasing the price of the goods or services being delivered
- Absorbing the cost and reducing the profit margin

There is no definitive best option here. If the criterion is something that might feed through into a general change in production methods, then initial outlay might be treated as a capital item, funded through overheads. If it is a one-off that applies to this contract only, logically it would sit within the direct pricing for the contract. If the contract is particularly important and/or the market is very competitive and market-share is important, it might be necessary to accept the lower profit.

The need for purchaser insight

Regardless of how the supplier treats the additional cost of such criteria, purchasers should seek to understand what that cost element actually is. Without this information the real value of including the criteria cannot be assessed. There may be other more cost effective ways of achieving the same objective or the increased cost may be disproportionate to the impact achieved.

Monitoring social and environmental criteria in practice

As with any element of a specification, the purchaser needs to know that what is being paid for is actually being delivered. This can be difficult to achieve. Most specification deliverables fall within the purchaser's sphere of operation as inputs into their own business. Social and environmental elements may not be visible on the surface or in the performance of the goods or services, especially if they relate to methods of production. Monitoring these aspects will include audits and site inspections of the supplier's operation. The detail of how to conduct such audits is beyond the remit of this module, but it can be a complex and costly exercise, especially in global supply chains. If this work is not done, however, there can be no certainty that the specification is being complied with.

> *Remember*
> Social and environmental criteria may add to the cost of delivering the specification – but this is not always the case. Purchasers should seek disclosure of costs associated with social and environmental criteria to ensure that costs are not disproportionate to gains, and must monitor suppliers closely to ensure that the requirements are being met. Monitoring is likely to need on-site auditing of suppliers.

Incorporating the criteria into the specification

Social and environmental criteria should be written into the specification in the same way as any other aspect of the requirement.

- Use international standards where these exist.
- Ensure that the inclusion of the criteria does not create a conflict with other aspects of the specification.
- If different aspects are specified by reference to standards, ensure that the standards do not themselves create conflicts.
- Include an order of precedence for standards if there are conflicts (or allow for such conflicts to arise if one or more standards is updated during the life of the contract).
- Be clear whether the requirement is a minimum standard, a mandatory level, or an aspiration or target. This can be important in determining whether failure to meet the standard would constitute a fundamental breach of contract.

Social and environmental criteria in public sector contracts

Social and environmental criteria are increasingly encouraged in public sector contracting. Some examples can be seen in the following organisations.

- In the UK: The Public Services (Social Value) Act 2012[4]
- In Australia: The State of Queensland, Australia's Department of Housing and Public Works Social Procurement Guide[5]
- In South Africa: Preferential Procurement Policy Framework Act No. 5 of 2000[6]
- In the USA: Socioeconomic Programs for Small Businesses[7]

These are all aimed at using public money to create public good, via procurement of goods and services rather than by direct government spending or subsidy.

There is generally a requirement that the social benefit to be achieved must be related directly to the nature of the contract.

The normal requirements of transparency always still apply and, except in cases of set-aside or preferential programmes, where the preference is intentional, the social criteria cannot be used to undermine the equitable treatment of tenderers.

Implementing the policies set out in these guides and regulations (and the many others that exist around the world) requires a combination of tender process design and supplier evaluation methods, as well as direct criteria in specifications. One thing for procurers to remember is that if the process is designed to encourage certain types of firms to tender for the requirement, this will be wasted if the specification is framed in a way that they cannot deliver.

Case study

Using smaller works packages (lots) to encourage SMEs

The most recent public procurement directive in the EU (2014) requires member states to break large contracts into smaller packages, known as 'lots', in order to encourage more participation by small and medium sized enterprises (SMEs). Where contracts are not broken down into lots, the purchaser has to give a reason for this in the published advertisement inviting tenders or expressions of interest. However, some markets simply do not exist and the division of a contract into lots will not create them.

When a housing association split its requirement for kitchen refurbishments into nine lots, with restrictions on permissible combinations of lots, to enable small and local firms to bid, the smallest lots that were directly aimed at very small, very local providers received no interest at all. The reasons for this were not specifically analysed, but it may be that it was difficult for the targeted firms to meet other aspects of the specification or qualification criteria.

The role of information assurance in developing specifications

Information assurance (IA) is the name given to the processes and methods used to protect information systems, databases, computer systems and networks, etc.

The five key elements or 'pillars' of IA are as follows.

- **Integrity**: ensuring that the data is not falsified or tampered with. This includes anti-virus software; policies relating to the use of laptops and external drives such as memory sticks; and codes of practice for users (e.g., in the event of receiving suspicious e-mails). All of these aim to protect against malicious codes entering the system, which could alter or destroy data.
- **Availability**: ensuring that the data can be accessed by those with the relevant authority when they need it. This includes general maintenance of systems to keep them bug-free and measures to protect against malicious codes entering the system, e.g., those that cause systems to overload, crash or block access.
- **Authentication**: ensuring that users are genuine and who they say they are; ensuring messages come from legitimate sources. This includes the use of passwords and other access keys.
- **Confidentiality**: ensuring that the data can only be accessed by those with the relevant authority. This includes the use of passwords, different access levels by job role, encryption and other access restriction methods; policies relating to screens being closed when not attended.
- **Non-repudiation**: ensuring that people cannot deny having taken actions which they did. This includes the use of automatic audit trails so that any changes made to information are logged by user, date, time, etc.

Remember
IA applies specifically to the technical ICT systems in which data is managed, stored, processed or exchanged.

IA should sit within a wider context of information governance (IG), which includes the protection of information that is managed outside of such systems and goes beyond the five pillars of IA. Despite the advance of technology, a lot of information in commercial organisations can be found in paper format, either because it is still stored and processed that way or because it has been printed out for a specific purpose, e.g., to be worked on or used in a meeting. IA only protects the data and information held within systems. The wider IG approach includes training and policies relating to general data management, such as these examples.

- A 'clear desk' policy, i.e. no paperwork to be left on desks when not in use
- Requirements for all filing cabinets to be kept locked
- Control of visitors to areas where data is being processed
- Control of the destruction of paper copies

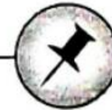
The two key roles for IA and IG in developing specifications are as follows.

- Ensuring that the specification is based on valid and accurate data; for example, that the likely usage rate of spare parts is forecast on good historic information and future projections. If such data is unavailable, specifications may be based on guesswork resulting in over- or under-ordering. If the data has been altered, the wrong technical specifications (e.g., size) might be used.
- Ensuring that the specification itself includes requirements for meeting the necessary standard of IA in delivery of the goods or services. The need for this is evident where the goods and services relate directly to ICT hardware, systems or software. But many other contracts also now include elements of

computerisation, for example, vehicles and heating boilers now have systems that monitor activity and predict servicing needs ahead of breakdowns. During the development of the specification it is important to consider what information may be collected, used or transmitted and what protective measures are needed.

IA and IG also have a wider role in the procurement process, especially where electronic tendering platforms are used, in ensuring that the process itself remains unthreatened by potential breaches of the systems.

Remember
Information assurance only relates to computer systems and networks. It needs to be supported by a wider information governance framework which covers all aspects of controlling the data, information, knowledge, etc., held within the business. Information governance includes paper documents, control of visitors, verbal communications, etc.



2.2 Appraise examples of key performance indicators (KPIs) in contractual agreements

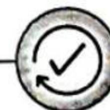
Section 1.1 considered the need to include key performance indicators (KPIs) within a contract to ensure that they can be enforced. This section looks at examples of KPIs in more detail with a view to understanding how to define and implement KPIs that are actually useful.

Defining contractual performance measures or key performance indicators (KPIs)

The purpose of KPIs

As already seen, the purpose of the specification is to set out exactly what the purchaser expects the supplier to provide, in terms of the characteristics of the goods or services, timeliness, pricing and delivery: essentially the Five Rights of procurement.

Check
Remind yourself of the Five Rights listed at the beginning of section 2.1.



Naturally, it is for the purchaser to understand what 'right' means in their own context. This will depend on the huge number of factors and influences that define the organisation and its operating environment. The 'right' quality for a luxury brand will be different to that for a budget brand.

The purpose of KPIs is to measure how well the contract is performing in delivering those elements. It is important to understand that the performance is a function of the contract, not just a function of the supplier. While the majority of KPIs do measure supplier activity, that activity can be influenced for good or ill by the purchaser's actions or indeed the structure of the contract itself.

It is worth considering whether there also need to be purchaser KPIs. This does not mean procurement team KPIs – as used for assessing the effectiveness and efficiency of procurement as a business function – but contract-specific KPIs. These are still not common practice, but may be something that suppliers will increasingly seek to have incorporated into contracts. Measures that might be considered include the following.

- Number of payments made within terms (a very common complaint among suppliers is late payment)
- Timeliness of orders, e.g., the number of urgent orders as a percentage of total orders
- Accuracy and completeness of orders

Performance management, which is the purpose of having KPIs, is not only a means to control poor performance. It should also highlight, encourage and reward excellent performance.

How many KPIs do you need?

There is a modern affliction of measuring things simply because one can. This creates work without adding value. It takes time and money to collect and interpret KPI data. It therefore makes sense to limit the number of KPIs and only use them to monitor and manage what really matters.

This might go beyond the Five Rights to take into account other areas of risk (e.g., health and safety) or, equally, it might be that one or more of the rights is so fixed (e.g., price) that it does not need to be performance managed.

Author and marketing blogger Laura Tyson describes useful KPIs as falling within the IPA rule.[8] An interpretation of her rule states that each KPI should do the following.

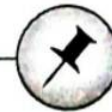
- Be **important**. There is no point measuring or trying to manage things which neither add nor detract significant value. Remember that monitoring and responding to KPI information is costly in terms of time and money.
- Relate to a **potential improvement** or a **potential problem**. If the measure simply confirms an unchanging state which cannot be influenced, the costs of monitoring are wasted.
- Fall within the **authority** or **ability** of the parties to influence the results. Monitoring KPIs simply involves looking at what they tell us about performance; in order to manage them, you must act on those results.

Accordingly, if the measure or indicator you are considering is not important, does not relate to a potential improvement or problem, and/or you can do nothing about influencing future results, then it should not be used.

It should not be necessary to have more than five or six KPIs. The word 'key' in this context means 'most important'. Once you exceed about six measures, you are clearly starting to look at less important things.

An absolute rule is that the costs of capturing and analysing the KPI information must never exceed the potential benefits from improvement or likely costs of the potential problems occurring.

Remember
KPI measurement is about improvement. The measures must be about things which are important, which relate to potential problems or potential improvements, and which can be influenced. The costs of capturing the information must never outweigh the potential benefit from avoiding the problem or generating the improvement.



Apply
Think about something commonly bought by your organisation or one in which you would like to work. What are the most important aspects or features of that product or service that you think should be covered by key performance indicators?

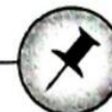
Types of KPIs

There are three main types of data used in KPIs.

- **Binary measures**. This is where only one of two options is possible. They are yes/no questions or pass/fail measures. Either a project was delivered on time or it was not.
- **Numerical measures**. This is the most common type of measure, where a range of solutions is possible. The measure may be a definite number (e.g., actual number of orders incomplete or otherwise inaccurate during the time period) or as a percentage (e.g., number of inaccurate orders as a percentage of the total number of orders).

  There are arguments for and against both approaches. For example, if variations on a contract meant that the original contract sum was exceeded by 2%, that might not seem too bad. If it was a $25 million contract, however, the figure is significant. Conversely, an overspend of $50,000 might sound like a lot, but if that were on a $25 million contract, it would be less significant. Any overspend is clearly to be avoided if possible, but the example illustrates how figures are interpreted if they are not contextualised.
- **Qualitative or subjective assessments**. These are pure opinions about how well or otherwise the goods are performing or the service is being delivered. Most often, these will be linked to, or converted into, a numerical measure (e.g., users may be asked to provide ratings of **unacceptable**, **poor**, **adequate**, **good**, or **excellent**, which are then converted into a 0 to 4 score). However, such satisfaction surveys often also include free fields for respondents to explain **why** they feel the way they do, and what they might have liked to have been different. It can be difficult to fully incorporate such commentary as part of the KPI itself, but it does provide useful context for determining how to manage it.

Remember
Some of the data captured for KPI measurement may not be directly usable as a measure, but can still provide useful context for deciding the correct management response to the performance level being achieved. This is particularly true of qualitative assessments.



Sources of data and who controls them

All KPIs are dependent on the availability of the relevant data. A lot of the information required for the most common KPIs already exists in one or more systems.

- Cost data can be derived from both the purchaser's and the supplier's ordering and finance systems.
- Delivery of goods and services will be evidenced through ordering and receipting records.
- Health and safety records are often required to be kept by law.
- Help-desk and complaints departments will retain records of their activity.

It should already be clear that some of this information is acquired by the purchaser, some of it by the supplier. Some of it may be in linked systems (e.g., procure-to-pay systems which cover everything from order, through delivery and invoice, to payment). There may also be bespoke systems to which both parties have access and can feed in their share of the data.

Such systems are usually electronic databases and computerised processing systems but, in some cases, records may still be paper-based. These records still qualify as a system for the purposes of data collection, but they are highly inefficient and difficult to manipulate.

Using information from existing systems clearly reduces the costs of collection, but there are potential problems with this approach. There is a risk that KPIs are designed around the available data, rather than being constructed to 'measure what matters' – even if that means collecting additional information.

Check

What difficulties might there be in measuring the following KPIs?

- Number of incomplete orders
- Late deliveries
- Non-reportable accidents and near misses

Think about the data you will need, who owns it, and how easy it is to access.

Case study

Potential KPI data problems

When there was a change of political leadership at a London Borough Council, the council's own scrutiny committee investigated the housing repairs service, part of which was provided by the council's subsidiary and part of which was provided by a commercial contractor. The KPI results were consistently high.

'As part of the scrutiny inquiry, members of the committee listened to fifty randomly selected recordings of telephone calls from residents to the repairs hotline. They found that 42% of these related to problems with previously reported repairs. This was at odds with the official KPI data showing that over 90% of people were satisfied with their last repair and 79% of repairs were completed in one visit. A further 32% of the calls

concerned missed appointments, again undermining the KPI reporting which said 99% of appointments were kept.'

'To add to this, the calls showed that operatives would usually give a new reference number, even if the call was about an existing, uncompleted job. This meant the KPI would often count multiple repairs, even if only one had actually been carried out, and many would be recorded as completed within the target timescales, even if they took longer in reality. [...]'

'It was clear from listening to the satisfaction survey that tenants did not understand that when they gave a rating of '3' out of '5', they were stating they were satisfied with the service. The rating system was rarely explained to tenants before they gave their answer. In three examples, tenants who angrily criticised the quality of the service they had received went on to give a rating of 3 or above – which would show up as 'satisfied' in the KPIs. The results were further skewed in favour of a higher satisfaction rate by the practice of only calling people with recently completed repairs, which meant that those whose repairs had been outstanding for weeks and sometimes months were not being asked for their opinion of the service.'

(Source: www.unison.org.uk/content/uploads/2013/06/On-line-Catalogue212803.pdf)

Careful thought needs to be given to how the KPI data is collected and stored. Some of the key things to consider are set out in figure 2.1.

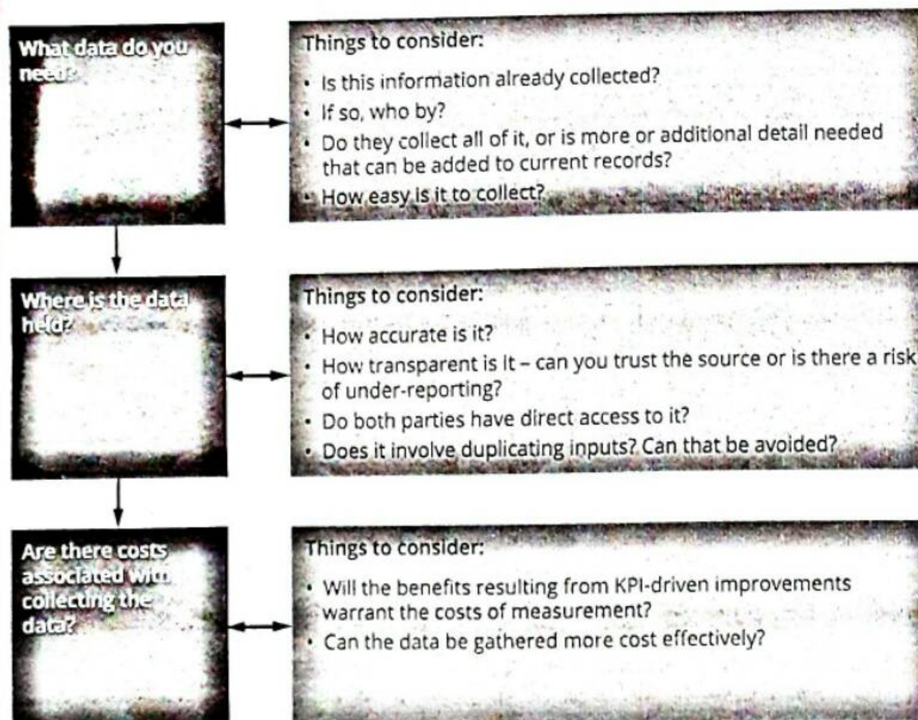
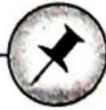


Figure 2.1 Considerations when defining KPI data

Contractual remedies for enforcing KPIs can only work if the performance level can be determined with a reasonable degree of certainty. To encourage such certainty, it can be helpful for each party to have a right to audit the information used by the other party to determine KPI outputs.

That is not as simple as it sounds, since granting such a right of audit might permit access to some highly commercially sensitive areas of the purchaser's or supplier's accounting or operating systems.



Remember
KPI data must be easily accessible and capable of being trusted by both parties.

Converting a measure into a score and setting targets

A metric (or measure) alone is not very meaningful. For example, in a given sector, if 87% of deliveries are accurate and on time, is this an extremely good or a rather poor result? What impact does having the other 13% either inaccurate or late or both have on the business concerned?

Converting a measure into a score involves understanding what 'good' means to the organisation concerned. A common method of converting KPI measures into performance scores is to use a 0 to 4 scale, as shown in table 2.7.

Score (0 to 4)	Performance/measure
0 = unacceptable	A breach of contract
1 = poor/below standard	A situation which cannot be allowed to continue
2 = meets the requirement	Complies with specification, but does not go beyond it
3 = good/very good	Exceeds the specified requirement, without adding additional costs or creating waste
4 = excellent	A significant improvement on the required standard, without additional cost

Table 2.7 Performance of KPI measures on 0 to 4 scale

Where a binary measure is used, it is commonly stated that the only possible results are 0 or 4 – the worst or the best outcome. Another, and perhaps more accurate, interpretation is that the only possible results are 0 or 2. It meets the requirement, or it does not. As an example, consider the common health and safety KPI of number of accidents, where the target is generally zero. One of the following will apply.

- There were one or more accidents, which does not meet the requirement and so scores 0.
- There were no accidents, which meets the requirement and so scores 2.

Is it possible, on this KPI, to exceed the requirement? A 'negative accident' would be a freak event which left the party involved healthier than they were prior to it. This is unlikely in any commercial situation.

Where a numerical measure is used, the range of results falling within each of the scores 0, 1, 2, 3 and 4 has to be determined. This is a value judgment on the part of the designers of the KPI and depends on these factors.

- The severity of the consequences for inadequate performance (scores 0 and 1)
- The degree of tolerance or otherwise against the specification (score 2)
- The targets set for improvements (scores 3 and 4)

Tolerance against specification

In some organisations there is a tendency to misunderstand the relationship between the specification and KPIs, and as a result to misuse the KPI concept. KPI measures can undermine the very point of the specification.

For example, suppose the following.

- The specification states that all deliveries must be made within 28 days of order.
- There is a KPI to measure how many deliveries are made within 28 days.
- The KPI target is 95%.

This creates a contractual conflict. The contract says **all** within 28 days; the KPI suggests that 'all' only means 95%.

This underlines how important it is to be clear on what elements of the specification are absolutely mandatory and that there is tolerance or option. Where tolerances are allowed, the specification should refer to the KPI targets.

Setting targets

Part of the purpose of having KPIs is to drive improvements in performance. Therefore targets should be set against criteria that any such improvements can be compared with. This is essential if incentive payments are to be used.

It is now a common business concept, but worth recapping, that any target used must be SMART (see table 2.8).

SPECIFIC	For example, the measurement of timeliness of deliveries could be any of the following. • The actual number of missed delivery dates • The percentage of deliveries on time • The average time from order to receipt Whatever is used must be a specific number.
MEASURABLE	Targets must be capable of being measured, even where what is being measured is the user's perception. It is important to set out exactly what the measure is and how it will be determined.

ACHIEVABLE	The purpose of the target is to drive performance. It cannot be too easy to achieve, or it will serve no purpose. On the other hand, if it is too difficult, then it will be counter-productive. It may well disincentivise efforts to improve performance, since any effort expended will still be met with a negative response.
RELEVANT	The target must be relevant and relate to something which matters in terms of the objective to be achieved.
TIME BOUND	Time bound (sometimes expressed as time-limited) refers to the time period within which the relevant level must be achieved, or the deadline by which it must be achieved.

Table 2.8 SMART in relation to targets

Other considerations to bear in mind when setting targets include the following.

- What value will an improvement in a particular KPI deliver to the business? Ideally this should be able to be converted to a cash value (either in savings, cost avoidance or increased sales).
- What will it cost to deliver the improvement and who will bear that cost? There may need to be capital investment, such as new machinery with a greater capacity or speedier output, or additional labour input. These are costs which the supplier is likely to seek to recover at least in part through the contract. There may also be internal costs. For example, in order for the supplier to improve on the order-to-delivery time, the purchaser may need to alter its ordering processes.
- Are there likely to be any unintended consequences? If the supplier diverts resource to one aspect, will it cause detriment in another? Requiring ever shorter delivery times for non-urgent items can increase the costs of delivery, putting pressure on pricing. It may be more important for the support personnel to be able to fully resolve the query on the first call, than for them to be able to answer the phone within 30 seconds.

Case study

The risks of goal setting

An often-quoted example of the risks of setting goals without considering the overriding context is that of the Ford Pinto. This late 1960s/early 1970s motor car was driven by a goal to produce a car 'under 2000 pounds and under $2000'. It seems that in the rush to production, safety testing was overlooked or much reduced and the car's fuel tank had a tendency to explode when involved in a rear-end collision. A number of people died.

(Source: adapted from: Silverthorne, S. (2009), When Goal Setting Goes Bad [online]. Retrieved from: www.hbswk.hbs.edu/item/when-goal-setting-goes-bad [Accessed on: 14 November 2018])

Five steps to defining KPIs

This information has been summarised into five steps for defining KPIs in figure 2.2.

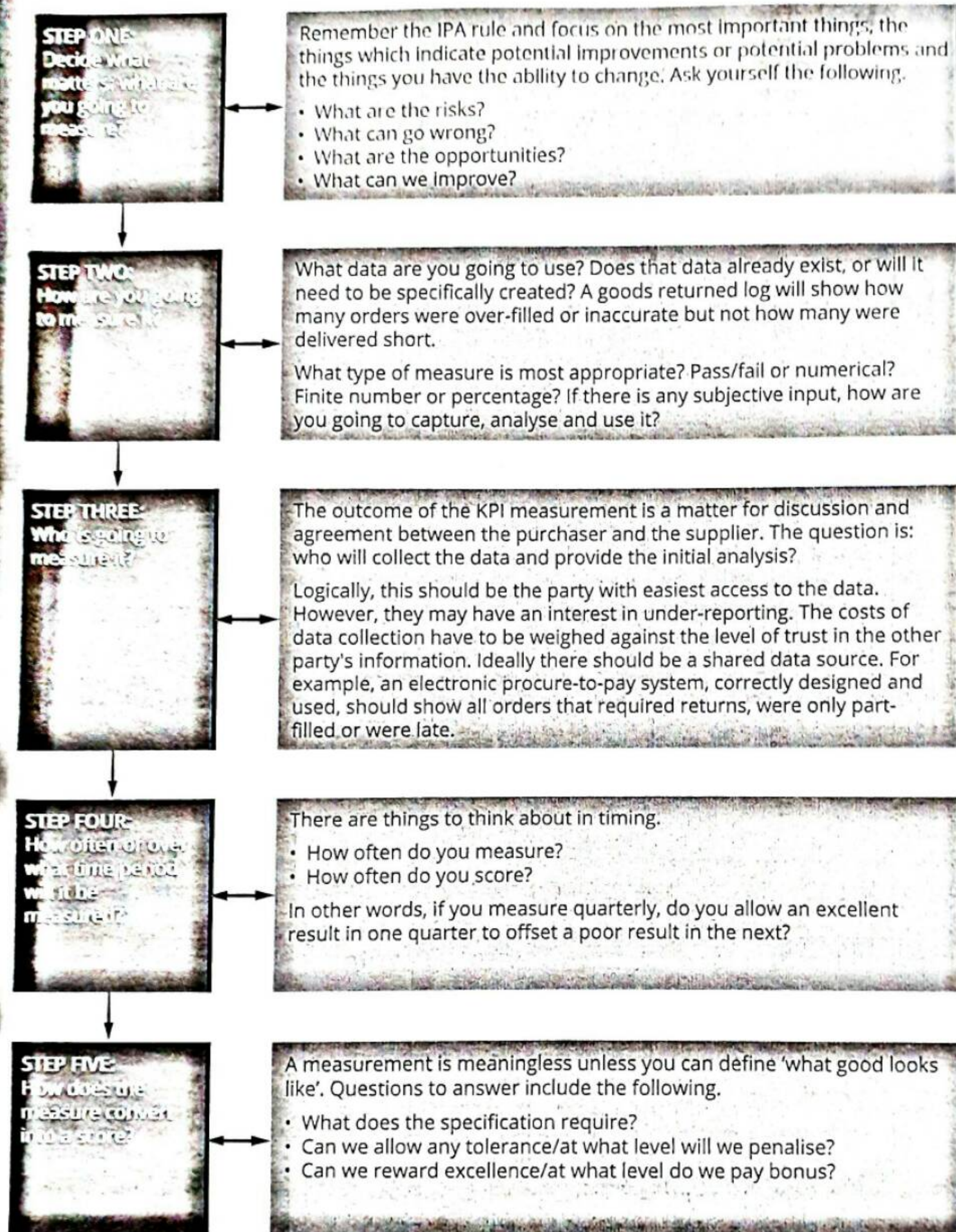


Figure 2.2 Five steps to defining KPIs

Apply
Imagine that you are responsible for purchasing next season's team strip for a premier league sports team. The design has been agreed and you are inviting bids from manufacturing companies. Using the steps in figure 2.2, define three or four KPIs that would be appropriate for the contract to supply the team kit.

The use of service level agreements (SLAs)

Remember
KPIs are measures of the outputs of activity.

By attaching KPIs to a concept of 'what good looks like', KPIs can be converted into scores which indicate the degree to which they meet the specified requirements.

Targets – either with or without bonus payments – can be set to drive performance levels to improve above the baseline required by the specification. Penalty clauses or service credits can be used to compensate the purchaser if targets are not met.

Service level agreement (SLA)
An agreement between the provider and the user of a service that details what performance and quality will be provided; this agreement is legally enforceable if it is referred to in a contract

The detail of how KPIs will be monitored and the actions or consequences resulting from scores achieved must be documented and agreed between the parties. This detail may be embedded in the specification or the main body of the contract, or it may be set out in a **service level agreement (SLA).**

What is a service level agreement (SLA)?

An SLA means different things to different people.

- It can refer to a non-contractual agreement between different divisions or departments within a single organisation.
- It can also refer to a single document within a suite of documents that make up a contract.
- It is often incorrectly used to mean the entire contract.
- In some circumstances it may be a side-agreement, which is not part of the main contract itself, but which is still intended to be legally binding.

When talking about SLAs, it is important to know which of these is meant, so that all parties have a common understanding of the status and application of the document under consideration.

The nature of an SLA does not, however, fundamentally change, whatever its status might be. It is always an agreement between the provider of a service and the recipient of that service, setting out the quality standards of various aspects of the service, actions to be taken if those standards are not achieved, the consequences if such actions do not resolve the problem, and (where applicable) the consequences of such standards being exceeded. To understand this fully, see the details in figure 2.3.

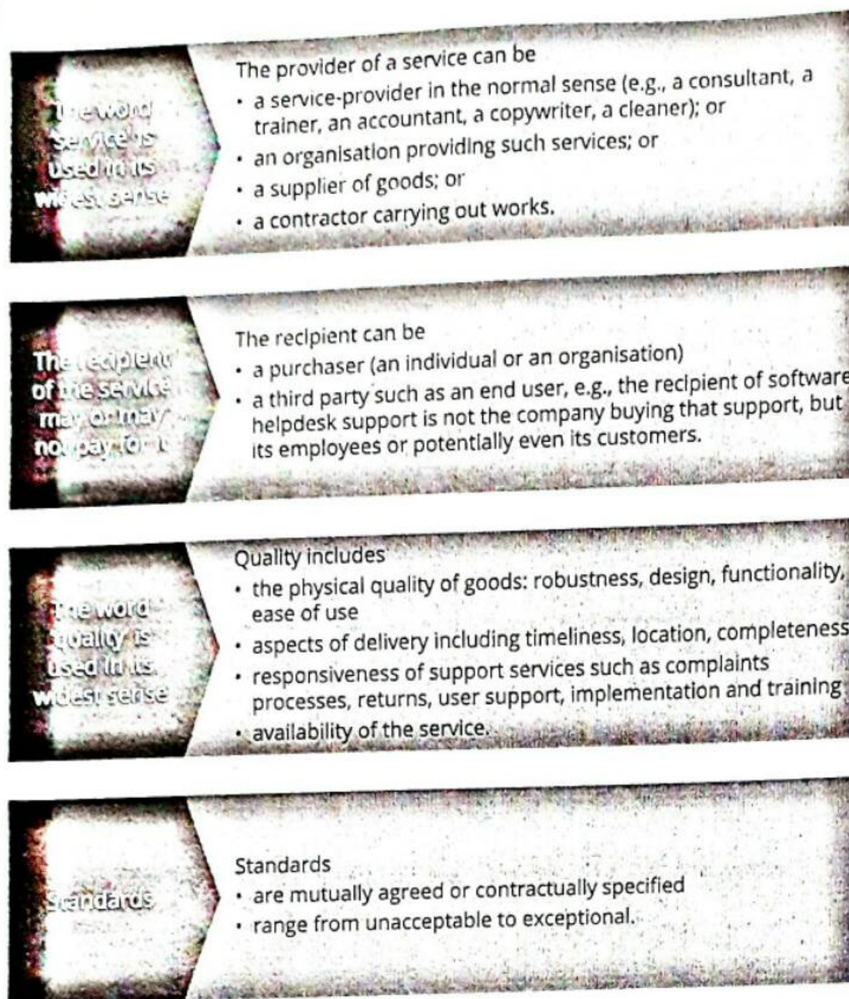
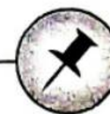


Figure 2.3 How SLAs work

> *Remember*
> A 'service level agreement' may mean a non-contractual agreement, a schedule or section of a wider contract, the whole contract, or a side agreement. The nature and status of the agreement must be made clear. In all cases it fulfils the same function: to define the standards and provide details of what could happen if they are not met and (sometimes) if they are exceeded.



Supplier-defined SLAs

We have considered SLAs as being part of commercial contracts which have been largely specified and drafted by purchasers. There are also circumstances where suppliers have standard SLAs in respect of their product, which purchasers may have to accept as a standard part of the package. This is particularly common in the IT sector, for example, where a single software product or hosted service is being sold to many purchasers but is subject to a single central methodology for managing faults, bugs, security patches, design upgrades, and so on. Wherever possible purchasers should seek to avoid accepting supplier-drafted SLAs.

Designing an SLA

Having looked at what an SLA is, it should be clear that it closely resembles a specification. This can lead to confusion as to whether certain elements of the requirement should be included in the specification or in a supplementary SLA. Conversely, if you have a very detailed SLA do you even need a specification? If your specification is robust and mandatory, is there still a role for an SLA?

There is no definitive answer. As with much else in procurement and supply it can depend on exactly what is being procured and supplied. The core elements of an SLA are set out in table 2.9.

SLA core element	Key considerations
;ervice definition	What, exactly and precisely, is to be provided by the supplier? Is this set out elsewhere in the contract (e.g., in a specification document)? Do not duplicate information, as this increases the risk of errors arising as the specification evolves and one document is updated but not the other. This gives rise to conflicts which may make the contract unenforceable. If the requirement is set out in another document, cross-refer to it.
Quality definition	This should cover the following. • Mandatory minimum standards, failure to reach which is a breach of contract • Unacceptable standards, which may not be immediately considered a breach of contract, but could become a breach if not rectified within stated timescales • Poor standards, which may not ever be serious enough to become a breach of contract, but which warrant compensation by way of penalty payments or service credits • Acceptable/required standards as per the specification • Good (and, if thought necessary, excellent) standards which exceed the specification This information could be in the SLA **or** the specification, but not both. If both documents exist, one should cross-refer to the other so that there is only one version of the requirement.
:PI details	This section should set out the full details of the KPIs, including the following. • What is measured • How it is measured • Who measures it • How often it is measured • How measures convert into scores (and any allowable offset of results between reporting periods) • Targets This information will normally be set out separately from the specification, either in an SLA or a performance management framework schedule to the main contract.

SLA core element	Key considerations
KPI management response	This should cover the following. • Actions and consequences if targets are not reached • Consequences (if any) if targets are exceeded This information could be in the SLA **or** in the rights and remedies section of the core contract document, but not both. If both documents exist, one should cross-refer to the other.
Operational performance	Not all performance matters will be covered by a KPI, so this section needs to pick up day-to-day issues and how they will be managed. Targets are not relevant here because this is simply the way it should work all of the time. This section should consider foreseeable operational failures and set out how significant they are, and how quickly they need to be resolved. Examples might include the following. • ICT contracts where severity is linked to how many users are affected and the overall impact on the business • Supply of goods contracts where delays in delivery or inaccuracies in consignments can incur cumulative service credit deductions • Liquidated damages clauses for late completion of works or similar project-based contracts. This information could be in the SLA **or** in the rights and remedies section of the core contract document, but not both. If both documents exist, one should cross-refer to the other.
Operational performance management response	As with KPIs, the day-to-day issues also need to be resolved. The SLA should set out the actions and consequences for each performance failure. It should include the following. • A 'first response' action and a timescale for resolution • An escalation procedure to be implemented if the first response is not carried out or is unsuccessful • A threshold (which could be time or cost of impact, depending on the nature of the failure) at which non-KPI operational failures become potential breach of contract issues and how these will be managed – whether by referral to mediation, arbitration or through the courts This information could be in the SLA **or** in the rights and remedies section of the core contract document, but not both. If both documents exist, one should cross-refer to the other.
Constraints or mitigating factors	This section should set out any circumstances in which the parties agree that normal service levels cannot be maintained, so the requirements should either be waived or eased. This might be equivalent to a force majeure clause in the main contract, but it could also include actions on the part of the purchaser that prevent or inhibit the supplier from meeting its targets (e.g., unclear orders, delivery sites being inaccessible). This information must cross-refer to any similar clauses in the main body of the contract.

Table 2.9 Core elements and key considerations when designing an SLA

Ensuring the SLA is contractually binding

Table 2.9 shows that core elements of the SLA are the management responses and consequences in the event of performance being below that required. Careful consideration must be given to the wording of these elements. In order to ensure that the SLA is effective, it must have the same force as any other part of the contract. It must be legally binding. The method for achieving this will depend on the type of SLA being used.

Case study

Service level agreements which are not contracts

Southend-on-Sea Borough Council provides this distinction between service level agreements and contracts, and the rationale for having separate SLAs.

'An SLA would focus only on the performance measuring and service quality agreed to by both parties, and may be used as a measurement tool as part of the contract. The service levels themselves may be established based on various factors, for example, a service provider may provide online credit checks to its customers. A service level in the contract may state the online service must be operational 99% of any given month, or it must provide the requested information with 3 hours after a request, etc.

'The rationale for having a separate SLA document is that you can revise the SLA without having to revise the contract. The contract can just refer to the agreed SLA. The contract might then last for 2 years but the SLA may be reviewed quarterly, for example. This reduces the administrative burden of reviewing the contract too frequently.'

(Source: www.southend.gov.uk/southendchildrenspartnership/download/158/the_difference_between_a_contract_and_an_sla)

There is, however, a risk in this approach. If the SLA is referred to in the contract and the contract does not make explicitly clear that it means the latest revision to the SLA, then there is some uncertainty as to how valid the revised SLA is as a contract document. The contract wording would need careful drafting.

Between departments or divisions in a single company

Internal SLAs of this type are not normally contractual. They are not intended to be legally binding. In any event, a single company cannot sue itself.

Constituting the whole agreement between the parties

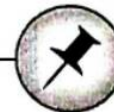
If the SLA is the only document setting out the requirements, it may in effect be the contract. This is a very poor approach, since the likelihood is that service levels have been the main, possibly only, focus of the discussions between the parties and many other contractual risks are ignored as a result. However, if this is the approach taken, the agreement should clearly state the following points.

1. KPIs: how they are to be measured, who measures them and how often
2. How the measurements convert into scores
3. Any other service level standards, which may be of lesser importance than the KPIs
4. Minimum acceptable standards or scores in each case
5. Range of scores both above and below the minimum acceptable
6. Any mitigating factors which might apply in the event of poor performance
7. Any time period permitted in which to remedy a situation of poor performance
8. Remedies available to the injured party if the situation is not remedied (e.g., damages, penalties or service credits, ability to terminate the contract)
9. Process to be followed in order to access the remedies (e.g., any formal notices which need to be given, escalation procedures in the event of disputes, mediation or other **alternative dispute resolution (ADR)** processes to be used in preference to full legal action)
10. How any inconsistencies or conflicts between the KPIs and any standards referred to are to be dealt with

Alternative dispute resolution (ADR)
Any method of resolving a dispute between two parties which does not involve court action, including escalation to higher levels of authority, mediation, adjudication and arbitration

Additionally, the normal rules of contract formation must be followed; that is, it must be clear that there has been an offer, acceptance and that there is capacity to contract, consideration and an intention to be legally bound.

> *Remember*
> If the SLA is the only form of agreement there is, and it does not include reference to consideration, the agreement must be executed as a deed in order to be legally binding. (Review section 1.2 to refresh the rules on formation of contract.)



Part of a set of contract documents

This is the more usual approach. In this case, the SLA may or may not be called an SLA. It could instead be called a 'performance management framework' or simply labelled as a 'schedule' or 'appendix' to the contract.

Where this approach is taken, the SLA or service level schedule/appendix or performance management framework must be clearly identified as a contract document and should clearly state items 1 to 7 on the list above under 'Constituting the whole agreement between the parties'.

Note that if there is a separate specification document, care must be taken to ensure that items 1 to 4 of that list exactly match the requirements of the specification, preferably by cross-reference to that document.

The remedies available in the event of poor performance should be set out in the body of the contract, along with those for any other contractual breach. These clauses should be cross-referenced in the SLA and (in line with the previous list) should cover items 8 and 9 on that list.

A hierarchy of clauses/schedules may be needed to confirm how any inconsistencies or conflicts, either within the SLA or between it and the specification or any other contract document, are to be dealt with.

Stand-alone agreement in respect of a separate contract

This is not a common approach, but can occur in the following situations.

- Where, for reasons of urgency, a contract has been put in place prior to full KPIs being established and agreed
- Where there are a number of separate contracts and a single SLA is needed to ensure consistency of approach

In this case, there must be a clear cross-reference between the relevant contract(s) and the SLA and the SLA should clearly state items 1 to 6 on the list on the previous page.

Note that if there is a separate specification document, care must be taken to ensure that items 1 to 4 exactly match in the two documents, preferably by cross-reference to that document.

The remedies available in the event of poor performance may be set out in either the SLA or the main contract, but not both. These clauses should cover items 8 and 9 on the list on the previous page.

A hierarchy of clauses/schedules may be needed to confirm how any inconsistencies or conflicts, either within the SLA or between it and the specification or any other contract document, are to be dealt with.

If the SLA is created after the main contract, it will require additional consideration or execution as a deed in order to be legally enforceable.

Where the SLA exists as a standard document prior to the formation of the contract, there must be a clause in the contract which effectively embeds the terms of the agreement (and any subsequent amendments to it) into the contract.

Check
How does the use of an SLA create a potential risk of inconsistency or conflict of terms within a contract? How can this be avoided or managed?

Reviewing KPIs and service levels

The KPIs and SLA should be reviewed regularly. The frequency of such reviews will depend upon the nature of the contract and of the KPI itself. It may be appropriate to measure some KPIs monthly (e.g., timeliness of deliveries) whereas others may be more appropriate once a quarter or even less frequently (e.g., innovation proposals). The review programme should be set out in the original quotation/ tender request and firmly embedded within the contract documents. There can be a risk if initial targets are set on the basis of past performance, especially if that was with a different supplier, under different contracting or general economic conditions, with the result that they are less appropriate for the new contract (either because they are now much harder or much easier to achieve).

For example, improvements in technology may make short-run orders much more cost effective, which enables more frequent ordering with shorter delivery times. Alternatively, the inclusion of more environmental objectives could do the reverse and argue for fewer delivery journeys and a move away from lower value orders.

If KPI targets are being consistently exceeded, they clearly need to be strengthened or replaced. There is limited value in measuring something which is consistently good and has no further scope for improvement.

Typical KPI measures

Having considered how KPIs are designed and incorporated into contracts, this chapter ends by looking at some common measures which should serve to illustrate the points made so far.

The following tables are purely illustrations that may be useful for future reference. You are not expected to retain the details shown in them.

Tables 2.10–2.16 look at sample measures and raise potential issues with the use of the KPI in each case. These costs, risks and unintended consequences will not apply in all cases. They are included to stimulate thought and discussion.

When reading the tables, remember that these are contract KPIs not procurement team KPIs. They are measuring the performance of the individual contract to which they apply.

Delivery compliance			
Activity description	**KPI**	**How is it measured?**	**Cost, risk or potential for unintended consequence?**
Delivery in full	Quantity supplied matches the quantity ordered and each line of the order has been supplied.	Inaccurate deliveries as a percentage of total no. of deliveries for period.	Time in detailed checking of all orders. Orders may be delayed if part-orders will not be accepted.
Delivery on time	Delivery to be made within the agreed time.	Missed deliveries as a percentage of total no. of deliveries for period.	None – this should be a basic contractual requirement.
Average lead time	Current lead time compares favourably with previous lead time.	Improvement of lead time for this period as a percentage of lead time for previous period.	Lead times may be improved by more efficient processes, but can also be achieved by simply increasing up-front resource, which may result in shortfall of resources for later stages. An improvement in lead time on some elements may not necessarily reduce the overall project length. It may also result in the purchaser having to increase its own stock-holding as items are delivered ahead of need.
Average time to fill emergency orders	Time must be in line with agreed contractual turnaround or within pre-agreed timescales for these particular orders.	Average time checked against contract and/or call-off order requirement. Target could be percentage improvement in time over previous period, or percentage improvement on the contract requirement.	Good performance on emergency orders can encourage poor practice on the part of purchasers who come to rely on it, resulting in inefficient ordering practices.
Consignment stock availability	Supplier holds adequate range/no. of units of stock to offer a reliable service.	No. of stockouts as a percentage of total no. of requests for consignment stock.	None – stock holding for normal order levels should be a basic contractual requirement.

Table 2.10 Delivery compliance KPIs and potential issues

Product/service quality			
Activity description	**KPI**	**How is it measured?**	**Cost, risk or potential for unintended consequence?**
Product/service compliance	Product/service to meet the agreed, documented standards and also be fit for purpose (during whole life cycle).	Acceptable items as a percentage of total no. of items ordered.	Any delivery which is not fully automated will always have potential for error or shortfall; there is a point at which the additional cost of quality control may exceed the gains from fault-free delivery. More stringent checking of orders may delay timeliness of delivery.
Reliability/ durability	Product/service to have been reliable/durable throughout its use.	Number of non-routine service call-outs per period.	Could result in over-specifying 'routine' servicing in an attempt to pre-empt faults which may never have materialised.
Usability/user satisfaction	The product is user-friendly.	Periodic user survey (0 to 4 scoring).	Costs of surveys. Is the survey sample representative? Is the response rate statistically significant? Are the reasons for poor or good scores also captured? If not, resource may be wasted seeking to address the wrong root cause of poor satisfaction.
Technical support	Acceptable quality of technical information/ support provided by supplier for goods supplied.	Periodic survey (0 to 4 scoring).	(As above)
Supplier response time	Timely attendance on site in response to initial fault report.	Agreed response times missed as a percentage of no. of calls logged.	Can create a rush-to-site mentality which reduces the ability to resolve problems on first attendance.
Repair lead time	Compliance with agreed lead times for repairing the product or restoring service.	Agreed 'fixed or resolution' times missed as a percentage of total no. of repairs carried out.	Does not necessarily take into account the severity of individual incidents.

ble 2.11 Product or service quality KPIs and potential issues

Health and safety			
Activity description	KPI	How is it measured?	Cost, risk or potential for unintended consequence?
Endangering health and safety	Zero reports in relation to the product/service endangering the H&S of staff, visitors, users or general public.	Count number of reports.	If only focussed on reportable accidents it may not take account of near-misses.

Table 2.12 Health and safety KPIs and potential issues

Administration			
Activity description	KPI	How is it measured?	Cost, risk or potential for unintended consequence?
No. of credit notes per month	Supplier issues no more than X credit notes per month.	Count number of credit notes.	Although aimed at ensuring accuracy of original invoices, may simply delay the issue of due credit notes to keep the monthly figures low.
Invoice preparation	Invoice to contain all information required to enable prompt payment.	Number of invoices requiring further detail as a percentage of invoices issued.	None – this should be a basic requirement.
Provision of quotations	Quotations requests are turned around within X days.	Total of late & not-submitted quotations as a percentage of quotations requested.	Most likely used on a framework agreement, could result in 'cover prices' being submitted or quotations issued where workloads will not permit effective scheduling.
Documentation	Full supporting documentation received for all installations/ updates within X days of acceptance of installation/ update.	Count number of instances of late documentation. Average number of days late.	None – this should be a basic requirement.
Management information	Management information reports provided on schedule.	Count number of instances of late documentation. Average number of days late.	Creates potential risk that information will be provided on time, but will be rushed and inaccurate.

Table 2.13 Administration KPIs and potential issues

Best practice & continuous improvement			
Activity description	KPI	How is it measured?	Cost, risk or potential for unintended consequence?
Supplier nnovation	Supplier is proactive in suggesting innovative, workable solutions.	No. of innovations implemented.	Resource might be diverted to seeking innovation rather than delivering on the core contract.
.ist of targeted /alue-added ıctivities	Targeted value-added activities are identified in advance.	No. of targeted value-added activities identified in advance.	(As above)
/alue-added ıctivities	High success rate in bringing value-added activities to fruition.	Percentage of targets achieved.	None if 'success' is adequately defined and includes core delivery being maintained at or above target levels.
'roactivity	Supplier is proactive in managing its relationship.	Periodic survey (0 to 4 scoring).	Relies on an agreed perception of what 'proactivity' means – could result in wasteful contacts and meetings.
:eponsiveness	Responds rapidly to requests for information and support without having to be chased.	Number of times requests chased as a percentage of number of requests.	None – this should be a basic requirement.
:esponsive to hange/flexibility	Supplier is flexible in response to purchaser changing requirements.	Periodic survey (0 to 4 scoring)	Risk that if the supplier is over-accommodating, purchaser will seek changes which add very little value with the result that the contract becomes incrementally less efficient.
)penness and o-operation	Supplier is open and co-operative in its relationship with purchaser, e.g., in terms of joint problem solving.	Periodic survey (0 to 4 scoring).	Very much a 'perception' evaluation, can rely too much on personalities.
nderstanding of ccountabilities nd esponsibilities	Supplier has a clear understanding of its accountabilities and responsibilities under the contract.	Number of rework requests and disputes during period.	Should be a basic requirement – but poor performance may be the result of poorly drafted documents.

ɔle 2.14 Continuous improvement KPIs and potential issues

Contact centre/call centre service measures			
Activity description	**KPI**	**How is it measured?**	**Cost, risk or potential for unintended consequence?**
Abandonment rate	Percentage of calls abandoned by caller while waiting to be answered.	Calls abandoned as percentage of total calls received.	Resource is dedicated to quick pick-up of new calls at the expense of quality of response and query resolution of calls in progress.
Average speed to answer	Average time it takes a call to be answered (in seconds).	Time taken for each call averaged out over the specified period.	(As above)
Time service factor	Percentage of calls answered within a given timeframe, e.g., 90% within 30 seconds.	Number of calls within timeframe as a percentage of total number of calls.	(As above)
First time resolution (or first time fix)	Number of problems resolved at the first point of contact.	Percentage of incoming calls that do not require repeat contact.	Provides a better service but at the expense of being able to pick up calls quickly.

Table 2.15 Contact/call centre service KPIs and potential issues

Cost management			
Activity description	**KPI**	**How is it measured?**	**Cost, risk or potential for unintended consequence?**
Savings	Reduction in unit price.	Percentage reduction of unit price over previous rate.	May not feed through to budget savings if the only reason for the unit cost reduction is higher volumes ordered.
Savings	Total cost reduction.	Final account sum as a percentage of original contract sum.	Only a true saving if quality and scope are maintained.
Cost avoidance	Value of spend avoided by pre-emptive action, e.g., agreeing forward orders in response to likely market-wide price rises.	Estimate of likely spend in the absence of action taken less actual spend.	It is a 'what if' measure that can never be accurately verified. The likely spend is subject to debate. The opportunity cost of funds used in the pre-emptive action is equally unknowable.

Cost management			
Activity description	KPI	How is it measured?	Cost, risk or potential for unintended consequence?
Transaction cost reduction	Reduction in number of invoices	Number of invoices in previous accounting period less number in current accounting period.	Only valid if order volumes remain constant or increase. Can present a risk to the supplier if invoice consolidation interrupts cash flow. Invoice queries may become more complex and more difficult to resolve resulting in poorer purchaser/ supplier relationship.

Table 2.16 Cost management KPIs and potential issues

Apply
Think about how relevant any of the individual measures in tables 2.10–2.16 are to your sector or the area in which you want to work in the future.

Chapter Summary

- Previously used specifications are useful starting points for creating new ones but there are risks in doing so, as different circumstances must be taken into account. If more than one sample is used, care is needed to ensure consistency of language. Using samples provided by suppliers risks favouring them and undermining free competition.
- Market dialogue between purchasers and suppliers should be ongoing (and not restricted to specific tender opportunities) to ensure early feed-in to specification design. Care is needed to ensure commercial confidentiality is respected. The type of dialogue should vary depending on the specific objective. Options include general open meetings, confidential one-to-one discussions, group visits and formal competitive negotiations.
- Standards, especially international standards, are useful tools for specifications. They can ensure all suppliers know exactly what is required without having to reproduce the finite detail in the specification. Care is needed to ensure that there are no conflicts between the standard and other aspects of the specification or SLA. Contract clauses must be clear on whether updates to the standard automatically become embedded within the contract requirements.
- Typical sections of a specification are: title, version control, foreword, scope, definitions, consultation requirements, references to standards and codes of practice, characteristics of the goods or services, timescales,

performance, lifespan, packaging, information requirements, implementation, and guarantees and warranties. These will vary depending on what is being purchased.

- Standardisation reduces costs and ensures a consistent quality, but reduces product ranges, which can hinder innovation and the agility to respond to changes in the market.
- Social and environmental criteria are increasingly used in specifications, driven by ethical considerations, consumer demand, stakeholder pressures and economic incentives. The cost of such criteria must be taken into account, as well as the effectiveness of the measures. Not all such criteria will add cost, but some may.
- KPIs are used to measure performance in order to manage poor performance and drive improvement above specification levels. KPIs should be few and focused on the most important deliverables. The sources of data must be easily accessible and verifiable so that they are trusted by both parties. The costs and risks associated with KPIs should be considered when they are being designed.
- SLAs are used to set out how the performance indicators (not only KPIs) will be applied. SLAs may be embedded in a larger set of contract documents or be standalone agreements.

End of Chapter Assessment

1. Analyse the relative importance of a specification and a service level agreement in the context of a contract and explain the problems which might arise where both are used. **ANALYSE**
2. Appraise the usefulness of international standards in specifications, including any actions that might be necessary to avoid or mitigate potential disadvantages. **APPRAISE**
3. Suggest **three** different social and/or environmental criteria that might be incorporated into a specification. In each case, analyse why they are used and appraise the advantages and disadvantages of doing so. (All three do not need to be relevant to the same specification, and you can use different goods or services for your examples.) **ANALYSE**
4. Compare SLAs which form schedules as part of a wider contract with those which are standalone agreements. Which would you recommend and why? **COMPARE**
5. Suggest **four** KPIs for a contract for the provision of software and ongoing technical support. In each case, explain how you decide on the measures, how you would capture the data, and any problems or conflicts that might arise as a result of using them. **EXPLAIN**

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CHAPTER 3

Key clauses that are included in formal contracts

Learning outcome

By the end of this chapter you will understand the most important (key) clauses that are included in formal contracts for purchase and supply.

Chapter overview

3.1 Analyse contractual terms for contracts that are created with external organisations

You will understand:

- The use of express terms
- The use of standard terms of business by both purchasers and suppliers
- The use of model form contracts such as NEC, FIDIC, IMechE/IET

3.2 Recognise examples of contractual terms typically incorporated into contracts that are created with external organisations

You will understand:

- Key terms in contracts for liabilities and indemnities, insurances subcontracting, guarantees and liquidated damages
- Terms that apply to labour standards and ethical sourcing

3.3 Recognise types of pricing arrangements in commercial agreements

You will understand:

- The use of pricing schedules
- The use of fixed-pricing arrangements
- Cost-plus and cost-reimbursable pricing arrangements
- The use of indexation and price adjustment formulae
- The use of incentivised contracts
- Payment terms

Introduction

This chapter delves deeper into commercial contracts to analyse some of the most common terms that are used. This includes why express terms are needed; how, when and why standard terms and conditions are used; and the role played by standard (or model) form contracts. Section 3.2 considers the detail of typical clauses, and section 3.3 looks at how aspects of pricing are dealt with within contracts.

When analysing contract clauses it is important to consider them from both the purchaser and the supplier perspective. Each party will seek to protect its own position via the inclusion of specific wording, but the contract will function most effectively if there is a balance between purchaser and supplier interests.

3.1 Analyse contractual terms for contracts that are created with external organisations

This section looks at express terms (by contrasting them with implied terms), and it considers standard terms of business and the use of model forms of contract.

The use of express terms

A contract term is any provision of a contract. Each term gives rise to a legal obligation either to do something or to refrain from doing something, or to do something in a specific way. Breach of these obligations will have specific consequences which may be enforced through legal action or litigation.

Note: both the expressions 'contract term' and 'term of a contract' are used to mean two different things. In a legal sense they both mean the provisions of the contract, as defined in the paragraph above. However, the expressions are also used to mean the time period during which the contract is in force. For example, 'the contract term for the provision of catering was three years' or 'the term of the vehicle spares contract was four years'. In this section, the expressions are used in the legal sense, **not** the time period sense.

Express terms
Contractual terms which are specifically stated in contract documents

Implied terms
Contractual terms that exist but are not written within the contractual documentation, i.e. the law of the land

Understanding express terms by contrasting them with implied terms

Express terms are those that are specifically and clearly 'expressed' in words. They are specifically stated either orally or in writing and set out the definitive agreement between the parties.

Express terms can be contrasted with **implied terms**, which are provisions or conditions that are assumed to form part of a contract even though they are not stated by either party. Terms can be implied into a contract in a number of ways.

One such way is what is often called 'custom and practice'. If it is normal in a given locality or a given industry, or potentially even between two parties who regularly contract with each other, for things to happen in a certain way, a requirement for that to be so might be implied into the contract. This would normally only happen if the contract itself was silent on the matter. If the contract includes a term that goes against custom and practice – or if there is a specific side contract deliberately created to set out different conditions – then the implied term will not hold. An express term in a contract will normally override an implied term.

Case study

Overriding terms implied by custom and practice

Assume that in a given type of business it is custom and practice for all debts to be settled at the end of a day's trading (as can be the case on fast-moving commodity and futures markets). Then assume that two parties who regularly trade with each other in this market agree that they can reduce their administration costs if they only settle their debts with each other at the end of every week. They could create a contract that expressly states this to be the case. That contract would override the custom and practice of daily settlement.

An express term in a contract will **normally** override an implied term, but there is one circumstance where it might not be permitted to do so, and that is where the term is implied by statute.

A more common way, nowadays, for terms to be implied into contracts is through statute. For policy reasons, governments may decide that all contracts of a given type will include certain measures. They may enact a law requiring that to be done and stating that even where it is not done by means of express terms in the contract, a term will be implied (that is, deemed to be included). In these cases the law itself will state whether or not contracting parties can use express terms to override the implied term.

In a similar way, international agreements may be used as a mechanism to imply terms into a contract (see section 1.2 on the Vienna Convention on the International Sale of Goods). Again, the agreement will state whether the implied terms can be overridden by express terms.

« Case study

Can you override terms implied by statute?

There are two contrasting examples from UK and EU law which show how an implied term might be permitted to be overridden by an express term, or how such avoidance of the implied term might not be allowed.

Rights of third parties: UK law Contracts (Rights of Third Parties) Act 1999[1]

UK law specifically states that people who would normally benefit under a contract can enforce the terms of that contract, even though they are not a party to it.

There is therefore an implied term that such rights exist. However, the Act goes on to say that this 'does not apply if on a proper construction of the contract it appears that the parties did not intend the term to be enforceable by the third party'.[2] This sentence means that the parties to the contract can **expressly** state that they do not intend the terms to be enforceable by third parties. If they do so, the implied term is cancelled out. This general approach has been followed in a number of other countries in their approaches to dealing with third-party rights.

Right to terminate a contract that as a result of a change becomes non-compliant with EU public procurement rules

Regulation 73 of the UK Public Contracts Regulations 2015[3] (enacting the EU Public Procurement Directive 2014[4]) places a requirement on public bodies to include a right to terminate the contract in circumstances where modifications to it place it outside the parameters permitted by the regulations. The regulations go on to state that if such a right is not expressly stated in the contract, the power to terminate the contract on reasonable notice will be an implied term. There is nothing which permits the parties to agree otherwise.

Remember

Express terms are explicit and will normally override implied terms unless the implied term is created by statute and the law states that it cannot be overridden.

Why do you need express terms in a contract?

We have established in the previous sections that 'a contract' is not a written document, but rather it is the whole conceptual 'agreement' between the parties.

Express terms are used to set out as clearly as possible what that agreement is. They should do the following.

- Set out the obligations of the purchaser
- Set out the obligations of the supplier
- Set out the rights of the purchaser if the supplier defaults
- Set out the rights of the supplier if the purchaser defaults
- State how the parties will deal with circumstances beyond the control of either party
- Where possible, either confirm or override any potentially implied terms

In respect of the last bullet point, if there is a term that would in any event be implied, it can be useful to include it as an express term. Doing so makes the contract more complete and reinforces the fact that both parties are aware of the

implication. For example, the Regulation 73 requirement quoted in the previous case study will be implied into contracts falling under the Public Contracts Regulations. It can be useful to state that 'this contract is subject to the Public Contracts Regulations 2015 and the employer reserves the right to terminate the contract in the event of modifications which fall outside the parameters permitted under Regulation 73 thereof'.

Express terms and contract schedules

To avoid making the wording of the contractual clauses too complicated, they often refer to schedules. Schedules are appendices to the contract which provide more detail – often the technical detail – on the requirements.

The use of schedules in this way helps to clarify the difference between a 'contract clause' and a 'contract term'. The clause is the precise wording in the main document, which will have its own reference number. The contract term is the totality of that part of the agreement and so includes the clause wording and any schedule to which it refers. Anything set out in a schedule to a contract is also considered to be an express term.

Case study

Contract clause cross-referencing a schedule
One organisation's standard form of services contract might include the following clause.

'The Contractor shall supply the Services during the Contract Period in accordance with the Client's requirements as set out in the Specification Schedule 1 appended hereto.'

The contract 'clause' is just that wording. The contractual term is the combination of that wording and everything within the schedule to which it refers.

Establishing what the express terms of a contract are

In light of what has been said, in a well-drafted contract it should be easy to see what the express terms of a contract are. They are set down in black and white in the documents. But not all contracts are well drafted. The following are some of the potential issues.

- There may be no written contract.
- The written contract may be based on oral negotiations.
- The purchaser may not be aware of the conditions of a written contract at the point of contract.

Tables 3.1–3.3 discuss these issues in more detail. The cases quoted are from English case law, but the principles are generally followed in many other countries.

None of the issues highlighted have a definitive answer. If any contractual disputes of this type were to come to court, they would be decided based on the facts of the individual case. As professional purchasers and suppliers, however, it is best to avoid the issues in the first place.

Situation	Issues	Legal position	Recommendation
No written contract. All negotiations and agreements conducted orally.	What was said? Was everything that was said intended to form part of the contract?	It depends on the facts of the case, but it can be held that express statements were not intended to be contractual warranties. See *Oscar Chess Ltd v. Williams* (1957).[5]	Avoid oral contracts.

Table 3.1 Possible issues in identifying whether express terms are properly incorporated into an oral contract

Case study

Oscar Chess Ltd v. Williams (1957)

A man selling a car to a garage said it was a 1948 Morris when in fact it was a 1939 Morris, and he got a better price as a result. It was held that the statement of the car's age was not an express term of the contract.

This case could also be considered in light of the rules on misrepresentation outlined in section 1.2. The decision may have hinged on the fact that the seller did not know that the log book had been changed by a previous owner, and that the garage buying the car would be more expert than the seller in estimating its age.

(Source: Oscar Chess Ltd v. Williams (1957) EWCA Civ 5.)

Situation	Issues	Legal position	Recommendation
Written contract based on oral negotiations.	How much of the negotiation forms part of the contract?	The longstanding view is that the written word supersedes anything said prior to it. The contract means exactly what it says, which is what the court interprets it to say, regardless of what the parties might have intended. However, it is now possible to argue that 'the contract' is a contract partly in writing and partly oral; or that there are two contracts – one oral and one written. In both scenarios the argument would be that the oral part of the contract can supersede the written part. See *J Evans and Son (Portsmouth) v. Andrea Mezario* (1976).[6]	Include an express term in the contract that specifically excludes all prior discussions. Ensure that a proper contract is produced and signed – do not rely on standard terms and conditions.

ıble 3.2 Possible issues in identifying whether express terms are properly incorporated into a written contract ısed on oral negotiations

Case study

J Evans and Son (Portsmouth) v. Andrea Mezario (1976)
Evans and Son was an engineering firm that regularly imported machinery from mainland Europe. It employed Mezario as **forwarding agents**. Mezario changed its shipping methods to use containers (which were then relatively new). The matter was discussed and Evans agreed, subject to an assurance that its goods would be carried below decks.

A number of transactions occurred on Mezario's standard terms and conditions which included permission for goods to be carried above deck. Most containers are above deck. The dispute arose when a container containing goods being imported by Evans was lost overboard.

The Court of Appeal held that Evans could recover damages because of the verbal assurance, despite the written conditions that had been used since that assurance was given.

(Source: J Evans & Son (Portsmouth) Ltd v. Andrea Merzario Ltd (1976) 1 WLR 1078.)

Forwarding agents
Specialists in organising the transportation of goods for others

Situation	Issues	Legal position	Recommendation
Written contract where the purchaser may not be aware of the conditions at the point of contract.	Can a purchaser have actually agreed to conditions that they do not know about?	Surprisingly, yes. The most common application of this is bus or train tickets, which refer to terms and conditions published elsewhere (in a timetable, on the company's website). Because most of the terms and conditions are held not to be unusual, it has become accepted that they can be enforced. However, if the conditions **are** unusual then effort must be made to bring them to the attention of the purchaser. See *Thornton v. Shoe Lane Parking* (1970)[7] and *Interfoto Picture Library v. Stiletto Visual Programmes Ltd* (1989).[8]	Use properly constructed contracts and check the conditions carefully. Be clear on what you are agreeing to. If unusual conditions come to light after the creation of the contract, seek to negotiate amendment of them.

Table 3.3 Possible issues in identifying whether express terms are properly incorporated into a contract where the purchaser may not be aware of the conditions

Case study

Thornton v. Shoe Lane Parking (1970)
A ticket produced by an automatic entry barrier to a car park referred to conditions posted inside the car park. Clearly the users of the car park could not read the conditions until they had entered and parked and were therefore already subject to them. The conditions excluded liability for damage to cars (which is quite usual) but unusually also purported to exclude injury to drivers. It was held that the term could not be enforced.

(Source: Thornton v. Shoe Lane Parking Ltd (1970) EWCA Civ 2.)

Case study

Interfoto Picture Library v. Stiletto Visual Programmes Ltd (1989)
The library lent 47 photographic transparencies to Stiletto Visual on its usual terms which were free for 14 days and £5 per photo per day thereafter. After a month a bill was sent for £3,783.50. The late fee was held to be an unusual condition which had not been properly communicated. As late fees, in general, are not unusual it is assumed that it was the large amount of the charge that caused it to be considered unusual in this case.

(Source: Interfoto Picture Library v. Stiletto Visual Programmes Ltd (1989) QB 433.)

Remember
Oral contracts also include express terms. Terms from pre-contract negotiations might be implied into a written contract unless the written contract clearly precludes them.

Check
What is an express term and how does it differ from an implied term?

Standard terms and conditions
Basic terms and conditions of business governing transactions that do not have a definitive contract, usually designed to be included in form documents such as orders

The use of standard terms of business by both purchasers and suppliers

Virtually all organisations have their own standard terms of business, often known as **standard terms and conditions**, which cover all of their transactions except for those that are subject to a specific overriding contract.

Figure 3.1 shows an extract from a set of standard terms and conditions.

3.1

STANDARD TERMS & CONDITIONS OF PURCHASE

1 Definitions and interpretation

1.1 Definitions

In these terms and conditions ('the Terms') the following have the meanings set out below:

'Company' means Serco Sodexo Defence Services Pty Ltd or any related subsidiary.

'Contract' is defined in Clause 2.1

'Deducted Amount' is defined in Clause 11.1

'Deliverables' means goods, rights and services identified in the Purchase Order.

'Delivery Location' means the place identified in the Purchase Order in relation to the provision of the Deliverables.

'Goods' means all goods, materials, equipment and parts provided by the Supplier to the Company as detailed in the Purchase Order.

"GST" means A new Tax System (Goods and Services Tax) Act 1999 (Cth).

'Laws' means the requirements of all statutes, rules, regulations, proclamations, awards, ordinances, by-laws or Australian Standards, present or future, and whether state, federal or otherwise.

'Material' means any material brought into existence as part of, or for the purpose of producing the Supply, and includes but is not limited to documents, equipment, information or data stored by any means.

'Moral Rights' means the right of attribution of authorship of work, the right not to have authorship of work falsely attributed and the integrity of authorship as defined in the *Copyright Act 1968* (Cth).

'Party' means a party to the Contract.

'Personnel' means:

(a) in relation to the Supplier, any of its employees, Subcontractors (including Subcontractors' Personnel), agents and representatives involved either directly or indirectly in the performance of the Supply;

(b) in relation to the Company, any of its past or present officers, employees, agents or representatives

'Supplier Default Notice' is defined in Clause 17.2

'Supply' means the supply of Deliverables in accordance with the Purchase Order.

1.2 Interpretation

Unless the context requires otherwise, the singular includes the plural and vice versa, reference to a gender includes all genders, reference to a 'person' includes a natural person, company, body corporate or other form of legal entity, and reference to 'including' and 'includes' is to read as if followed by 'without limitation'.

2 Evidence of Contract and precedence of documents

2.1 Contract

(a) The Contract consists of the following documents:

(i) The Purchase Order;

(ii) These Terms and Conditions ('the Terms'); and

(iii) Any express written agreement from the Company which is attached to, or incorporated by reference in, the Purchase Order or these Terms.

(b) The Company is not contractually bound until a formal Purchase Order is placed by the Company and then only to the extent of the issues specifically covered by that Purchase Order.

2.2 Precedence of documents

If any of the terms of the Contract conflict with or contradict each other, those terms will over-ride each other in the following order of priority: (1) any express written agreement from the Company; (2) our Purchase Order; (3) these Terms.

2.3 Entire agreement

(a) The Contract contains the entire agreement between the Company and the Supplier with respect to its subject matter and supersedes all prior communications and negotiations between the Company and the Supplier in this regard, unless those communications expressly form part of the Contract.

Figure 3.1 Sample extract from a set of standard terms (Source: adapted from www.ssds.com.au/wp-content/uploads/docs/SSDS%20Standard%20Terms%20and%20Conditions%20of%20Purchase%20Iss1%20Jan12.pdf)

Most organisations are both purchasers and suppliers. They buy in materials or components if they are manufacturers, or goods for resale if they are wholesalers or retailers, as well as goods and services to manage their buildings, their staff and their equipment and to generally keep the business functioning. At the same time they will supply goods and services to others, depending on the nature of the business.

Most organisations will therefore have two sets of standard terms: one for when they are acting as a purchaser and another for when they are acting as a supplier. Each set will seek to protect and further their interests from the relevant perspective. For instance, the purchasing terms will seek payment terms that are as long as possible (within reason) in order to keep hold of the money for longer, whereas the sales terms will aim to get the money in quickly and so seek shorter payment terms.

What are standard terms?

> *Remember*
> An organisation's standard terms will be different when they act as a purchaser compared to when they act as a supplier.

Standard terms aim to be a very short form of contractual agreement, normally printed on no more than one or two pages. They try to cover all eventualities for any type of goods or services that the organisation would normally purchase (or supply). As a result they are very generic and do not allow for the specific circumstances of a particular purchase. This need for generalisation means that they only provide a basic level of contractual protection, but this is better than none at all which can be the result if orders are placed orally or purchase orders are issued without any conditions attached.

Standard terms are often written with the aim of them being attached to order forms and/or delivery notes. However, this can normally only be achieved by reducing the text size until it is virtually unreadable (hence the expression 'the small print').

With increased use of electronic ordering systems it is possible to avoid this by publishing the terms on a website and providing an electronic link to them on the order. The rules established by *Thornton v. Shoe Lane Parking*[9] and *Interfoto Picture Library v. Stiletto Visual Programmes Ltd*[10] (see the previous case studies) would apply in such a case, namely that if any of the terms were unusual or especially onerous then specific attention would need to be drawn to them. This was reinforced more recently in a 2012 High Court Case in the UK, *Allen Fabrications v. ASD Ltd* (2012)[11]. It is not necessary to understand the detail of this case, merely to note that the rule established by the early cases still holds.

Non-negotiable

When an organisation is contracting on standard terms, it will normally require the terms to be accepted before the transaction can proceed. They are therefore unilaterally imposed by the purchaser (or in some cases the supplier) without having been negotiated with the other party.

When should standard terms be used and when are they best avoided?

Standard terms are generally used for repetitive transactions, particularly those that are low value and low risk. They are standard in nature and should therefore only be used for 'standard' transactions.

They ensure that there is at least a basic level of legal protection for those transactions that might otherwise have none.

Any purchase (or supply) that is subject to the rigours of a full tender exercise with a precise specification and the potential for negotiating variations should have a specific contract and not rely on standard terms.

There is a risk that terms can become outdated, particularly in industries or sectors where regulations or codes of practice are frequently updated, or where technological developments are fast-moving in a way that can affect the nature, speed or risk of the transactions. For example, if a purchaser's standard term requires compliance with a regulation or code of practice which has been

superseded, it is unlikely that it will be able to enforce compliance with the latest edition. If the regulation is such that the supplier is legally obliged to comply (e.g., a health and safety law), it may be able to claim extra costs for having to do so.

Care must be taken if standard terms are attached automatically to purchase orders and the same purchase ordering system is used to call off items under term contracts. The legal position as to which contract takes precedence can become unclear. To avoid this the standard terms would need to include an express provision that they do not override any formal written contract between the parties. To be safe, such contracts should include a reflecting provision to the effect that said contract does override any standard terms that may appear on or be referenced by either party's paperwork.

The advantages and disadvantages of using them are set out in table 3.4.

Advantages	Disadvantages
Time saved in negotiating individually with many purchasers (or suppliers) Reduced administration costs – not having to produce a new contract for every interaction Consistency of approach – all transactions on the same terms; staff understand risks and act accordingly; both parties understand 'the deal'	Risk that they do not become effectively incorporated into the contract – legal uncertainty and potential 'battle of the forms' (see section 1.2) Do not allow for contract-specific risks Can become out of date Can create conflicts if attached to purchase orders that are also used as call-off orders under term contracts

Table 3.4 Advantages and disadvantages of standard terms

What happens if any of the standard terms are ineffective?

Ineffective contract term
A term in a contract which cannot be legally enforced

An **ineffective contract term** is one which cannot be enforced because of the legal rules of the jurisdiction applying to the contract. Examples of ineffective clauses (depending on which country's legal system applies) might include the following.

- Exclusion of liability for negligence
- Unusual and unexpected conditions that would not normally apply and to which the other party's attention was not specifically drawn
- Exclusion of liability for death of an individual
- Lack of a warranty of fitness for purpose of the goods (i.e. no guarantee that they will do what they purport to do under normal operating conditions)

What happens in these cases will depend on the legal system applying to the contract. In civil law countries (those that have a fully developed legal code, such as Germany) there may be statutory rules which will be inserted into the contract in place of the ineffective terms. In common law countries (those reliant on case law, such as the UK, the USA, etc.,) there may also still be statutory provisions which will imply terms to replace those found to be ineffective. In the absence of this, the balance of interests will most likely be taken into account, with the courts simply taking a view on what they consider to be a 'just' outcome in the circumstances.

What should be included in standard terms?

The precise wording of standard terms must reflect the nature of the business being carried out by the organisation (for example, whether it deals in goods, services or a mixture of both) and whether the terms are for the purchase of goods or services or the supply of them.

However, there are key areas that must be covered in all cases. Table 3.5 shows these from a purchasing perspective but it could easily be converted to reflect a supplier's standard terms.

Definitions	If key phrases are used repeatedly, it can save space to have a separate section showing the precise meaning of each of them. This is particularly important if words are used in a narrow sense or differently from standard dictionary definitions.
Express term to override other standard terms	This is an attempt to avoid the 'battle of the forms' by including an express term that prohibits the substitution of the other party's standard terms by way of attaching them to standard process documentation. For example: 'These terms shall apply irrespective of any terms printed on the supplier's standard operating documentation including but not limited to order acceptance, delivery notes and invoices.'
Express term to state that in specific framework or term contracts signed by the parties, the express terms take precedence over standard terms	This is important if term contracts are used for some kinds of supply but the call off of purchases under those contracts uses the normal purchase ordering system, with standard terms automatically attached.
Formation of the contract	This sets out which documents will be considered contract documents under the standard terms. Normally they will be: the order form, the standard terms and anything necessarily implied by law. Some commentators and drafters advocate concluding this term with 'but nothing else',[12] but that does create a potential problem if an order that has been issued has to be cancelled or amended.
Order of precedence	An express term which sets out what happens in the event of terms or documents conflicting with each other. For example, 'order of priority (1) any express written agreement from us; (2) our order; (3) these terms'.[13]

Price	Where the price will be stated (normally on the order), how any tax liability such as VAT or other sales tax is treated, what is deemed to be included in or excluded from the price such as delivery charges, insurance, the currency or any discounts that might apply.
Invoicing and payment	Requirements regarding invoices (quoting of purchase order number, where invoices should be sent, any cut-off date for invoices); time period within which payment will be made (all references to time periods should make clear whether 'days' means calendar days or working days, whether a month is a calendar month or a four-week period etc.); any entitlement to set off outstanding debts against payments due.
Specification	Cross-reference to where any specification is to be found, if not quoted specifically on the order. This must include any references to intended purpose of use, which may be important if implied terms relating to fitness for purpose need to be relied on. This should also include a facility to change the specification or cancel the order, and what the price/payment implications are of doing so.
Obligation to comply with the law	This may be included within the specification term or set out separately. It places a specific obligation on the supplier to comply with all laws relating to the specification and supply, and it confirms that such compliance (including in the event of a change in the law) is deemed to be included in the price.
Delivery and risk	This should include a reference to the order, which will normally set out place of delivery; any time restrictions should be noted unless these vary, in which case they need to be on the order; a '**time is of the essence**' clause; the point at which ownership and risk pass from supplier to purchaser should be stated, along with any rights to reject the supply at the point of delivery and how **defects** will be managed.

Time is of the essence
A legal term used in contracts to underline the importance of timely delivery. Time **is** of the essence if failure to supply in accordance with the contract terms has a significant impact on the purchaser's ability to perform its normal functions. Time is **not** of the essence if the late delivery has limited or no impact. On a purchaser's standard terms, time will almost certainly be stated to be 'of the essence'. In negotiated contracts, depending on the nature of the supply, suppliers may seek to argue that it is not of the essence

Defects
Any aspects of delivery that do not match the specification

Warranties and liability	Set out the warranties required from the supplier. These will normally include quantity, quality, description and specification matching those on the order; freedom from defects; fitness for purpose; any services to be performed by appropriately qualified and experienced staff. This will normally also include a requirement for the supplier to carry appropriate insurance cover against such liabilities.
Intellectual property and similar rights	There should be a requirement to ensure that all relevant rights needed to enjoy the use of the goods or services are provided as part of the supply.
Termination	Set out the circumstances in which the contract can be terminated. This may sound like something that is of little practical value to include in standard terms, but it should cover what happens to goods delivered but not yet paid for, etc.
Confidentiality and use of data	General rules regarding data protection and data management should be included, as well as reference to complying with relevant laws.
Ethics and corporate social responsibility	Requirements regarding ethical considerations must be included, at least at the level of complying with international law. More detail may be appropriate depending on the nature of the business and the priorities of the organisation.
Law and jurisdiction	Sets out which country's legal framework is applied to the contract and, in the event of disputes, which country's courts have the power to issue judgments.

Table 3.5 Key areas to cover in standard terms

Remember
Standard terms and conditions must cover all of the key areas, no matter how short the document is. Review table 3.5 as a reminder.

The key features, advantages and disadvantages of standard terms are summarised in figure 3.2.

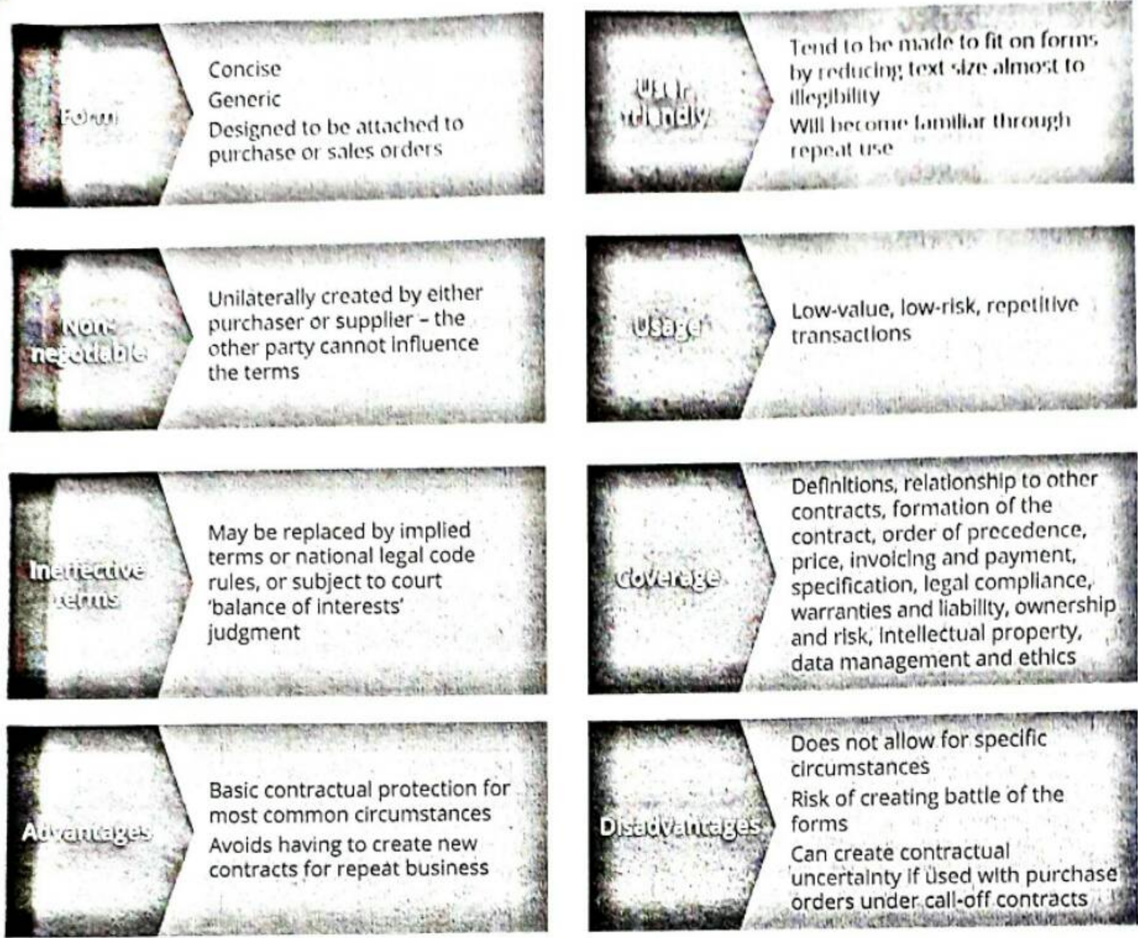
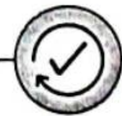


Figure 3.2 Summary of the key features of standard terms

Apply
Find a set of standard terms and conditions (many are available on the Internet) and consider any areas where the protection is insufficient from the perspective of either the buyer or the purchaser. (Clue: if they are supplier terms, think like a purchaser; if they are purchaser terms, think like a supplier.)

Check
What are standard terms of business, when might they be used and what are the disadvantages of using them?



The use of model form contracts such as NEC, FIDIC, IMechIEE

This section looks at model form contracts, why they are used and how to use them safely.

Why are contract documents so complicated?

Drafting contracts is a complex activity.

The ability to draft purchase and supply contracts requires knowledge of the purchase or supply category and the norms of trading behaviour in that category. For example: how much tolerance might be normal for late delivery, or how big an impact would a 3mm variance against specification of a component have? As shown in previous sections, it is crucial to not only get the specification right, but also to understand how to set targets around compliance with it. This is part of the contract drafting.

The other part of the contract drafting is the substantive set of terms and conditions: the obligations and rights of both parties and the consequences of not meeting those obligations.

Writing these requires a mix of category knowledge and legal knowledge. A common complaint about contracts is the obscure language that is used within them. In common law jurisdictions (those whose law systems rely on case law rather than a full, formal, written legal code), certain phrases and expressions come to have a specific defined meaning in the context of a contract. It works as follows.

Precedent
A court judgment which is binding on future legal decisions

1. A dispute will go to court.
2. In the course of settling the dispute the judges will explain how they have made their decision – known in Latin as the *ratio decidendi*. Anything said in this part of the judgment can become a fixed **precedent,** depending on the hierarchical level of the court concerned.
3. The judges may also add other remarks (*obiter dicta* in Latin). These are never binding, but they can be persuasive when future cases are considered.
4. Both the *ratio* and the *obiter* are linked to the very precise wording in the case at hand, so if people drafting future contracts want to rely on that judgment, they tend to use the same wording.
5. Over time the wording becomes archaic (old and no longer normal usage) and less easy to understand.

It is easy to be cynical and say that this is what keeps lawyers in work, but another view is that using fixed terminology that has been tried and tested in the courts helps to protect both purchasers and suppliers because the definitions are known. Disputes can be avoided because of a concept known as **'legal certainty'**.

Legal certainty
The ability to predict how a court will decide a matter of dispute

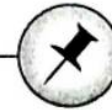
Legalese
Complex legal language

Legal certainty means knowing what the law says, what it means, and therefore how the courts will decide in the event of a dispute. It cannot be always 100% certain, but it means that the law is as clear as it can be. Purchasers and suppliers (the parties to the commercial contract) can have a large degree of certainty as to what a court will decide if a particular argument is taken through litigation. The main benefit of this is that it stops arguments getting that far, which saves everyone time, money and administrative resource.

The net result is that there will always be a certain amount of '**legalese**' in contract documentation.

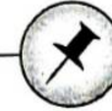
In turn, this means that purchasing and supply professionals need a minimum level of legal knowledge – at least enough to know what they do not know – and they should cultivate strong relationships with their legal teams or external legal advisers.

Remember
Contracts are complicated for a reason. Simplifying the language might remove some of the protection intended to be afforded by the wording – never do so without taking legal advice.



Why model forms of contract exist

Remember
Standard terms are useful for low value, low risk, repetitive purchases. They are not appropriate for any purchase which warrants a full bespoke specification and tender.



When it is decided that standard terms do not offer enough protection for a particular purchase (or supply) the question is: is it necessary to write a fully bespoke contract? Not necessarily. Indeed, it is better to avoid doing so if possible.

Contractual disputes may seem many and varied, but in reality they all hinge on a few variables, commonly: price and payment, timeliness of delivery, fitness for purpose and defects (i.e. quality), management of the contract, data protection and property rights, warranties and guarantees.

Other contractual aspects around ethical considerations tend (rightly) to be dealt with at supplier management level, rather than contract management level. The clauses are written into contracts to provide the ultimate leverage in the event that supplier management engagement does not achieve the desired results.

How those variables play out depends very much on the nature of the industry involved, but within a given sector (e.g., manufacturing, engineering, construction, health care, accountancy) there will normally be a consensus view on the likely problems and the best way of protecting both suppliers in that sector and organisations purchasing from them. Once this is established, it is a relatively short – though not necessarily easy – step to develop a model form of contract to cater for the sector.

A model form of contract is effectively a template. It sets out core wording to cover all of the normal scenarios and problems in the context for which it is developed. This means that anyone choosing to use the model form does not have to start with a blank piece of paper and do this for themselves.

It also means that suppliers tendering (or purchasers buying) against a model form are likely to have some familiarity with it and therefore be relatively comfortable with most of its terms.

Examples of model forms of contract

Some examples of model forms of contract are shown in table 3.6.

Apply
Investigate via colleagues, other contacts or the Internet which forms are used in the various sectors or a sector in which you want to work.

Many of the model forms are subject to copyright so a copy would have to be purchased in order to view them in detail. If you can get one, look at it in detail.

The different forms follow a different structure and are designed for specific sectors, but some principles apply across all of the standard forms. These principles are as follows.

- Contract-specific details: parties to the contract, contract subject matter (that is what is being procured/supplied), dates, etc.
- Standard common clauses, covering all of the items listed in table 3.5, formulated in a way that is most applicable to the type of purchase normally expected under the relevant form
- Schedules to cover pricing, specification and any other contract-specific detail

Model forms of contract	Produced by/used for
NEC	New Engineering Contract – a family of standard contracts primarily used in construction in the UK; includes works, consultants, subcontracts, services
JCT	Joint Contracts Tribunal – a family of standard contracts used in construction in the UK; includes works, consultants, subcontracts, services
AS	Australian Standards contracts – different contracts for a range of purchase types including construction, consultancy, periodic supply of goods
FIDIC	International Federation of Consulting Engineers – construction industry forms including works, consultants, subcontracts, mechanical and electrical – these are the most widely used forms internationally, including by the World Bank
IMechE/IET	Institution of Mechanical Engineers/Institution of Engineering and Technology – two separate institutes that issue jointly agreed model forms covering the design, supply and installation of electrical, electronic and mechanical plant 'including special conditions for the ancillary development of software'[14]
CIPS	Chartered Institute of Procurement and Supply – CIPS has developed its own suite of standard forms of contract for IT functions including: supply and installation of computer equipment, support and maintenance of bespoke software, servicing of computer equipment
ITC	International Trade Centre – contracts specifically designed for small companies doing international business, covering the sale of goods, distribution, services and joint ventures

Table 3.6 Examples of model forms of contract

When searching for model forms of contract, the results may show a heavy bias towards the construction sector. There are a number of reasons for this.

- It is a sector that has long had professional institutions which have traditionally taken the lead in developing model forms in the interests of protecting their members.
- It is a sector known to have wide scope for contractual dispute and legal action, which can be avoided if good contracts are in place.

- The nature of the procurement is such that the basic contractual requirements are relatively easily reduced to a common formula.

However, the concept of the model form is now expanding beyond construction and many organisations have their own internal 'model forms'. These are often derived from other forms, suitably adapted to specific circumstances and then checked by legal teams for anomalies, clarity, compliance with the law, etc.

Case study

A newly formed procurement team creates its own model forms

A property management company had grown to the point where it needed to standardise contracts. Some aspects of the business, particularly in construction, were already using industry standard forms such as those shown in table 3.6. Technical consultant appointments (architects, quantity surveyors, structural engineers and the like) were appointed on standard forms issued by the relevant professional bodies. Much of the other purchasing (services, supply of goods for general business operations, ICT, etc.,) was done either without formal contracts or on forms created from scratch on a one-off basis.

This meant that there was a lack of consistency across the organisation, that in some cases the same consultancy firm might have different appointment terms depending on which service they were providing, and there were a number of risks in many other areas of spend that were not covered.

A contract review determined that the construction contracts were generally standard and the approach did not need to be changed.

The technical consultant forms were reviewed and a standard in-house template was produced which could be used for any consultant appointment. Where appropriate, this allowed for cross-reference to the relevant professional institute standards or wording, allowing those professionals to be comfortable with the familiar terms in some key areas while all other terms and conditions were common to all appointments. It also permitted the same basic template to be used for other types of consultant appointment where no industry standard existed.

In the wider business, the national government 'public contract' templates were taken as a starting point, and again these were adapted to provide a model that worked within the organisation's own context.

Solicitors were appointed to review the model documents for robustness (i.e. to check that they would stand up to a legal challenge) and fairness.

The organisation now had a standard suite of contract documents, which staff and suppliers could be trained to implement effectively.

Over the years, each of the models was kept under periodic and responsive review and updated to ensure that changes in regulations, codes of practice, technology, etc., were reflected. (Periodic reviews were those carried out every two to three years; responsive reviews were held whenever there was a change, for example, in relevant regulations.)

Remember
Model forms contain core clauses that are standard, but they are templates designed to be used with supporting documentation that is project-specific.

How model forms of contract are developed

Traditionally, model forms of contract would be developed by professional institutions with the stated aim of producing a contract which protects the interest of its members. Many of these institutions would be supply-side bodies, representing building contractors, consultants and the like.

More recently, standards organisations, national governments and independent third parties have started to develop model contracts which are more balanced in representing the interests of both suppliers and purchasers. At the same time, the original professional bodies widened the stakeholder representation on their own development panels so that their models also became more balanced and reflective of the wider interests. This progression ran alongside a general shift in attitudes in procurement and supply generally, away from the old adversarial approach of supplier versus purchaser into the more modern world of collaboration, partnership and joint working to improve outputs for all parties.

The institutions and bodies named in table 3.6 – and others doing similar work in different countries and for international organisations – usually have working groups set up who meet at regular intervals to review how well the current forms of contract are working in the real world and to look at possible improvements. Such improvements might come about due to the following.

- Changes in national or international law
- A number of legal disputes have highlighted a particular ambiguity or weakness in the contract
- Technological change in the sector creates new problems, risks or opportunities that need to be catered for within the contract

Involvement with such working groups can be a useful source of professional development and growing influence for procurement and supply professionals.

Apply
Seek out any working groups operating in the arena in which you work.

How to use a model form of contract

There is a danger in using a model form of contract that the person putting it together thinks all of the work has already been done. This is not the case. Care must still be taken to ensure that the contract that results from using the form protects the interests that need to be protected, on both sides, does not create ambiguity or legal uncertainty, and accurately and completely reflects the agreement between the parties.

A model form is just that: a model or a template. Every clause should still be reviewed to ensure that it is applicable in the precise circumstance in which the contract is being used.

In order to carry out this task effectively and efficiently, procurement and supply professionals must be adequately trained in the use of contracts generally and understand the circumstances with which they are dealing. In some cases, in more complex transactions, procurement professionals will need to use legal advisers to help prepare contracts. One of the purposes of using a model is to ensure that the contract can be drafted relatively quickly and easily, but that does not mean blindly or without thought.

Most models will have an accompanying guidance note. This note will highlight the following.

- Blank spaces on the model form which need to be filled in (e.g., with names, contact details, dates, other contract-specific information)
- Optional clauses that may only apply in certain circumstances and should be deleted in others
- Options with a default position. A common example is defects periods: the model might state that defects have to be notified within six months unless an alternative period is stipulated; the default position is then six months, but the contracting parties are free to insert an alternative period, 12 months being common in construction.
- Schedules to be completed or attached

In addition, each organisation may have its own standard amendments that it wishes to impose whenever it uses an industry model form. Purchasers may feel that, despite the involvement of stakeholder groups in designing the model, it is still unduly biased in favour of the supplier and requires additional changes. Where these changes are standard to the organisation (i.e. they are used on every contract) a model form of amendment can be created which acts effectively as a further schedule to the contract, provided that it is properly referenced by amendment to the main contract clauses.

Case study

Amending a JCT contract

A company that regularly uses the JCT Measured Term Contract for maintenance works to its buildings has a standard set of amendments that it requires suppliers to agree to on all of its projects. These are set out in a format that can simply be attached as a schedule to the contract. To ensure that they are properly embedded in the contract, however, requires the main body to be amended by the addition of another 'article' (see table 1.6 if you need to review what an article is).

> The model additional article in the contract guidance notes is:
>
> '**Article 9** Insert new Article 9: Amendment to conditions
>
> This Agreement and the Conditions shall have effect as modified by the amendments set out in the Attached "Schedule of Amendment to Conditions".'
>
> This amendment was generally handwritten onto the printed form of contract and initialled by both parties until electronic versions of the form came into use when it could be properly incorporated within the final text.

Of course, there is always the risk that a particular amendment within the standard amendments may not be needed on a particular project, or that other amendments which are non-standard are needed to cater for unusual circumstances.

This underlines the need for contracts to be considered carefully on a project-by-project basis by personnel adequately trained to understand both the technical and legal aspects of them.

There is a view that model contracts should never be amended. They will always need the completion of the project particulars and schedules, but (the view holds) the key clauses should never be changed beyond the options that are allowed for within them. This view holds that either a model contract is suitable for the project, in which case it does not need to be amended, or it is not, in which case a project-specific contract should be drawn up. There is no definitive answer to this.

Any change to a model contract creates risks that the internal logic of the contract gets broken (e.g., cross-references between clauses cease to make sense if some of them are deleted or changed; or the order of precedence becomes confused; or payment periods say one thing in one circumstance that is not reflected elsewhere).

Changes also alter the 'balance' of the contract in favour of either the purchaser or the supplier. This is usually the very reason for making the changes, but the other party may feel that it is a step too far.

The opposing view, which says it is better to amend a model than to write a bespoke contract, rests on the fact that the parties will generally be familiar with the model. They are therefore happy to work with it. They understand the mechanisms (for payment, dispute, etc.,) that are embedded in it. This makes for a certain ease in the relationship between purchaser and supplier during both the tender stage and (at least the early) contract stage. It avoids unnecessary resource deployment to review what are familiar and standard clauses 'just in case' there is something to worry about. The things that have not been amended are 'knowns' and only the changes need to be reviewed.

Once the contract is in place, contract management proceeds as it would under any other form, with the exception that it is useful to keep an even closer eye on legal developments. Many legal firms offer free newsletters that include recent case law on disputes where standard forms have been used. These can inform how an organisation uses them in future.

> *Remember*
> When amending standard forms be careful to ensure that all cross-references have been appropriately amended.

Figure 3.3 sets out key steps in setting up and using a model form of contract.

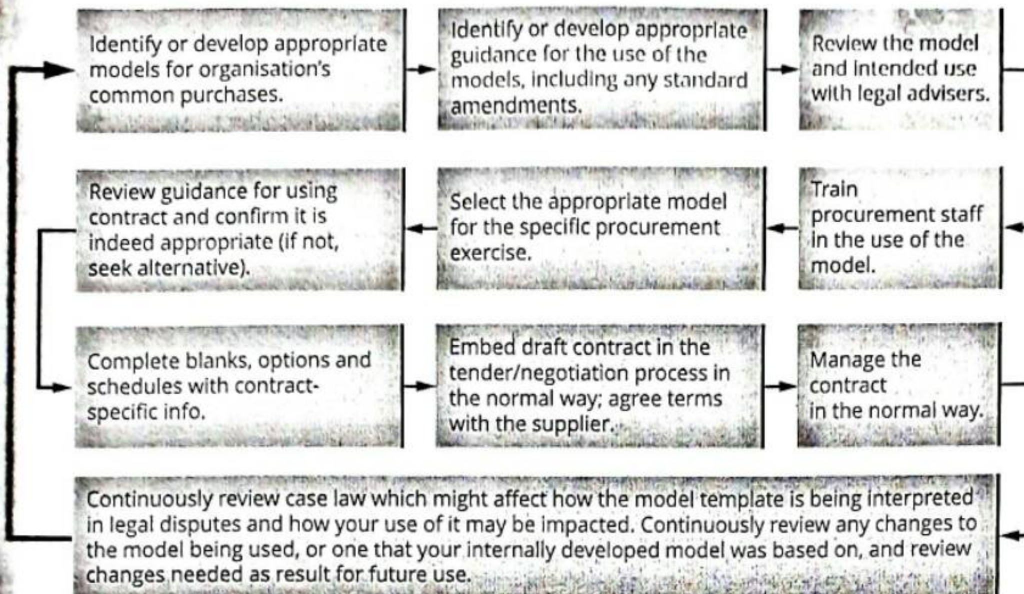


Figure 3.3 Key steps in using model forms of contract

Apply

Investigate via colleagues, tutors or the Internet whether there are any model forms of contract that apply to your areas of work or interest. Who produces them? Is there any indication as to which stakeholders have been consulted? Consider what you might need to know if you wanted to amend any of their terms.

Advantages and disadvantages of model forms of contract

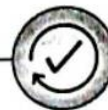
It should be clear by now that there are both advantages and disadvantages to using model forms of contract.

Advantages	Disadvantages
Saves time and resource drafting bespoke contracts.	Poorly trained staff may use templates incorrectly or choose inappropriate model.
Both suppliers and purchasers familiar and comfortable with main terms.	Amendments to published templates can create ambiguity.
Specific to sector or purchase type.	May become out of date if not reviewed regularly.
A measure of legal certainty on court's response to disputes.	May be biased (supplier or purchaser), depending on ownership of the model.

Figure 3.4 Advantages and disadvantages of using model form contracts

Check

Describe the development and use of model forms of contract. What advantages are there in using them?



3.2 Recognise examples of contractual terms typically incorporated into contracts that are created with external organisations

This section looks at the some of the key terms that are typically included in commercial contracts, in particular those covering liabilities and indemnities, insurances, subcontracting, guarantees and liquidated damages, as well as those relating to labour standards and other aspects of ethical sourcing. All of these will generally be covered in the standard clauses where model forms of contract are used.

Key terms in contracts

Liabilities and indemnities

Virtually all contracts will include a number of clauses on liabilities and indemnities. The relevant section may actually be headed 'Liabilities and indemnities' or it may be something like 'Injury, damage and insurance' (JCT) or 'Liabilities and insurance' (NEC).

ability
eing legally sponsible for mething

rict liability
iability that exists thout proof of ongdoing

demnity
ecurity or otection against s, usually by y of financial ompense

First, it is necessary to understand the concepts.

- In the contractual context, having a **liability** means being legally responsible for something. The person to whom the liability attaches is legally or contractually responsible for paying compensation for any injury, loss or damage that has occurred.
- Some liabilities only come into being if there is some kind of failure by the party concerned, for example, negligence or poor workmanship. Others are set down in law as being absolute without any need to prove fault. The latter are known as **strict liability.**
- An **indemnity** is a security or protection against loss. Accordingly, for one party to indemnify another means that it will offer that protection. For example, if the purchaser suffers loss because of a supplier's product or service, the indemnity provided by the supplier is the contractual obligation to make good that loss, usually by way of financial compensation or reimbursement.

Clearly it cannot always be possible to know in advance the nature of the possible loss or the extent of the compensation that might be required. It is common, therefore, for the parties to a contract to seek to either exclude or limit (either in scope or by value) their liability.

Table 3.7 sets out the key aspects of liability and indemnity clauses and things to consider when agreeing to them.

Liquidated damages	Sets out the circumstances in which liquidated damages may be charged (normally late delivery) and the rate at which they will be charged, e.g., $300 per week.
Exclusion of liability, i.e. force majeure	Some liabilities cannot be excluded. Where a strict liability exists in law, or where the action is a criminal offence rather than simply a contractual matter, then the contract will generally confirm that neither party excludes its liability to the other party.
Negligence of the other party	It would clearly be wrong for one party (say the supplier) to be held legally responsible for consequences that only occurred because of the negligent act of the other party (the purchaser). If the client's (i.e. the purchaser's) action contributed to the event but it was not solely responsible for it, then the contractor's (supplier's) liability is only reduced, not fully removed.
Indemnity	Indemnity clauses may include complex language that results from trying to cover all angles. This is more likely in common law countries, such as the UK, the USA, Singapore and Australia, than those with a civil law code such as Turkey, Vietnam and most of Europe (except for the UK, Ireland and Cyprus). In the civil law countries, the definitions are more likely to be embedded in the code, making the contract simpler.
Financial limit of indemnity	Organisations need to plan how they will meet any liabilities in the event that they should need to. No business would willingly accept an open-ended financial liability. The question is: at what figure should the liability be capped? Commonly, suppliers might seek to restrict it to the value of the fees being paid under the contract. However, the potential loss could far outweigh those fees.
Limiting scope of liability	Indirect losses are virtually impossible to calculate. How can the cost of 'loss of goodwill' be measured? (A drop in share price, perhaps?) And over what time period? And if goodwill returns (and share price rises) is the loss then mitigated such that compensation should be repaid? Where would you draw the line in the remoteness of the indirect consequence, either in time or through a chain of consequences? These are impossible questions to answer. They result in legal and financial uncertainty and are best avoided. Thus: indirect and consequential loss are generally excluded.
Transfer of liability – often called transfer of risk	Where goods are being supplied or materials incorporated into works, the contract must state the point at which the liability for damage to them transfers from one party to the other. The NEC4 contract, for example, includes the following wording: 'Client's liabilities [include]... loss of or damage to any Plant and Materials after they are included in the affected property... Contractor's liabilities [include]... loss of or damage to any Plant and Materials before they are included in the affected property.'[15] So, at the simplest level, loss or damage to spare parts for a boiler is the contractor's (supplier's) liability until they have been fitted, when they become the client's (purchaser's) liability. Note that this is loss or damage to those parts, not caused by them, which would be a different matter. This may be set out in the 'liabilities' section of the contract, or may fall under an 'ownership and risk' clause. Note that ownership and risk may not necessarily transfer at the same time. Goods might be paid for in advance so that ownership is then with the purchaser, but the risk (the liability) remains with the supplier until they have been delivered.

Table 3.7 Things to consider in respect of liability and indemnity clauses

Remember
Liability is a legal responsibility and indemnity is a promise to meet the costs arising from the liability. Contract terms may seek to limit liability by placing a financial limit on indemnity levels.

Insurance

nsurance
ın arrangement
vhere a fee is paid
ɔ one party (the
ısurance company)
o that it will accept
ıe risk and meet
ny costs that would
ormally fall to the
erson who has
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sk is transferred
om the person with
ıe legal liability to
ıe insurer

The concept of insurance is familiar from our domestic and personal lives. It operates exactly the same way in the commercial world.

For those who may not have given it much thought, a definition might be helpful. **Insurance** is an arrangement where a fee is paid to one party (the insurance company) so that it will accept the risk and meet any costs that would normally fall to the person who has the legal liability for them. Effectively the risk is transferred from the person with the legal liability to the insurer.

To be clear: the legal liability does not transfer to the insurance company (known as the insurer). It merely agrees to meet the costs on behalf of the party with the liability, up to an agreed limit.

Insurance works by way of a pooling of risk. The insurer takes a fee and agrees to meet any costs resulting from the risk event actually happening, in given circumstances and up to a pre-agreed financial limit. This works because in the scale of the insurer's business, relatively few risk events will occur, and the fees (premiums) paid together with investment interest earned on that money will cover any payments that do need to be made.

Why is insurance referenced in contracts?

In commercial contracts, where liability has not been limited – and in many cases where it has – the sums involved are significant and can run into millions of dollars. The impact of having to meet such an exceptional cost, particularly for a small firm, could be catastrophic. The scale of the compensation will undoubtedly disrupt the business of the party having to pay by impacting on cash flow, making it harder to pay bills on time and/or to obtain credit finance, meaning it might not be able to obtain the materials and components needed to fulfil orders, etc. In the worst case scenario it could cause the financial collapse of the business.

This is not just a problem for the supplier concerned. It also becomes a problem for those purchasers with whom it is in contract: both the purchaser on the contract where the problem has arisen, and the others who might find their own orders delayed or unfulfilled.

To avoid this it is standard practice for suppliers to insure against having to make such payments and, indeed, for the contract to require them to do so. The contract will often set out the type and level of insurance cover required.

Clauses relating to insurance normally fall within the same section of the contract as those relating to liability and indemnity.

Types of insurance cover referenced in contracts

The most usual forms of cover are as follows.

- Employer's liability – a legal requirement for any company that employs staff, this covers the duties of care owed by an employer to those staff; for example, compensation for injury suffered in the course of their employment.

- Public/products liability – sometimes known as 'third-party cover', this relates to any injury, loss or damage caused by the company's products, or on its premises, or as a result of the actions of its personnel.
- Professional indemnity cover – this relates to losses that occur as a result of poor or negligent advice that is given in a professional capacity (for example, by accountants or engineers).
- Goods in transit cover – this is for damage caused during the delivery process.
- Works/buildings – this is cover for partially completed building works, or the buildings in which they are being carried out.

Table 3.8 sets out the things to consider in respect of insurance clauses. Insurance is a specialist area, and procurement and supply professionals are advised to consult their insurance advisers (whether these are in-house specialists or external consultants) on the adequacy of the clauses they have in their contracts.

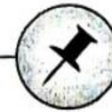
Employer's liability	Employer's liability cover is normally a statutory legal requirement. Although the claims that arise may be completely unrelated to the contract in hand, having evidence that such cover is in place gives comfort that the supplier is running a responsible business and complying with the law, and that one of the potential risks that could disrupt its cash flow (and therefore its ability to meet its contractual obligations) is being properly managed. There is also an ethical dimension in that it indicates that the employer has to some degree considered its duty of care to its employees. Minimum values are normally set by law.
Public/products liability	Public liability and products liability are often linked, but depending on the nature of the purchase, it may be that only one or the other is required. A consultant who purely provides a service with no tangible goods being involved is unlikely to need products liability, but may well need public liability. For example, the catering company that runs the office canteen will have liability for the service it provides and equipment within the canteen area (public liability) and also for the food it prepares and sells (product liability), whereas a management consultant who simply comes into the office and talks to senior leaders would probably not need product liability. However, they may need public liability cover, as well as professional indemnity cover.
Professional indemnity insurance (PII) or PI cover	This covers professional advice which is relied on by the purchaser. It includes services such as legal advice, accountancy, audit, project management, investment advice, and also technical design services such as those provided by architects and engineers. It is important to understand the concept of PII, because the fact that insurance might be required is not always obvious. It might be clear that a structural engineer needs such cover, but what if an engineer has not been appointed and the design is being produced by the building company?

Goods in transit	Whoever 'owns' the goods while they are moving between the supplier and the purchaser, there is a risk of them being lost or damaged en route. It is sensible for them to be insured against such loss. The relevant clause should set out who is responsible for arranging and paying for such cover, which may or may not be the company that owns the goods at the time they are moving.
Works/buildings in which works are being carried out	The insurance of partially completed works is a complex business. Model forms usually set out a variety of options as to who will insure the building, who will insure partly completed works, and any requirement for policies to be in joint names of both client and contractor (purchaser and supplier). Those working or wanting to work in construction-related sectors could usefully obtain one or other of the standard forms of contract used locally in that sector and compare the different options.
Level of cover required	Insurance is provided for a fee. One of the things that influence the level of the fee (or premium) is the level of cover provided in financial terms. Cover for $20 million will cost significantly more than cover for $5 million. Contract clauses normally stipulate a minimum level of cover needed. There is no definitive rule on how this is calculated, though purchaser organisations normally have a standard requirement. This should be reviewed periodically to ensure it is still adequate. Specialist advice should be taken. The key thing for the procurement professional to remember is that there is a cost–benefit analysis at work here. Any decent supplier will have insurance cover. If the purchaser wants a higher level of cover, this will be an extra cost to the supplier, who will seek to recover that cost through its contract pricing. The questions for the purchaser are: what are the risks, how likely are they to occur, what is the likely damage if they do occur, does that warrant the extra contract price?
Aggregate or 'each and every'	Insurance clauses, when stating levels of cover required, will refer to 'aggregate' cover levels or 'each and every claim' levels. Aggregate cover means that the total claims under that policy or in a given time period (often 12 months) cannot exceed a given level. If there are several claims in that period, the later ones are unlikely to be met. 'Each and every claim' cover means that the financial limit applies to each individual claim, no matter how many claims are made. 'Each and every claim' obviously offers better protection but comes at a higher cost.
Scope of cover	It is rarely possible to provide finite detail of the cover required within the contract terms, so this will normally be done by the use of expressions such as 'in respect of all customary risks'. This wording is necessarily vague, so it is important that the procurement and supply professional knows what those risks are and that they are catered for within the cover provided. From the purchaser's perspective, supplier policies should be checked, not just to see that they are in date, but that they do not include restrictions on things like working at height, working in other legal jurisdictions, methods of transportation or whatever might be relevant to the contract concerned.

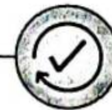
Auditability of insurance	Having created a contractual requirement for the insurance to be in place, the purchaser should then also ensure that it has a right to access evidence of cover. Ideally, the contract should go further and allow the purchaser to put in place insurance itself if it is not satisfied that the contract requirement is met, and to reclaim the costs of doing so. Sample wording: 'The Contractor shall give the Client annually upon request and in any event annually upon renewal copies of all insurance policies referred to in this clause or a broker's verification of insurance to demonstrate that the appropriate cover is in place, together with receipts or other evidence of payment of the latest premiums due under those policies.' If, for whatever reason, the Contractor fails to give effect to and maintain the insurances required by the provisions of the Contract, the Client may make alternative arrangements to protect its interests and may recover the costs of such arrangements from the Contractor.

Table 3.8 Things to consider in respect of insurance clauses

Remember
Insurance is used to make certain that the offending party can meet the financial costs of its liability in the event of a claim. Contract terms should be used to require that subcontractors are also appropriately insured.



Check
Describe the key features of liability and indemnity clauses. How are they used to try to limit the risks?



Subcontracting

Subcontract
A contract that sits below, is directly linked to and is partly governed by a higher contract to deliver part of the requirements of that higher contract. There can be several layers of sub- and sub-subcontracts

Commercial contracts are often layered, with a main contractor or supplier appointing other contractors or suppliers to fulfil an aspect of the order. This second contract, sitting underneath the first one, is called a **subcontract.** For example, a council may contract with a building company for a new school. The building company will likely do some of the work itself but appoint specialist firms to provide some aspects of it, such as the plumbing or the scaffolding. This is subcontracting. There may be several layers with sub-subcontracts and so on. Generally the expression 'sub-subcontract' is rarely used. When talking about a subcontract, it means one that sits underneath a higher one, is directly related to it and often partially governed by it.

The layers of contracts are often referred to as 'tiers', so a tier 1 supplier is one with whom the purchaser has a direct contract, a tier 2 supplier is one with whom that direct supplier has a contract, tier 3 would be the next level down, etc., (see figure 3.5).

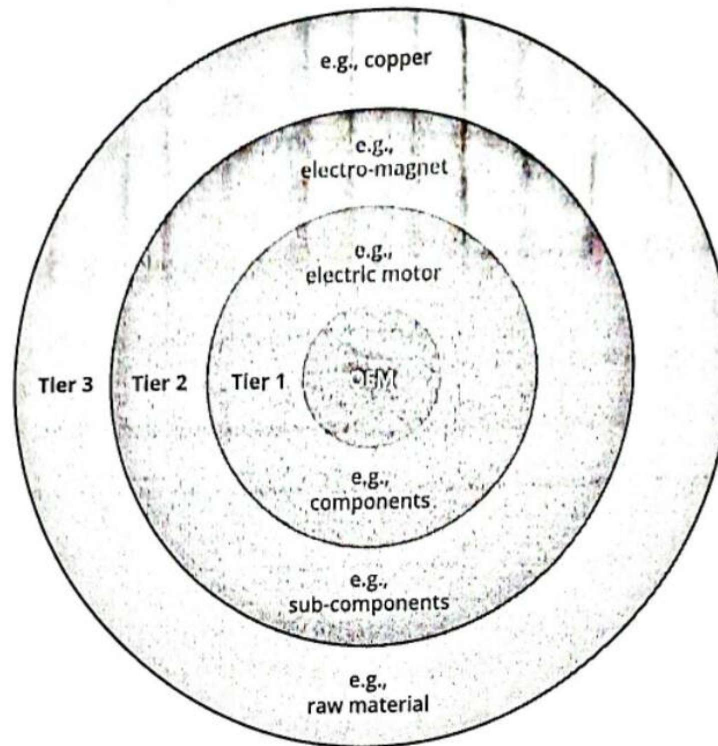


Figure 3.5 Contract tiers

The contract between the tier 1 supplier and the tier 2 supplier may or may not be a subcontract. The direct relationship between the two contracts is important. To go back to the example of the builders of the school: the plumbers appointed to install the water and heating systems, etc., are subcontractors. Their contract is tied directly to the main building contract. By contrast, the builder's contract with the suppliers of bricks normally would not be a subcontract. The builder would be buying bricks anyway, possibly a different number, possibly a different type, and certainly for delivery to a different place, but the relationship between one specific building contract and the need for the brick-supply contract is less direct. It would therefore usually be a standalone supply contract. However, both the plumbers and the brick suppliers are tier 2 suppliers.

Note: subcontracting can occur, not just on works projects, but also on those for the supply of goods and/or services. The expression 'subcontractor' is normally used regardless of the nature of the supply, simply because it is easier to say. 'Sub-supplier' is sometimes used in respect of supply of goods contracts. On services contracts the term 'sub-service-provider' would never be used. It would always be 'subcontractor'.

Why is subcontracting referenced in contracts?

There are a number of reasons why the purchaser will want to control the supplier's subcontracting.

- Supply chain: a lot of effort is put into choosing a supplier, ensuring that it is financially stable and can deliver the contract and trade ethically, etc. That work is wasted if the chosen firm simply passes the contract down to a subcontractor who may or may not have been vetted to the same degree. The more layers there are, the less the purchaser will know about the person who

is actually doing the work for them. There is a need to control the choice of subcontractor to some degree.

- Contract terms: having agreed the terms of the contract, the purchaser may wish to ensure that these are reflected in the subcontracts. For example, an ethical purchaser may wish to ensure that payment terms in subcontracts reflect those in the main contract. See the case study 'Subcontract payment terms'.
- Liability: the purchaser needs to ensure that even if some of the supply is subcontracted, the main contractor remains legally liable for fulfilling the contract. They cannot simply blame the subcontractor for any faults and walk away.

Case study

Subcontract payment terms

Large construction companies subcontract a lot of the actual building and installation work to smaller firms. They are known to have very long payment periods, i.e. the period between the subcontractor invoicing and actually getting paid. Ninety-day periods are not uncommon. This means that many small firms can be waiting three months or more to receive payment, which obviously causes them cash-flow problems.

This would be understandable if the construction companies themselves were waiting similar periods to receive their income. But often this is not the case. When carrying out work for public sector clients the payment period will normally be 30 days.

As a result, the large firm is holding (and investing) money for two months before paying it across to the firm that actually did the work. For some firms this delay is actually part of their business model. The income from that 60-day investment period enables them to offer more competitive rates to the purchaser and so, in theory at least, win more business.

However, this is at the expense of creating risk further down the supply chain.

The risks are being carried by small to medium-sized companies, who often do not have the buying power to negotiate better terms with the main contractors. This was seen to be such a problem that the European Commission decided that – where they have some influence on contract terms, namely in the public sector – contracts and all subcontracts should have a requirement that payment terms throughout the supply chain for a public contract must be no longer than 30 days. In Europe this is now required by the Public Procurement Directive 2014.

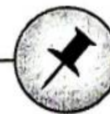
Table 3.9 sets out the things to consider in respect of clauses relating to subcontracting.

Do you wish to permit subcontracting at all?	There may be valid reasons not to allow any subcontracting, particularly if working on contracts that may have security or defence implications or include commercially highly confidential information on radically new products or processes. It is normally accepted, however, that properly controlled subcontracting is beneficial for purchasers, suppliers and the economy generally. It allows smaller firms to survive, increases competition, spreads the risk, etc. The latest public procurement rules in the EU (Public Procurement Directive 2014/24/EU) include a provision that suppliers must be permitted to rely on the resources of others. In other words they must be permitted to subcontract. However, purchasers are permitted to include reasonable rules on how they do so. Sample wording: 'The Contractor shall not without the prior consent of the Contract Administrator subcontract any Order or part of an Order. Such consent shall not be unreasonably delayed or withheld.'[16]
How much control over the selection of subcontractors do you need?	In most cases contracts can rely on a generic need for approval and a statement that it will not be unreasonably withheld, but that raises a question as to what 'unreasonably' means. In what circumstances would it be reasonable to withhold consent? Normal requirements will not need to be expressly stated. For example, if a licence or qualification is required in order to be able to provide a given service, rejecting a subcontractor without such a licence or qualification is clearly reasonable. If certain assurances are required which are not so clear-cut, so that the reasonableness of them might be questioned, it would be better to be explicit. Specific measures to ensure secrecy might come into such a category.
What influence over subcontract terms do you want?	Do you want to ensure that subcontractors are paid promptly? Do you need to ensure that data protection measures included in the contract are also in any subcontracts? Are the insurance requirements the same? Sample wording controlling payment (based on template clauses provided by Crown Commercial Service, an executive agency and trading fund of the Cabinet Office of the UK Government – the clauses cross-referred to relate to payment within 30 days, prompt notification of queries on invoices, etc.): 'Specifically where the Contractor enters into a Subcontract with a supplier or contractor for the purpose of performing its obligations under the Contract, the Contractor shall include in that Subcontract provisions having the same effect as clauses 1 to 3 of this Agreement; and a provision requiring the counterparty to that Subcontract to include in any Subcontract which it awards provisions having the same effect as clauses 1 to 4 of this Agreement. In this Clause 4 "Subcontract" means a contract between two or more suppliers, at any stage of remoteness from the Client in a subcontracting chain, made wholly or substantially for the purpose of performing (or contributing to the performance of) the whole or any part of this Agreement.'[17]

	A somewhat simpler sample wording controlling insurance is: '... as a minimum, the Contractor shall ensure professional indemnity insurance held by the Contractor and by any agent, subcontractor or consultant involved in the supply of the Services has a limit of indemnity of not less than £5,000,000 for each individual claim or such higher limit as the Client may reasonably require (and as required by law) from time to time.'
Ensure that the main contractor retains liability	Wording must be included to ensure that all legal liability stays with the main contractor. Sample wording: 'The Contractor shall be responsible for the acts and omissions of its Subcontractors as though they are its own.'[18]
Beware the impact on price	When deciding how far to control subcontracting bear in mind that any restriction on the main contractor being free to choose its own subcontractors may have an impact on the price paid by the purchaser. Restrictions might limit the number of potential subcontractors, thus driving up price as a result of less competition. It might mean that the main contractor cannot use its normal subcontractors, increasing the administration costs of its subcontract management as well as potentially resulting in a directly higher price.

Table 3.9 Things to consider in respect of clauses relating to subcontracts

Remember
Contract terms should be used to control subcontracting, including whether it is permitted at all and any specific terms that may be necessary in the subcontracts, regarding payment terms, insurance, etc.



Guarantees

A guarantee is a formal written assurance that certain quality conditions will be fulfilled, and it provides a specific remedy if they are not, for example, that a product will be repaired or replaced free of charge if it fails within a given time period.

Guarantees could apply to services, but they are much more common in respect of goods, whose lifespan will go beyond the actual contract under which they are provided.

The guarantee outlives the contract. A hotel chain may have a one-off contract for the supply of mini-refrigerators to be installed in guest bedrooms. The contract itself is completed once the refrigerators have been delivered and paid for, but the guarantee could run for two years.

The more complex the product being purchased, the more likely that a guarantee is required; also the longer the purchaser will want the guarantee to last. From the supplier's perspective, there is a cost to providing a guarantee. Some products will fail within the guarantee period and will need to be repaired or replaced free

of charge. However, assuming the supplier has good quality control that number should be very small in comparison to the total numbers being produced and sold. Therefore the value of the guarantee to the purchaser is much greater than the cost of it to the supplier.

Table 3.10 sets out the things to consider in respect of guarantees.

Do you need a guarantee?	How likely is it that the product will fail and how much impact does such a failure have? If it is very likely to fail, you should not be buying it at all. If it is not likely to fail but failures are costly to rectify then a guarantee is essential. The numbers of the product you are purchasing should also be taken into account. The more of them you buy, the more likely you are to get a faulty one.
How long does the guarantee need to be?	Most manufacturers offer a standard guarantee period. Depending on the nature of the product this could be anywhere between two and ten years. Extended guarantee periods will be offered but these may be at an additional cost. In many cases it will not be worth paying for the extra period, because the kind of failures covered by guarantees tend to happen early or very late in the life of the product.
What needs to be included in the guarantee?	This depends on the nature of the product. In some cases a simple replacement is the easiest and cheapest solution for both purchaser and supplier. However, if the product is a component that has been installed in a building or is part of a larger piece of equipment, it may be more convenient to repair rather than replace it. If the repair option is the most logical, be careful that it is full 'parts and labour' cover. The replacement part might be relatively cheap but fitting it could be expensive. The effect of the guarantee must be to put the product back into good working order. Thought should also be given to what kind of faults or failures are covered by the guarantee. Accidental or wilful damage, for example, will not normally be covered. Consider response times. The thinking that would go into a repairs and servicing contract should also be given to a guarantee. The more complex the guarantee offer, the longer the wording of it will need to be, and it may be sensible to include it as a separate schedule to the contract, or to embed it as part of the specification.

Table 3.10 Things to consider in respect of guarantees

Liquidated damages

'Damages' is the legal term for financial payments to compensate for a loss of some kind. Damages are paid when it is not possible to place the injured party in the position it was in prior to the injury or loss occurring.

'Liquidated damages' – sometimes also called 'liquidated and ascertained damages' – are damages whose amount is predetermined during the formation of the contract as being payable for a specific breach of contract. They are most commonly used in respect of late delivery.

Liquidated damages are specifically intended to be compensation and **not** a penalty. The object is not to penalise the supplier, but to redress the loss or extra costs that the purchaser incurs as a result of the lateness of delivery. The figures

are either set out by the purchaser as part of the contract terms information provided at tender stage, or they are agreed between the parties during the contract negotiations. In either case they must be a genuine pre-estimate of loss. It is useful to keep a record of how the estimate was arrived at. That document has no legal standing in the context of the contract, but could be useful if the reasonableness of the estimate is subsequently challenged.

Table 3.11 sets out the things to consider in respect of liquidated damages.

Which breaches of contract should carry liquidated damages?	Liquidated damages are only appropriate when there is no other suitable remedy. Anything that can be 'fixed' should not carry liquidated damages as a remedy. Quality issues, therefore, must be addressed in a way that improves or rectifies the quality. They are most usually found in respect of late delivery. Once delivery is late there is no way that it can be made 'not late', so damages is the only solution.
Estimating the sum	The liquidated damages figure must be a genuine estimate. Think about what the impacts of the lateness are and how that converts into financial loss. For example: late completion of a building involves loss of rental income, additional interest on loans which cannot start to be repaid until the rental income commences, salaries for staff who have been recruited but cannot start work until the building is available, lost orders if the building is a factory and cannot go into operation on time, etc.
Tying the figure to the degree of lateness	The losses for the purchaser are rarely one-off costs, they mount up as the length of delay increases. The contract term should therefore express the damages as a sum of money for a period of time. Sample wording: 'The rate for liquidated and ascertained damages shall be $3000 per week or part thereof.'
Process for claiming damages	The contract should also set out how the damages are to be claimed. This will normally require a specific notice or notices to be given to the supplier stating that delivery is late and that damages are being claimed. The contract may also need to state whether the supplier must literally pay the money to the purchaser or whether it will be deducted from any payments still to be made on the contract. The latter is common, but it must be made clear that the damages due are to be considered a debt between the supplier and purchaser – this may enable interest to be claimed if there are unreasonable delays in payment and may also enable a **right of set-off** against other contracts between the parties.

Table 3.11 Things to consider in respect of liquidated damages

Right of set-off
The ability of a purchaser to deduct debts that are owed under one contract from payments that are due on a different contract

Labour standards and ethical sourcing

Ethical behaviour in contracting is becoming increasingly important. For any business to survive there are two aspects of its reputation that are critical: what investors think and what consumers of its products or services think. If a business is tarnished by association with poor labour standards, either directly or in its supply chain, or other failures in what might broadly be called 'ethical sourcing', then one or both of two things is likely to happen: investors will not want to invest, so the business capital will become strained, and/or purchasers (commercial or consumer) will not want to buy the product so sales will diminish. The net impact of both of these is a fall in share price, which undermines confidence in the business further. This could be a vicious cycle that ends in the total collapse of the business.

In practice that rarely happens. It appears that public and economic confidence in businesses, even those that exhibit shocking ethical failures, is relatively resilient. The death of textile workers in Bangladesh makes global news, but the international companies whose garments they were producing seem to recover very quickly from the headlines. Nevertheless, those international companies will need to spend significant time, effort and resources dealing with the association.

This underlines the fact that, as much as everyone wants to believe that businesses care about labour standards and ethical sourcing because it is 'the right thing to do', the reality is that we live in a capitalist society where the 'right thing' is a much easier sell to boards and directors if it is also a 'business beneficial thing' to do. In law, the first duty of a limited company is not to the society in which it operates, it is to its shareholders. If those shareholders are overall ethically minded – which is a slowly improving probability – then ethics will have a strong hold on company decision-making. If those shareholders are purely in it for the money, then the ethics angles have to be shown to be value-for-money angles as well.

Procurement and supply professionals are advised to understand the motivators of their own organisations and those of the firms with whom they contract, not because this will change how they behave but because it may need to change how they phrase the message.

CIPS is committed to ethical sourcing and ethical contracting, to the extent that it has introduced its own ethics test, which all members are encouraged to take and all Fellows and Chartered Professional members are required to renew on an annual basis.

Apply

Go to the CIPS website and search for 'ethics' for further information on its ethics test.

The use of contractual terms to promote and enforce labour standards and other aspects of ethical sourcing is only one of the tools available to procurement personnel. Joint working and education arguably have far bigger parts to play in driving improvements in these areas, but these would be less effective if the supply chain companies who fall below standard did not appreciate that eventually they will lose contracts as a result.

Remember

Contract terms are one tool to be used in seeking to impose or encourage ethical sourcing in the supply chain, but they must be supported by a right of audit to see what actually happens on the ground.

Terms that apply to labour standards and ethical sourcing

Labour standards

'Labour standards' refers to the terms and conditions of employment of the workforce, particularly the non-professional workforce who are generally the lowest paid and most vulnerable members of an organisation's human resource.

In the capitalist economic system that exists in most of the world, the organisations (who are the owners of capital) have much more power than individuals (who produce the labour). The rights and wrongs of this are a matter of private conscience and political opinion. The issue for the procurement and supply professional is to ethically manage their contracts in a way that (a) complies with laws and standards in this area and (b) does not unnecessarily exploit labour providers in situations which are not governed by specific regulations or standards.

Of all the ethical considerations in contracting, labour standards is the one with the longest history. Current standards primarily derive from the work of the International Labour Organization (ILO).

The ILO is an agency of the United Nations, although having been founded under the League of Nations in 1919 it pre-dates the current UN. It has 187 members. The only UN countries who are not members of the ILO are Andorra, Bhutan, Liechtenstein, Micronesia, Monaco, Nauru and North Korea.

The standards laid down by the ILO cover the following.

- The right of workers to associate freely and bargain collectively. This is what many people will understand as the right to be a member of a trades union and to have that union negotiate their terms and conditions.
- The end of forced and compulsory labour: slavery in other words. The current expression is 'modern slavery' because ideas related to what constitutes slavery have expanded since the 18th and 19th centuries to include such things as **debt-bondage** and travel restrictions enforced by the holding of passports or identity papers among other things.
- The end of child labour. The UN declaration on human rights includes provisions that everyone has a right to education and that education to elementary level shall be compulsory. Clearly this can only be made to happen if children are able to attend school, which in turn means that they need to not be in paid employment that impinges on their education.
- The end of unfair discrimination among workers on the basis of race, national origin, religion, gender, gender identity, sexual orientation, or physical or mental disability.

Debt-bondage
A person's pledge of labour or services as security for the repayment of a debt or other obligation, where there is no hope of actually repaying the debt

These standards are agreements between nation states who are the members of the ILO. The obligation created by the agreements is for those countries to apply the provisions of the agreements, which is done by creating national laws.

Not all national laws on labour standards derive from international agreements. Some may be wholly home-grown affairs. A common topic in many countries in recent years has been that of a minimum wage. Legally enforceable minimum wage levels exist in the vast majority of UN member states, but they do so in different formats. In some countries the minimum wage only applies to public sector employees, in others it applies to all. In some it varies by age, in others by occupation. In some countries it is set at national level, in others it is set in a

more devolved fashion. In the UK a minimum wage is set by the government, with variations according to age and geography (a higher rate applies in the London area), but there is still a long ongoing campaign to raise the legal minimum or, failing that, for employers to pay what campaigners call a 'living wage'.

Similarly, workers' rights when it comes to 'free association and collective bargaining' vary from place to place, partly in response to ILO standards but also in response to local history.

Apply
Research the rules and historical development of these aspects in your own country and internationally in the sectors in which you work or want to work. The detail goes beyond the scope of this study guide and what is needed for the CIPS qualification, but the broader contextual knowledge will undoubtedly help in designing and managing future contracts.

stream
: supply chain viding inputs to organisation's duction, from raw terials through to nponents, etc.

From the perspective of the procurement professional, the obligation is two-fold.

- As a minimum, to apply the national laws of the state in which they operate and the laws of any other state that affects the contract, subcontracts and **upstream** supply chains
- Wherever possible to seek to encourage higher standards by means of commercial negotiation

Commercial contracts must require compliance with relevant laws, but commercial leverage can often achieve what the legislators cannot, by applying economic rationale to a public good. In other words, they say to suppliers: 'If you do not understand or do not agree that this is the "right" thing to do, then understand that it is economically the most beneficial thing to do.' In the vast majority of cases it is both of those things.

However, care must be taken not to be too simplistic in approach. Things are never as simple as they might appear. Let us take one example as an illustration: child labour. Most sensible people would agree that children should not be working, they should be in school, but consider the following issues.

- What is a child? The definition of childhood has changed over the years and varies from country to country. Not very long ago, the age of sexual maturity (a biological function) would have been accepted as 'adulthood'. Few countries now consider 12 years old to be adult. Perhaps unfortunately, no standard age has yet been internationally agreed and the somewhat circular phrase now used is 'the age at which compulsory education ceases'.
- Do we want to end child labour for families where the only hope of any income is through the labour of the children? In the poorest families in the poorest places, with least access to medical and social care, it is often the case that the children may be the only members of a family capable of earning an income. If they are stopped from doing so, how does the family survive?

There are no easy answers to these societal problems. It is important that procurement and supply professionals recognise this so that they consider the issues in the wider context when deciding how to manage supply chains and individual contracts.

Rather than trying to construct contract clauses that require compliance with treaties, it is much more helpful to set out requirements in terms of local laws and practical application.

The following could be sample wording for setting contractual parameters that support working conditions without directly referencing them, in this case in relation to working hours:

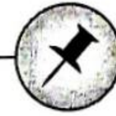
'Normal working hours will be between the hours of 7.30 am and 5.00 pm Monday to Friday, and 8.30 am and 12 noon on Saturdays. Any working outside of these hours must be agreed in advance with the contract administrator.'

Any such conditions set out in a contract must be accompanied by a clause which permits the purchaser to carry out unannounced local site audits to verify that terms and conditions are being implemented.

The conditions should also have as their ultimate sanction a right to terminate the contract in the event of non-compliance. That said, the practical response to non-compliance should always be one of trying to understand the reasons for it and ways to improve the situation, rather than simply walking away from the problem.

Some of the things to consider are included in table 3.12.

Remember
The ILO sets internationally agreed minimum standards for labour conditions. Many countries also have their own enhanced standards, such as minimum wages. Commercial contracts must include compliance with international standards and the national standards of the place where the contract is to be carried out, as minimum contractual terms. There may be scope to use commercial pressure to enhance these terms. Attempts to improve conditions should always be used before seeking other remedies such as termination of contract.



Ethical sourcing

'Ethical sourcing' is a broad term which covers a number of different aspects of choosing where supplies and service provision come from. One definition is:

> ***"ensuring the products being sourced are obtained in a responsible and sustainable way, that the workers involved in making them are safe and treated fairly and that environmental and social impacts are taken into consideration."***
>
> *McAvoy, 2016*[19]

The impact on the workers involved has already been considered under labour standards.

Embedding this concept into commercial contracts requires a multi-strand approach. It needs to consider the following.

- Things the supplier will do directly themselves: how they treat their own labour force, their own environmental policies and activities.
- Things that will be done via subcontract arrangements: the need to ensure that the rules flow down the subcontract chain.
- Indirect inputs: what might be called the upstream supply chain – how the supplier's suppliers act in producing the goods, components and/or services that feed into what the supplier does under the contract.

There are no quick and easy ways to do this. It is not possible to simply construct a few contract clauses that will cover 'ethical sourcing'.

One key aspect is selecting the right supplier in the first place. That is beyond the scope of this study guide, which focusses on the contract once the supplier has been selected, but choosing a supplier with a demonstrated commitment to ethical contracting is the most important starting point. Such suppliers are more amenable to the terms that the purchaser wishes to impose, and they are more familiar with delivering them. This sends a message to those who are not yet on board with this agenda.

Within the contract there are a number of different ways to encourage or mandate ethical sourcing. Which of these is used will depend on exactly which aspect of ethics the purchaser wants to address. Table 3.12 sets out some things to consider.

Labour standards	Are there any international, national or local laws or standards that need to be enforced? Can these be cross-referenced by a simple clause requiring compliance? Does the purchaser want, and can it afford, to go beyond the minimum requirements? A formal statement of commitment to eradicating certain practices (for example, those denoting modern slavery) embedded within the contract and a requirement that the supplier and all those in its supply chain support such actions might be difficult to police and enforce, but it is a solid starting point. Sample wording from a UK context referencing the Modern Slavery Act is shown below. Similar wording could be used to reference other standards such as those set out by the ILO. 'In performing its obligations under the agreement, the Supplier shall and shall ensure that each of its subcontractors shall: (a) comply with all applicable laws, statutes, regulations in force from time to time including but not limited to the Modern Slavery Act 2015; and (b) take reasonable steps to ensure that there is no modern slavery or human trafficking in the Supplier's or subcontractors' supply chains or in any part of their business. The Supplier represents and warrants that: (a) neither the Supplier nor any of its officers, employees or other persons associated with it: (i) has been convicted of any offence involving slavery and human trafficking; and (ii) having made reasonable enquiries, to the best of its knowledge, has been or is the subject of any investigation, inquiry or enforcement proceedings by any governmental, administrative or regulatory body regarding any offence or alleged offence of or in connection with slavery and human trafficking.

	The Supplier shall implement due diligence procedures for its own suppliers, subcontractors and other participants to ensure that there is no slavery or human trafficking in its supply chains.'[20]
Environmental impacts	What are they? How does the contract impact the environment in the key areas: water and energy use, pollution through process, waste disposal? Think about embedded energy and 'whole life impacts'. Clean production processes can be outweighed if the resultant products are impossible to dispose of safely. Some might feel that nuclear power plants fall into this category. Having identified the issues there are a number of ways to deal with them, such as express clauses requiring compliance with legal standards, quality or design requirements within specifications including eco- or Fair Trade labelling, KPIs for improving impact scores, etc.
Social impacts	What are they? How does the contract impact? Some areas to consider might be the health and wellbeing of service users, for instance are there safeguarding requirements for children or vulnerable adults? Is the product or service more difficult for some members of society to use or access than others; can that be changed? As with environmental issues, having identified the potential problems or opportunities, a purchaser might seek to deal with them through express clauses requiring compliance with legal standards, quality or design requirements within specifications, or KPIs for improving impact scores.
Fraud, bribery and corruption	Millions of dollars are wasted annually as a result of bribery, fraud and other corrupt practices. Ethical sourcing and ethical contracting is based on fair and transparent processes, which are designed to help prevent such behaviour. Even so, contract terms must explicitly state that fraud, bribery and corruption are unacceptable in connection with anything that relates to the contract, with the ultimate sanction for such activity being termination of the contract and barring from consideration for future contracts. Sample wording could be: 'The parties represent, warrant and undertake to each other on a continuous basis that they shall comply with all applicable anti-bribery and anti-money laundering laws, rules, and regulations of the United States, European Union or any member state, the Republic of Singapore, and any other similar laws in all applicable jurisdictions. These laws include, without limitation, the currently effective or successor versions of the

	U.S. Foreign Corrupt Practices Act; the UK Bribery Act 2010; the UK Money Laundering Regulations 2007; the UK Anti-Terrorism, Crime, and Security Act 2001; the UK Proceeds of Crime Act 2002; and the Singapore Penal Code. In addition, the parties represent, warrant and undertake to each other on a continuous basis that they shall each respectively take no action which would subject the other to fines or penalties under such laws, regulations, rules or requirements.'[21]
Subcontracting	Any conditions that are imposed on the direct contractor/supplier must be covered by a clause requiring similar terms to be included in any subcontracts. Without this, the requirement will become more diluted as it passes **downstream** through the layers of subcontractors and suppliers. The sample wording for modern slavery given earlier in this table shows how this can be incorporated.
Upstream impacts	The potential environmental and social impacts may result not only from the contract and its outputs. Think also about the inputs. Consider where the supplier might be obtaining its energy, timber, minerals, precious and semi-precious metals, etc. Does the purchasing organisation really want to be associated with decimation of the rainforest or the use of '**conflict minerals**', for example? Alternatively, can it gain from association with fairer trading practices? The only way to avoid one and encourage the other is by contractual clauses that expressly prohibit certain inputs or expressly require others. In both cases this can be helped by traceability certifications from independent third parties. The methodology for embedding such considerations will vary from contract to contract and may be a combination of specification and express contract terms.

Table 3.12 Things to consider in respect of labour standards and ethical sourcing

Downstream
The supply chain that the organisation feeds into, from product to end user

Conflict minerals
Metals and minerals sourced from areas where their mining is used to finance armed conflict and is linked to human rights abuses and corruption. The most commonly recognised ones are tin, tungsten, tantalum and gold

Apply
If you have not already completed it, log onto the CIPS website and complete the ethics e-learning.

3.3 Recognise types of pricing arrangements in commercial agreements

This section looks at various types of pricing arrangements and how they are incorporated into commercial agreements. By the end of this section you will

understand the use of pricing schedules, fixed-pricing arrangements, cost-plus and cost-reimbursable pricing arrangements, the use of indexation and price adjustment formulae, as well as the use of incentives and the importance of clarity over payment terms.

The context of the section is the incorporation and use of these elements in the contractual setting. However, consideration should also be given to how the various models need to be built into the procurement process from the outset. Whether the contract is tendered or negotiated, the following must be very clear from inception.

- Which pricing model the purchaser envisages using
- Whether it is willing to look at other options

It is necessary to know which pricing model will be used in order to be able to evaluate prices offered, i.e. to compare prices from competing suppliers and also with historic or benchmark prices in order to determine whether value for money is being achieved. This can only be done if prices are provided in a consistent format.

If purchasers are willing to look at other options, this allows suppliers to offer other methods if they feel that produces a better offer.

Whatever pricing mechanism is used, a primary objective for the purchaser is that the pricing is transparent. It must be sufficiently broken down into its elements to permit the following.

- Variations or changes to the contract to be adequately costed
- Price adjustments to be applied correctly
- Any recharges or distribution over different cost centres to be accurately produced

Cost and price

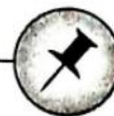
Before examining aspects of pricing within contracts, the difference between cost and price needs to be clarified.

- Price is the amount expressed in units of currency (pounds, dollars, etc.,) to be paid by the purchaser to the supplier in order to obtain the goods or services.
- Cost is the total sum of amounts paid by the supplier in order to produce the goods or provide the services.

There is clearly a relationship between cost and price, but it is not always a direct one. For the supplier to make a profit, price must exceed cost. The degree to which it can do so will be determined by the competitiveness of the market, the business strategy of the organisation and the relative bargaining power of the supplier and the purchaser.

In some circumstances the supplier may (on a short-term or contract-specific basis) be willing to accept a loss, in which case the price will be lower than the cost. It may do so in order to break into a new market, or to ensure continuity of work for skilled employees who might otherwise leave and be difficult to replace.

> *Remember*
> Price is the amount paid by the purchaser; cost is the total sum of all the inputs required to produce the product or service.



The use of pricing schedules

Pricing is one of the most important elements of any contract for both the purchaser and the supplier.

In the simplest contracts there may be no need for a schedule. The price will be easy to calculate, it will not change and will not need to be split into its constituent parts for any reason. If that is so, the 'contract price' clause will simply state that the goods or services will be provided as specified '...for the total sum of $10,000 payable upon completion'.

Most commercial contracts are more complex.

- Call-off contracts will not have a predetermined total price; it will depend on exactly what is called off, how many orders there are, etc. The price may differ at different volumes.
- Even where the total fee is known, payment might be made in stages as key milestones are reached. This is common in construction, supply of large complex pieces of equipment, and major ICT projects.
- The price may need to be broken down into various elements so that any changes to the contract can be accurately priced, e.g., if more staff are required or more days are needed to complete the work, then the day-rate of staff might need to be shown.
- The price may have to be broken down for accounting reasons. For example, a multi-national firm may need to apportion the costs of a service or a system between different localities based on usage; the costs of operating a building may need to be recharged to a number of different tenants.
- There may be changes to the scope or duration of the contract which require variation orders. It will be necessary to be able to accurately assess the cost impacts of these, and therefore calculate whether that needs to affect the price.

Price schedule
Sometimes this is called a 'fee schedule' when it applies to professional or consultancy services. It is an appendix to a contract setting out what the prices are

It is important that purchasers think about these issues before approaching the market. This cannot be done by the procurement team alone. Other stakeholders (contract managers, finance, income recovery, strategic planners) should be consulted in order to understand what they may need to do with the financial information from the contract. The **price schedule** should be designed as far as possible to accommodate that.

The more complicated the schedule becomes, the less easy it is to use, and in particular the less easy it is to compare one offer with another.

Remember
The design of price schedules must take into account how the price information may need to be used, other than for the primary function of invoicing and payment. Consider which other stakeholders should be consulted.

Schedule of rates
An itemised list of component parts within a lump-sum contract, or a list of individual products, giving a price for each unit. Note that the rate may be different for different order volumes

Terminology: 'price schedules' and 'schedule of rates'

The terms 'price schedule' and **'schedule of rates'** tend to be used interchangeably, but there needs to be a word of caution. A price schedule (sometimes called a 'fee schedule' when it applies to professional or consultancy services) is an appendix to a contract setting out what the prices are. Sometimes

it also includes how and when the prices will be charged, although this might be covered in a separate part of the contract if it is particularly complicated. A schedule of rates is an itemised list of component parts within a lump-sum contract, or a list of individual products, giving a price for each unit. Note that the rate may be different for different order volumes.

Calculating and expressing price

There are a number of different ways in which prices can be expressed.

Unit price

The simplest pricing method is unit price. This expresses the price in dollars (or pounds, euros, etc.,) per unit. A 'unit' in this context could be a single item, particularly if it is something large, complex or expensive. Smaller items will be supplied in specified volumes and the 'unit' will be a given number of boxes. For example, a printing company might buy a single new high-tech printing press; it will not buy one single ream of paper. The paper will still be priced in dollars per unit, but the 'unit' will be, say, a box of 10 reams.

If the supplier wishes to charge the same price no matter how many boxes are ordered, this will be expressed as a single line on the schedule. If the company orders one box it will cost $20; if it orders 100 boxes it will cost $2000.

Item	Unit	Unit price ($)
A3 200gsm paper (green)	Box of 10 reams	20.00

Table 3.13 Linear pricing

However, it is more costly for the supplier to ship one box a hundred times than to ship 100 boxes all at once. Therefore, it could insist on minimum orders of, say, 20 boxes, or it could simply encourage purchasers to buy larger quantities by making larger orders cheaper. This will need to be expressed as several lines on the schedule.

Item	Unit	Unit price ($)
A3 200gsm paper (green) (up to 10 boxes)	Box of 10 reams	10.00
A3 200gsm paper (green) (11 to 20 boxes)	Box of 10 reams	8.00
A3 200gsm paper (green) (more than 20 boxes)	Box of 10 reams	6.00

Table 3.14 Non-linear pricing

The first example (table 3.13) is known as linear pricing; the second example (table 3.14) is non-linear pricing.

Unit pricing can be used for goods or services – but it is most commonly used for goods.

Hourly rates/day rates

Hourly or daily rates are used for services, where most of the cost is for the person or people providing the service, e.g., consultants, lawyers, training providers.

Although it sounds quite different, this is really just a specific type of unit pricing where 'the unit' is one hour or one day.

There may still need to be a schedule because the hourly rate may differ depending on the seniority or expertise of the person providing the service. See table 3.15 in respect of charges for consultancy services, which reflects the fact that the director will be paid more by his firm but also will have much more experience. The example also sets a minimum charge for work done at the client's office but allows for lesser charges for work done at the supplier's base.

Fee earner	$/day	$/half-day (minimum charge for on-site work)	$/hour (off-site)
Director	950	475	133
Head of service	815	407	114
Consultant	550	275	77
Support officer	350	175	48
Admin officer	250	125	34

Table 3.15 Consultancy fees schedule showing different rates at each level and also setting a minimum charge for work done at the client's office

Combination rates

Where the service being provided is a mixture of goods and services (or parts and labour) a schedule of rates may be produced which combines the two. These schedules are common in repairs and maintenance contracts. A simplified extract is shown in table 3.16, which shows the different 'units' that might be used, even within a single schedule. This example uses linear pricing, but it could be expanded to use non-linear terms.

Description	Unit	Unit price $
Combination boiler	Item	700
15mm copper pipework	Metre	25
20mm copper pipework	Metre	50
Wall-mounted thermostat	Item	85
Repaint disturbed surfaces	Square metre	10

Table 3.16 Simplified schedule of rates

Remember
'Units' used on price schedules do not need to be individual items, they can be batches of items or other measures such as square metres.

The use of standard schedules

Just as there are standard forms of contract, there are also standard schedules of rates for certain types of supply. These may be published by professional bodies

for services provided by their members, or they may be produced commercially or by stakeholder interest groups. Some examples include the following.

- APS (Australian Psychological Society) recommended fees for various types of consultation
- NHF (National Housing Federation) rates for repairs and maintenance works to domestic properties (UK)
- DPSA (Department of Public Service and Administration) professional consultancy fee rates (South Africa)

Where standard schedules exist, they are designed to give a reasonable estimate of the price for a given product or service. Negotiations and tenders can then be carried out by reference to that price level.

For example, when contractors were tendering for a term maintenance contract in the UK housing sector, it used to be common practice to ask them to price on the basis of a variation percentage from the NHF schedule (plus or minus). This allowed for very simple pricing and direct comparison between tenders. However, this is a very broad approach and does not allow for the fact that some items on the schedule will be required often and others possibly not at all. Those variations will differ depending on the nature of the housing stock owned by the organisation or local authority, so cannot be taken into account within the schedule itself. As a result the practice is less common and there is a move towards very specific schedules related directly to the repairs history and likely requirements of the individual contract, or in the opposite direction towards a 'price-per-property' approach where inclusive fees are set based simply on the number of properties.

Incorporating the prices into the contract terms

Clearly the completion of the pricing schedule is a fundamental part of the tender or contract negotiation exercise. It is critical that once the final version is produced it is properly incorporated into the contract as a contract document. This is normally done by a simple contract term which states that the goods or services will be charged for at the rates set out in the schedule. The schedule is then appended to the main contract.

Where a standard schedule is used it is possible to simply cross-refer to it from the contract rather than reproducing the entire schedule as an appendix. If that approach is taken, the contract must make clear which edition of the schedule (by reference number and/or date) is referenced and also whether that remains the case in the event of the schedule being updated.

Consider the following example.

- A contract is awarded on the basis of the ABC Schedule of Rates, 8th edition, minus 3%.
- All prices are therefore 3% less than those quoted in the schedule.
- Then a new edition of the schedule is produced with new standard rates.
- The question is whether the contract rates are still 8th edition rates minus 3% or whether they are now 9th edition rates minus 3%. Which outcome is better for the purchaser and which for the supplier would depend entirely on whether the rates in the 9th edition are higher or lower than those in the 8th edition, so there is an obvious opportunity for dispute unless the contract is clear.

There are a number of possible options.

1. The contract might not allow any change to the contract rates at all.
2. It could require the contract rates to remain tied to the original edition (8th edition in the example) and any adjustment of prices to be by way of changing the percentage adjustment.
3. It could require the minus 3% to remain fixed but permit it to be applied to new editions of the schedule as they are published.

Any of these are possible. Option 1 gives price certainty but allows neither side to gain from changes in average rates. Option 2 allows for a free negotiation of any changes between the parties. Option 3 retains the discrepancy from the benchmark rate, but as neither party can influence the standard schedule rates it is potentially risky for both the purchaser and the supplier.

Remember
Standard schedules exist as a starting point for pricing, but are rarely compulsory. Tendering and negotiation can be carried out using them as reference points against which prices can be compared. Using them also avoids the costs and potential risks of designing a totally new schedule.

Check
What is a schedule of rates and how is it used in a commercial contract?

The use of fixed pricing arrangements

One alternative to the schedule of rates approach is fixed-fee pricing or fixed-pricing arrangements.

In the case of goods, the purchaser will simply say they want 'X' amount of a product and will be quoted a fee for that one order. That is the simplest use of fixed pricing.

However, it can also be used for services or works in two quite different circumstances.

- It is useful for small to medium scope projects, with short timelines, where what is delivered can be adequately specified and the likelihood of changes to the specification, scope and input costs is limited. The near certainty of both delivery requirements and likely costs of delivery makes the calculation of price a simple matter of arithmetic.
- It can also be used where a service is repeatedly required, but the specifics of which vary slightly on each occasion. It may take a shorter or longer period of time, or may need more or fewer resource inputs.

  For these services the fixed-fee approach works if the overall costs even out over time, such that price can be calculated on the basis of an average cost. For this to function effectively certain assumptions may need to be made (for example, how often a particular service will be required every year) and the assumed scope of a service (a summary of the minimum specification)

must also be clearly stated. An example is given in the case study 'Fixed-fee legal services'.

Case study

Fixed-fee legal services

Table 3.17 sets out the 'fixed-fee' pricing element of a tender for legal services to be provided to a housing association. The nature of each 'service' is very specific but the activity is commonplace in the context of the work being tendered for. Both the purchaser and the potential suppliers have a reasonable idea of what is involved. The lawyers would know from experience how long the various processes normally take, but they cannot predict how many court appearances ('hearings') might be necessary, so that has to be defined. Some cases are more difficult than others, but with a reasonable caseload over a year the costs should even out, so pricing can be averaged.

Service	Fixed fee $	Notes
Review of tenancy terms – (Initial review, provision of advice and clarification)		Assume common residential tenancy agreements (secure tenancy, assured tenancy, shared ownership lease, PRS lease, assured shorthold, licences, etc.)
Review of commercial lease terms (Initial review, advice & clarification)		Assume primarily common commercial terms
Managing agency contracts – review of terms (initial review, advice & clarification)		Irrespective of whether ABC is the agent or is granting the agency contract
ASB (or similar) injunction:		
– On notice		To include one court hearing
– Without notice (undefended)		To include two court hearings
– Without notice (defended to trial)		Full service
Gas servicing or other access injunction		To include preparation, service and one court hearing
Breach of tenancy injunctions:		
– Undefended, including one hearing		To include one hearing
– Defended		To include two hearings
Possession proceedings:		
– Order made at first hearing		
– Defended claim, including first hearing and trial		
Unlawful occupier/squatter proceedings		To include one hearing

Service	Fixed fee $	Notes
Debt recovery (lines 35 & 36)		
- To letter before action to debtor stage		To include full file review and associated work
- Judgment		To include full file review, letter before action and default judgment
- Judgment and enforcement		To include full file review, letter before action, default judgment and enforcement. Enforcement shall assume bailiff, high court officer or Attachment of Earnings order (but shall not cover bankruptcy, winding up, third party-recovery options, etc.)

Table 3.17 Example of the 'fixed-fee' pricing element of a tender for legal services to be provided to a housing association

Benefit and risk in using fixed-pricing arrangements

Some commentators argue that the fixed-price model places all of the risk with the supplier since they cannot claim extra payment for additional work, or if the factors which influenced the original price calculation (say raw material input prices) change significantly.

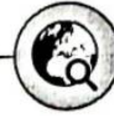
However, this overlooks the fact that the reverse is also true in that the purchaser cannot claim a rebate if those input factors change in the supplier's favour, or if the amount of work required to deliver the objective is less than anticipated.

The cost risk is therefore shared between the parties. It may not be shared equally. That will depend on the following.

- How accurate the specification is
- How robustly the supplier resists post-contract change requests
- How good the original price estimation is by both parties. Suppliers clearly carry the risk of getting their pricing wrong and making a loss, but at the same time purchasers carry the risk of getting their price assumptions wrong and therefore not budgeting correctly, which may lead them to accept a fixed price that is inadequate to deliver the tangible objectives (product or service) or – at the other end of the spectrum – one which delivers the outputs but does not deliver value for money. All of this depends on good, accurate data and an understanding of the other factors that might influence both the costs to the supplier and, in the case of term contracts with fixed-price elements, the order volumes from the purchaser.

The main advantage is a planning advantage. The purchaser has budget certainty, the supplier has income certainty. In both cases the figures are fixed at the outset.

Note that fixed-fee pricing may not cover the whole of the contract. In a term call-off contract it is possible to have fixed pricing for some elements and a schedule of rates for others. See the case study 'Fixed pricing and schedule of rates combination'.



Case study

Fixed pricing and schedule of rates combination

Fixed-price arrangements do not necessarily need to cover the whole of the pricing for a contract. The legal services tender referred to in the previous case study included the elements shown as a 'fixed-fee' elements. Other aspects of the work to be provided by the contracted legal firm would be done on a time-charge basis.

Imagine that the same housing company appointed its main repairs contractor on a price-per-property basis: a fixed fee payable per year for every dwelling covered by the contract, regardless of whether any repairs were done. Some dwellings had no repairs; others had frequent and significant repair needs. The aim was to balance the total costs over the year. While this arrangement can work in theory, in practice it can also be overwhelmed by a sudden need for hugely expensive major repairs to a significant number of properties. Therefore certain types of repair were excluded from the price-per-property model and reverted to a schedule of rates approach.

The ability of these models to deliver value for money is heavily dependent on the reliability of the data on which the original assumptions are made. The price-per-property repairs model requires accurate historical data on the numbers and types of repairs across the whole dwelling portfolio, so that historical averages can be calculated. But it also needs information on the number of new properties coming into the contract from the development programme. For example, do these hit the contract on day one, when they are still covered by a builder's warranties, or only in year three when those warranties have expired? And information is required about any major renewal and refurbishment programmes that might reduce certain repair types (e.g., rewiring or heating system renewal).

The advantages and disadvantages of using fixed pricing are summarised in table 3.18 which indicates that the disadvantages outweigh the advantages. The inflexibility of the model suggests that it is not really suitable for anything other than those circumstances where the requirements can be established quickly and firmly, and where the contract is of short duration.

Advantages	Disadvantages
• Budget/income certainty – prices are fixed up front and should not change. • The impact of changes to the supplier's cost base is not fed through to the purchaser. If costs diminish, the supplier will benefit from this, and if costs rise, the purchaser will benefit.	Time needed to fully specify exactly what is included and excluded in the price. The impact of changes to the supplier's cost base is not fed through to the purchaser. If costs diminish, the supplier will benefit from this, and if costs rise, the purchaser will benefit. Assumptions, for example, on the balance of high-cost/low-cost items not being met, could lead to disputes. Potential for quality issues if the fixed price is too low – supplier will deliver down to price.

Table 3.18 Advantages and disadvantages of fixed pricing arrangements

Remember
Fixed pricing and schedules of rates can be combined within a single contract to cover different aspects of the supply.

Cost-plus and cost-reimbursable pricing arrangements

The terms 'cost-plus' and 'cost-reimbursable' are used interchangeably. The premise is that the price moves with costs. To understand cost-plus pricing, it is necessary to understand how cost impacts on price. As already stated, there are other influences on price, but cost is the biggest.

Understanding cost impacts on price

Fixed cost
A cost that remains constant in the short term irrespective of production volumes

Variable costs
Costs that change directly in line with the output of the organisation

All prices are set in the context of cost. A supplier that is tendering or negotiating for a contract must know its cost-base, i.e. what it will cost to produce the goods or services it has to deliver. Those costs are a combination of **fixed costs** which do not change in response to short-term changes in the volume of production, and **variable costs** which fluctuate as production increases and decreases (see figure 3.6).

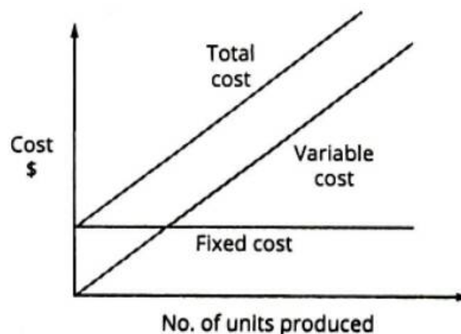


Figure 3.6 Fixed and variable costs

For the contract to be sustainable, the supplier must at least break even. It must at least cover its costs. For it to be worthwhile, it must make a profit: income

must exceed costs. Prices must be set to ensure that one or other of these things (preferably profit) is achieved. Once the value of the number of units sold exceeds the cost of producing them, the supplier is making a profit (see figure 3.7).

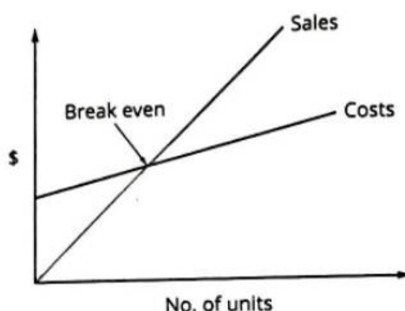
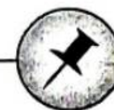


Figure 3.7 Break-even point. Note that costs do not start at zero since fixed costs have to be met even at nil production

Once the break-even point is reached, the fixed costs are covered. If the supplier can produce and sell more, it only needs to charge for the variable costs. In practice, many suppliers charge for all units at a price which covers both fixed and variable costs. This means that above the break-even point, the part of the price charged for fixed costs is additional profit. It is this 'extra' profit which enables suppliers to provide 'special offers' either for a short time or to certain clients. These might be offered at a price that would not cover the fixed costs if applied to all of their production.

Remember
Purchasers need suppliers to make a profit in order for contracts to be sustainable, but that profit should not be excessive. Understanding supplier mark-ups and margins can help purchasers determine whether they are getting a reasonable deal.



Despite all of the work that purchasers put in to designing the structure of the price schedules for both schedule of rates and fixed-fee arrangements, the actual pricing of them remains largely within the control of the supplier. Purchasers can reject all available offers on the basis of price, but they cannot accept a price that is not offered. Suppliers determine their prices on the basis of calculated or assumed costs, plus an additional element for hoped-for profit.

Mark-up
Profit as a percentage of costs

Margin
Profit as a percentage of sales value

The difference between costs and income is profit. **Mark-up** is profit as a percentage of total costs. Profit **margin** is profit as a percentage of total sales value. For a given amount of profit, the mark-up will be greater than the profit margin. For example, assume a product costs \$1000 to make and sells for \$3000. The profit is \$2000. This means the mark-up is \$2000 as a percentage of \$1000: $\frac{\$2000}{\$1000} \times 100 = 200\%$. The profit margin is \$2000 as a percentage of \$3000: $\frac{\$2000}{\$3000} \times 100 = 66.67\%$. A supplier's overall profit margin will be reported in its income statement.

When the cost base changes in a fixed-price or schedule of rates contract, the mark-up will either grow or shrink as a direct result. If costs go up, the mark-up shrinks. If costs go down, the mark-up grows. In most contracts the impact of that will accrue entirely to the supplier. This gives suppliers an incentive to manage their costs through their own purchasing and contract management activity, but

there will always be issues outside of their control, e.g., currency fluctuations, the global price of crude oil and so on.

From the purchaser's perspective, this will not be of great interest unless the supplier's profit shrinks to a level where the contract (or even the supplier) becomes unsustainable. Purchasers do not want suppliers to make an excessive profit, but they **do** need them to make a profit in order that they stay in business and keep supplying.

If the supplier starts to make a loss, it will become disputatious (disputing even small matters) or 'claim happy' (looking for every opportunity to claim extra fees) or it will cut corners on quality. In the worst-case scenario the supplier could go bankrupt. None of this is good for the purchaser. At the very least there will be additional contract management costs, at worst it will be necessary to re-tender or renegotiate a whole new contract with a new supplier.

Use of cost-plus pricing/cost-reimbursable pricing

There is an alternative which addresses some of these issues: the cost-plus pricing model.

In this model the price is set on the basis of cost, plus an agreed profit mark-up:

- Cost + (cost × % mark-up) = price
- Assume the product costs $70 to produce and the parties agree a 5% mark-up.
- Then the price would be: $70 + ($70 × 5%) = $70 + $3.50 = $73.50. The price would be $73.50.

This simple illustration assumes that the price per item is constant, which it is not. The more items are produced, the lower the cost per unit becomes. As fixed costs are spread over a higher volume of output, the fixed cost per unit declines.

In practice, therefore, arriving at the agreed 'cost' figure may prove the stumbling block to agreeing a cost-plus pricing approach. To reach such an agreement there needs to be a large degree of trust and open-book accounting between the parties. The supplier has to be able to demonstrate the following to the purchaser's satisfaction.

- Exactly what the input costs are
- Whether they are fixed or variable
- How the variables normally move (what the mathematical relationship is between unit increases in production and unit decreases in cost; these relationships are rarely straight-line)
- How much control the supplier has over them and that they are exercising that control (a key concern for the purchaser has to be that if the supplier knows its costs are covered it loses the incentive to ensure costs are kept to an optimum low level)

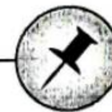
Table 3.19 sets out the advantages and disadvantages for the purchaser and the supplier of using this model, and it suggests that the advantages are weighted in favour of the supplier.

Advantages for the purchaser	Disadvantages for the purchaser
Value for money demonstrated by fixed profit mark-up – knowledge that the supplier is not making excess profit.	Lack of certainty over supplier cost base: how 'real' is the data sharing? Needs accurate data and a strong degree of trust between the parties.

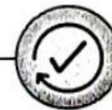
Advantages for the purchaser	Disadvantages for the purchaser
Risk of supplier collapse is reduced, particularly if the purchaser is a major customer of the supplier.	Changes in the supplier cost base feed directly into the price paid, with no room for negotiation (no 'pain share'). Supplier has no incentive to manage costs.
Advantages for the supplier	**Disadvantages for the supplier**
All costs are covered – it cannot make a loss. Guaranteed profit levels aid forward planning and may assist small companies in accessing cheaper credit. Easy to justify price increases.	Profit is limited, cannot gain from cost efficiencies. Cannot leverage market advantage to charge a higher price. Cannot refuse price reductions in response to input cost reduction.

Table 3.19 Advantages and disadvantages of cost-plus pricing

Remember
Cost-plus contracts place all of the risk of increased costs on the purchaser, and so there is no motivation for the supplier to control cost.



Check
Describe the key features of cost-plus pricing. Using your own figures produce a worked example.



The use of indexation and price adjustment formulae

The preceding paragraphs have hinted that there may be a need or a desire on the part of either the purchaser or the supplier to change the prices during the life of a contract. The longer the life of the contract, the more likely this is to be the case.

There are a number of possible approaches to this.

- The contract could unequivocally state that prices are fixed for the duration and there are no possible grounds for adjustment.
- The contract could remain silent on the matter, not providing any grounds or mechanisms for adjustment but not ruling it out altogether.
- The contract could state circumstances in which price adjustment will be considered, but leave the nature of the adjustment open for free negotiation between the parties.
- The contract could state circumstances in which price adjustment will be permitted and describe how such adjustment will be calculated.
- The contract could allow for automatic periodic adjustment of pricing by linking to a specified price index.

Each option has advantages and disadvantages which are summarised in table 3.20. To better understand some of those advantages and disadvantages it is worth looking at some of the common indexation and price adjustment formulae used in various types of contracts.

Indices in practice

Indexation
The linking of a payment (be it a price, a salary or some other due payment) to an index and the adjustment of the payment in line with the movements of the index

Price index
A way of showing the percentage change in prices over a given period, based on a starting year (the base) which is taken to be equivalent to 100%. Indices above 100 indicate a rise; indices below 100 indicate a fall

Base year
The starting point for an index, at which point the index is set to 100

As is often the case, it is necessary to start with some definitions. In this case, it is important to read and understand the definitions in the order that they follow.

'**Indexation**' means the linking of a payment (be it a price, a salary or some other due payment) to an index and the adjustment of the payment in line with the movements of the index. Thus, if the index increases by 5% so does the payment. If the index reduces by 3% so does the payment.

An 'index' or '**price index**' is a:

> "*percentage number that shows the extent to which a price (or a 'basket' of prices) has changed over a period (month, quarter, year) as compared with the price(s) in a certain year (base year) taken as a standard.*[22]"

It is not a 'price' but a measure of change in price against a set starting point. The index will have a **base year** which is a notional starting point. The index is always set at 100 for the base year.

The two most widely used indices in the UK are the retail price index (RPI) and the consumer price index (CPI). Both of these look at the movement in the total price of a metaphorical 'basket' of goods commonly purchased by UK citizens. However, it is not a simple total price movement calculation since goods which are deemed to be more important (housing and food) have a heavier weighting than discretionary purchases (tobacco, entertainment) when the price shifts are calculated.

The percentage shift in the overall price of the 'basket' is what is commonly called the change in the 'cost of living'. This provides a simple measure of the rate of inflation.

The difference between RPI and CPI lies in what is included in each 'basket'. For example, the RPI includes VAT and other taxes and mortgage interest payments, all of which are excluded from the CPI.

Already it is clear that the decision about which index to link the contract price changes to will probably be important. As a general rule, RPI increases are greater than CPI increases. So, if a contract is in the UK and a business wants to use automatic annual adjustments to permit the contract payments to reflect changes in the average price inflation in the country, there is a choice to make: RPI or CPI?

CPI would be the preferred option from the purchaser's perspective, since it is generally the lower of the two. The supplier, naturally, would prefer RPI.

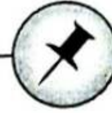
The next question, however, is whether either of those indices is really appropriate to the contract. Both are based on consumer/retail prices. For example, retail prices have very little bearing on the cost of kitchen installations or the cost of aircraft carriers. For these contracts it is necessary to look at indices that reflect the change in prices for the major inputs into the products being purchased.

In the case of kitchens, the two big variables are the price of chipboard (for which there are published index figures) and the cost of labour (again figures are

available, often at local level). In the case of the aircraft carriers, the global price of steel will be important.

The price movements in most commodities, raw materials, etc., are published on a regular basis. Procurement professionals, especially those involved in specialised category management, are required to keep a watch on these movements. More generalist procurement professionals need to be aware of how and where to find the relevant data for individual contracts.

Remember
If periodic price changes are to be linked to published price indices, take care to ensure that the most appropriate index is chosen. Using consumer price-related indices will not be appropriate if the main input into the contract price is the cost of labour, or the cost of one of the raw materials such as steel.



Apply
Look for indices that are relevant to the areas in which you work or want to work. A general Internet search is a reasonable place to start, but trade magazines and the financial pages of the press also carry useful information.

Once a suitable index has been established, the next question for the purchaser to ask is to what extent does a shift in that element of cost impact on the contract?

Consider the new kitchens and the price of chipboard. If there is a supply-only contract (the supplier provides the kitchen units but the purchaser fits them) then the shift in the price of chipboard will have a major impact on the supplier's cost base and therefore potentially on the price they expect the purchaser to pay. However, if there is a supply-and-fit contract, far more of the cost of the new kitchen is likely to be in the cost of labour rather than the cost of the units. So, in the first case using the price-of-chipboard index makes sense, in the latter case, less so.

It may be that more than one index needs to be deployed: the chipboard price index and the labour wage rate index. If this approach is taken some kind of weighting will need to be applied to ensure that each indexation change is applied pro rata to the proportion of that element in the total price.

So, if the materials cost of the supply-and-fit contract is 30% of the total price for a new kitchen, and the indexation element relating to kitchen units is an increase of 5%, then that 5% is only applied to the 30% of the price relating to the kitchen units and not to the total supply-and-fit price.

For complex projects the formulae would become complex.

Apply
Use the Internet to search for examples of price adjustment formulae (one easily found version is published by the Pakistan Engineering Council). Consider whether any of them are appropriate for the sector you work in or would like to work in.

A final question for the purchaser is whether it wants to totally protect the supplier against cost increases. There may be strategic reasons for wishing to do so in particular cases, but generally that is not the purchaser's concern. The purchaser wants to be working with a supplier that has its own ways of dealing with input cost

increases. If most of the supplier's contracts have index-linked payment terms, its incentive to manage costs and seek efficiencies is much reduced.

Alternatively the purchaser could permit index-linked price adjustments but not at the full level of the index change. For example, rather than the adjustment being at CPI, it could be CPI minus X%. So, if the CPI is 2% and the agreed contract adjustment is CPI minus 5%, then the contract rate uplift is:

$$2\% - (5\% \text{ of } 2\%) = 1.9\%$$

Yet another approach might be to require any requests for price variation to be justified on a case-by-case basis, but to cap them by reference to a stated index (see the sample clause in figure 3.8).

5.00 ANNUAL PRICE ADJUSTMENT

5.01 There shall be no automatic annual adjustment of prices. Where a request for an adjustment is submitted by either party, it shall be accompanied by full details demonstrating the rationale behind the request.

In any event rates shall not be adjusted by an amount exceeding that calculated by application of the movement in the Consumer Prices Index (CPI) (increase or decrease) as published by the Office for National Statistics, or if such publication is discontinued then whatever relevant document succeeds it. Base index for calculation purposes shall be the index published for September 2014.

The rates will be confirmed or adjusted annually with the first review being in April 2015.

The annual sum for Central Office Overheads will be assessed annually by the Partnering Team and then adjusted (increase or decrease) by an agreed sum, such adjustment shall not exceed that calculated by the application of the movement in the Consumer Prices Index (CPI) (increase or decrease) as published by the Office for National Statistics, or if such publication is discontinued then whatever relevant document succeeds it. Base index for calculation purposes shall be the index published for September 2014 Index.

The maximum annual increase for all parts of the contract will not exceed CPI as calculated in accordance with this clause (5.01). The Service Provider's Profit percentage as tendered shall be fixed (no adjustment) for the duration of the Term Programme.

The Service Provider tendered percentage adjustment(s) and rates as described in the 'Form of Tender' item 1 shall remain fixed for the duration of the Contract.

Rates will be confirmed or adjusted on:	1st April 2015
	1st April 2016
	1st April 2017
	1st April 2018
	1st April 2019
	1st April 2020
	1st April 2021
	And on each successive 1st April should the Term Partnership be extended

Typical calculation of CPI adjustment applicable from the first anniversary date:

Example (only):

Commencement Date	01.04.2003
1st Anniversary Date	01.04.2004
Base Index	September 2002
Base Index at September 2002	177.6
Index at September 2003	182.6
$\frac{182.6 - 177.6}{177.6} \times 100 =$	2.82% Movement Increase

Figure 3.8 Price indexation clause

So far, it has been assumed that any movement in the index is upwards. This is the normal trend, but there are occasions when inflation is negative: prices fall. As the wording in figure 3.8 shows, allowance should be made for the contract price adjustment to go in either direction. Suppliers will request price increases when their costs rise, but equally purchasers ought to seek price reductions when those costs fall. The contract wording needs to allow for this.

Advantages and disadvantages of using price adjustment formulae

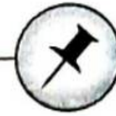
Table 3.20 looks at the advantages and disadvantages of each contractual approach to price indexation and adjustment formulae and suggests where each approach might be appropriate.

Approach to price adjustment	Advantages	Disadvantages	Suitable for
No adjustment permitted.	Fixed price gives budget certainty to purchaser, income certainty to supplier.	Inflexible. One party will gain and the other will lose from a change in cost base, no facility to share benefits. May lead to claims and disputes. Could undermine sustainability of the contract. Supplier likely to quote higher initial price to cover expected costs.	Short-term contracts which can be closely specified and will have limited or no variations.
Contract 'silent' – adjustments will simply be a matter for claim and negotiation.	There is an implication that no adjustments will be permitted and this may discourage the weaker party from seeking them, which is an advantage for the stronger party.	Claims (whether from purchasing or supply side) can quickly escalate into disputes as the contract offers no guidance on how to proceed. The lack of a specified route to seeking adjustment can result in quality being 'managed down to price', rather than price being 'managed up to quality'.	Never recommended. Contracts should always seek to foresee likely circumstances and cater for them.

Approach to price adjustment	Advantages	Disadvantages	Suitable for
Circumstances outlined, but no calculation mechanism quoted.	Clearly limits the circumstances in which discussions are possible – thus avoiding time wasted on those where no change will be considered. Flexibility in calculating the change could provide a greater gain for the party with more bargaining power or better negotiators.	Time may be wasted debating appropriate bases for the calculation, prior to the substantive discussion on what adjustment is actually sought. Weaker negotiators will lose out.	A partially inequitable approach that might suit a party confident of their ability to influence future negotiations, while willing to give some ground to the other party in order to maintain the relationship.
Circumstances and mechanism described.	Clearly limits when adjustment will be considered. Clearly states how such adjustment will be calculated. Contractual and legal certainty for both parties. Can be linked to contract-specific indices or general economy indices depending on the nature of the contract. Supplier may quote lower initial price knowing that some of the risk of cost increases is covered.	Relies on good market knowledge to be able to predict relevant circumstances and plan for them. Failure to capture a key influence could lead to disputes. Can distort prices if the index chosen suggests an impact that is not actually felt by the contracting party. Reduces incentive for supplier to control costs.	Despite the limitations this is the best option. It relies on good market knowledge but provides the most equitable approach to satisfying the needs of the purchaser and the supplier.
Automatic periodic adjustment (e.g., annually).	Budgetary certainty for the purchaser. Income certainty for the supplier.	As normally linked to broad based indices such as the retail price index or consumer price index it can result in unwarranted price rises. No incentive for the supplier to reduce or control costs.	Not recommended – does not deliver value for money.

ible 3.20 Advantages and disadvantages of price adjustment formulae

Remember
Indexation is a useful way of predetermining price adjustments by reference to an externally validated source of input cost changes. Automatic indexation reduces the incentive for a supplier to seek cost efficiencies.



The use of incentivised contracts

In the context of a contract, an incentive is an extra payment to encourage better performance.

Any aspect of performance for which a KPI can be set could be considered for incentivisation. The most common applications are in respect of cost control and completion times.

Incentivising cost control

Target cost
Estimated cost of supply as agreed between contracting parties

Target fee
In a cost-plus incentive contract, the fee or profit element which will be paid if actual costs equal target costs

Sharing ratio
Within a cost-plus incentive contract, the proportion of the cost/benefit which is allocated to the purchaser and the supplier

As indicated already, one of the problems with a cost-plus contract is that the supplier has no motivation to control costs. This can be addressed by introducing the concepts of **target cost**, **target fee** and **sharing ratios**. The fee is the amount payable by the purchaser over and above the cost element.

Target cost is the estimated cost of the supply, which is agreed between the parties at the beginning of the contract.

The sharing ratio is the proportion of the cost/benefit which accrues to the purchaser and the supplier. It is often different for costs over target and cost-savings below target. For example, for above target cost the ratio might be purchaser 80% : supplier 20%, while below-target it might be purchaser 60% : supplier 40%. In this scenario the purchaser would be carrying a larger share of the risk for overrun than the supplier but also retaining a greater share of the savings if costs are retained.

The target fee is the amount that will be paid if the actual costs (which can be proven) match the target costs.

The actual fee will be adjusted in proportion to the difference between the target cost and the actual cost. The usual calculation is:

Target fee + ((target cost – actual cost) × supplier share) = final fee

The final price then becomes:

Actual cost + final fee = final price

Implementing this approach creates a 'cost plus incentive' contract, also known as a 'target cost' contract or a 'gain-share/pain-share' arrangement. The last term is a good description because in these types of contract the benefits (gains) of good performance are shared between the supplier and the purchaser, as are the losses (pains) of poor performance. As well as rewarding good performance and penalising poor performance, this type of arrangement recognises that the purchaser has a role to play in enabling the supplier to perform well, e.g., by providing clear instructions and responding promptly to queries.

Target cost – a worked example

Assume:

Target cost = $1000

Target fee = $100

Sharing ratio for cost overruns:
80% purchaser : 20% supplier

Sharing ratio for cost savings:
60% purchaser : 40% supplier

If the actual cost is $1100 (i.e. above target), then the final fee is:

$100 + (($1000 – $1100) × 20%) = $80

And the final price is:

$1100 + $80 = $1180

If the actual cost is $900 (i.e. below target), then the final fee is:

$100 + ((1000 – 900)) × 40%) = $140

And the final price is:

$900 + $140 = $1040

Thus, if costs are kept below the target the supplier has all costs covered and receives a higher fee. If they rise above the target, all costs are covered but the profit is reduced.

To ensure that the focus on cost reduction does not harm the quality aspects, it may be necessary to set a maximum fee. This would be that once costs had reduced to a given point, any further reduction would not change the fee payable.

The supplier may wish to seek a minimum fee to ensure that some base level of profit is achieved. If this is done, then the incentive is somewhat weakened as the worst-case scenario for the supplier would be the equivalent of a normal cost-plus.

A further way of ensuring that costs are not permitted to be uncontrolled is to set a ceiling price: a maximum that will be paid by the purchaser irrespective of cost.

Finally, a simple bonus payment can be offered if costs are kept within given parameters over a specified period or reduced by a specified amount. The bonus payment could be a stated fixed sum or calculated as a percentage of the savings achieved. To ensure that such savings are achieved without reducing quality, such bonus payments must be conditional on quality KPIs being achieved.

Incentivising speed of delivery

Another key aspect of contract performance that can have significant impacts for the purchaser is the speed of delivery, particularly on large projects such as construction or engineering projects, or major ICT projects, or manufacturing equipment renewals. The ability to take early delivery means that the benefits of the new infrastructure or equipment start to accrue sooner. This has a direct financial benefit for the purchaser.

Liquidated damages as a disincentive for late completion have already been considered. The opposite would be a bonus payment for early completion. The

payment could be structured one of two ways: either a single payment for meeting a specific earlier target date, or an incremental bonus determined by how much earlier than the contract due date completion is achieved. The disadvantage of the former is that it is an all-or-nothing incentive. Once the earlier date is missed, the incentive vanishes. It is only useful therefore if there is a particular reason to hit the earlier date. If a new HR and payroll management system has to go live at the beginning of a financial year for instance, once the system availability date which would enable that to happen has been missed, any other time gains have no value.

In most cases, the incremental bonus provides a greater incentive because it remains in place right until the end.

An alternative approach is to allow for stage payments <en dash> a payment of part of the total fee following the completion of set 'work stages' or 'project milestones'. This can help to ensure momentum on a project as it relates directly to the supplier's cash flow. The value of the payments involved will determine how much of an incentive this is. It works well where the payments are large relative to the supplier's turnover, but is less effective if the sums are relatively small. Note also that in many sectors (construction, technical consultancy, software development and installation are key examples) stage payments are the norm and will not have an appreciable impact on performance. For lower-value contracts, not making any payment until completion may be a stronger lever.

Incentivising other aspects of performance

The achievement of any KPI or contract performance outcome can be incentivised via bonus payments, provided that a SMART target can be set for it. Care must be taken as focussing on one aspect of delivery could be to the detriment of another. For example, meeting targets for responsive maintenance of equipment (attending to breakdowns) could result in routine servicing not being carried out early enough or frequently enough, with the net result that more breakdowns actually occur.

Such incentives should only be used where there is a real demonstrable – and usually financial – gain to the purchaser in the improved performance. The bonus payment then becomes a way of sharing the gains.

There is a danger that bonus payments can be used to drive quality above the specified level, and mean paying extra for it. If those quality levels are necessary, they should have been specified in the first place.

Other incentives

Other incentives include the potential for contracts to be extended or for better payment terms (normally quicker payment) to be offered as rewards for good performance.

Contract extensions

A contract may include the possibility of it being extended subject to certain performance measures being achieved.

This must be carefully thought through. Consideration must be given to what level of performance needs to be achieved, whether it must be achieved across all KPIs or only some of them, how consistently it should be achieved (e.g., every reporting period or averaged across the whole initial contract period), and whether a weighted average of KPIs should be used in the event that some are more important than others.

You also need to think about whether the extension will happen automatically if that level of performance is achieved. For a pilot project, this would be sensible. For example, a two-year trial of a service that meets the standard could be extended for a further three or five years. For a normal contract, having an automatic extension subject only to performance measures could allow it to drift away from the competitive marketplace, especially if that market is innovative.

From the purchasing perspective, it makes sense for such contract extensions to be options that are conditional on performance. This would mean the purchaser retaining control over whether or not to extend, but not doing so in the light of poor performance.

From the supply perspective, an option to extend which may or may not be exercised is not a strong incentive to perform above and beyond the contract minimum.

Accelerated payments

Some commentators suggest that accelerated payment terms (i.e. quicker payment, for example, within 14 days of invoice rather than 30 days) can be used to incentivise performance. In reality, this is administratively difficult to do at contract or project level, unless you have a sophisticated software system that automatically links performance data from the contract management system to the payment terms in the purchase ledger accounting system. Making changes to payment terms to reflect the latest performance statistics will create additional administrative work for potentially limited reward for either the purchaser or the supplier. It will also create uncertainty as to what payment terms apply at any point in time, or to any particular invoice.

It is more feasible at supplier management level. This means looking at the supplier's performance across a range of contracts over a longer period, and applying the accelerated terms to all existing contracts. As a matter of practicality, purchaser ledger computer systems are likely to attach payment terms at supplier level, not at contract level. This means it may not even be possible within an organisation for different terms to apply to one supplier on different contracts.

Remember
Incentives should only be used where the improvement sought is of financial benefit (over and above the cost of the incentive) to the purchaser. Examples are controlling costs and speedier delivery.

Payment terms

Having looked at the various pricing mechanisms, consideration should be given to what the contract has to say about payment terms.

Clauses relating to payment must be directly cross-referenced to those relating to price and how actual payments are calculated. The payment terms clauses look at when and how payment is to be made.

They will include the following.

- Documentation required
- VAT and other taxes
- Payment period and how it is calculated
- Disputed invoices and pay-less notices

- Treatment of retentions
- Remedies for late payment

Table 3.21 shows the various issues and things to consider in respect of payment terms.

Documentation required	No payment should be made without a valid invoice that complies with local laws (and the laws of the contract-governing jurisdiction if it is an international contract covered by a different legal system). As most payments will be subject to VAT, sales and/or other taxes, these should be clearly identified on the invoice. Any other necessary breakdown of the costs being invoiced must also be clearly shown. The section on pricing schedules considered how costs may need to be allocated. There is no point doing this in the calculation schedule if it is not then shown on the invoice. Contract and/or order reference numbers must be shown. The list of required content for invoices, including how the invoiced amount should be analysed, should be set out in the contract. Some commentators will argue that this level of detail does not need to be set out in the contract. However, inadequate invoicing is a major barrier to good spend analysis. This can be vastly reduced if contracts require specific information to be on every invoice and give a right to refuse payment of any invoice that does not provide it (and if contract managers then exercise the right). The actual format of the invoice cannot be dictated, but the relevant information can. It can be provided as an accompanying schedule if necessary.
VAT and other taxes	VAT, sales tax, insurance premium tax and the like: it is generally the case that all contract sums are quoted exclusive of such taxes. The taxation rate may change during the contract period. Neither the purchaser nor the supplier can influence it and payment is a legal requirement. Payment terms clauses should simply confirm that such taxes may be due and that all sums quoted are exclusive of them. This gives clarity that there is no assumption that the taxes are included in prices quoted. It also avoids any potential disputes regarding liability for such taxes. On construction projects in the UK, regard should also be paid to the Construction Industry Scheme (CIS), which is a special facility for dealing with income tax due from labour-only subcontractors. The detail of this is beyond the scope of this book. The government's tax websites will have any relevant information.

Payment period	The payment period is the time between the invoice date and the actual payment being made. Care needs to be taken if requests for payment need to be validated (by a contract administrator, for example) prior to being invoiced, to ensure that the validation period is also taken into account. There should be a stated period for the request to be validated (and approved for invoicing) and a separate payment period running from the date of invoice. However, this is not always the case. Thought must be given to what the payment period is. Purchasers will want long periods, suppliers will want short ones. In the EU, 30 days has been set as the maximum on public sector contracts and all subcontracts in public sector supply chains. Discounts may be available if shorter periods are agreed to or achieved. Consideration should also be given to the organisation's own internal processes. Do not agree to a seven-day payment period if payment approval processes are such that it cannot physically be done in that time. As always with payment, or any other period listed in a contract, it is important to be clear whether references to 'days' mean working days or calendar days. If working days are indicated, a definition must be provided of what is not a working day. This is normally weekends and national holidays.
Disputed invoices and pay-less notices	Disputed invoices: not all invoices will be accurate and correct. Occasionally there will be mistakes. With unethical suppliers there may even be deliberate attempts at fraud. Invoices must be checked carefully by those approving them for payment. From the contractual point of view, there must be a process for rejecting fully disputed invoices. This will normally be done in writing. The contract should state a maximum time period within which this must be done. Fourteen days is the norm. **Pay-less notices:** in some cases the invoice may not need to be rejected entirely, but the purchaser may have reason to not want to settle it in full. This could be because only a part of the amount invoiced is disputed and it would be inequitable to withhold the full amount. It could be that liquidated damages are being deducted from the amount invoiced. In either case, the supplier must be notified that a lower amount will be paid, what that lower amount is, how it is calculated and the reasons for doing this. The main reasons for doing this are accounting ones: it keeps the audit trail clean. Everyone can see how and why the payment did not match the invoice. To ensure it is done – and done promptly – it is helpful to have a contract clause setting out exactly what is needed, and the deadline for doing so. Five days before the due date for payment is used in some contracts.

ay-less notice
formal notice under contract stating that n invoice will only e paid in part and iving the reasons 'hy the lower mount is being paid

Retentions	A **retention** is a proportion of a payment due that is withheld for a specific period in case of defects. The contract must set out what the proportion is and how long it may be held for. Both the figure and the time period will vary depending on the nature of the purchase. The contract must also set out the process that needs to be followed in order for the retention to be released. This may include an inspection and/or certification that there are no defects evident. Retentions are normally shown on the invoice calculation, but as an 'above-the-line' deduction, i.e. they are not actually being invoiced at that point. If the contract allows for a retention, the amount concerned is not due for payment until the end of the retention period. That will be the tax point and the point at which it can be invoiced. Showing it on earlier invoices is an accounting convention and helps to keep a clear audit trail of payments due. Retentions are **not** therefore covered by pay-less notices.
Remedies for late payment	Payments which are not made on time create cash flow problems for the supplier. They may not be able to make debt repayments on time or may need to borrow additional funds. At the very least there is a period of time when they do not have access to those funds for investment purposes. Accordingly, the contract must set out what remedies are available to the supplier in the event of late payment by the purchaser. This is normally by way of interest which can be charged on top of the sum actually due. The amount of interest capable of being charged may be an implied term under statute law. For example, in the UK the Late Payment of Commercial Debts (Interest) Act 1998 states that if no other figure is given in the contract the interest rate shall be the Bank of England Base Rate + 8%. So if the base rate is 0.5% (which it was in 2017), the contract interest rate will be 8.5%. If the base rate is 7.5% (as it was in 1998), the contract interest rate will be 15.5%. Given that the base rate is outside of the control of the parties, it is better for a specific interest rate to be stated within the contract. Most other legal jurisdictions do not have similar statutory provision, so the contract must lay down what is permissible.

Table 3.21 Things to consider in respect of payment terms clauses

Retention
A sum of money withheld from payment for a fixed period of time to be used to cover any costs associated with remedying defects that are not corrected by the supplier

Apply

If you are likely to be working on construction projects, research the requirements of CIS. If you are based outside the UK, investigate whether similar schemes operate in your country.

Chapter Summary

- Express terms are those precisely described in the text of contracts whereas implied terms are not written down but will be assumed to exist, either through custom and practice or because of laws which state that such assumptions will always be made.
- Standard terms of business can be helpful in avoiding long and complicated contract forms. However, their use can lead to uncertainty as to whether or not they apply in a particular case. This is especially true where a battle of the forms arises (supplier terms and purchaser terms taking precedence through a sequence of forms overriding each other). They are concise in nature and carry a risk of missing key elements that might apply in particular circumstances. They are not appropriate for complex contracts.
- Standard forms of contract reduce both the work required and the risks associated with writing every individual contract from scratch. They ensure that all key elements of likely risk, responsibility and liability are covered as they are designed to operate in a particular sector. Suppliers operating in the relevant sector will be familiar with them; however, many standard forms have been heavily influenced by supplier bodies and therefore may not adequately cover purchaser risks. Amending standard forms risks introducing conflicts between clauses and the possibility that cross-references become confused or meaningless.
- Key contract terms include wording in respect of liability, indemnity and insurance, subcontracting, guarantees and liquidated damages. Liability clauses set out which party is legally responsible if a particular failure occurs. Indemnity clauses state the extent to which they are required to compensate the other party for such failure. Insurance is a means of transferring the cost risk of indemnity to another body, namely an insurance company. Requiring insurance to be in place reduces the risks to both parties.
- Subcontracting needs to be controlled to ensure that legal requirements and reputational risks are effectively managed.
- Guarantees are assurances that the product will perform as specified over a given period and give the purchaser a direct course of action in the event of failure.
- Liquidated damages are most commonly used in respect of late completion. They are not a penalty, but a pre-agreed means of restitution. They must be a genuine estimate of the loss that will be incurred if completion is late.
- Contracts should also include clauses relating to labour standards and other ethical sourcing issues. Labour standards relate to the terms and conditions of employees. Minimum standards have been internationally

agreed under the auspices of the ILO, particularly in respect of the right to free association and collective bargaining, ending compulsory and enforced labour, ending child labour and removing discrimination between workers on the grounds of ethnicity, race, religion, gender, disability, etc. Other ethical issues include environmental concerns, social impacts, the use of conflict minerals, together with fraud and other forms of corruption in tender processes. Including contract terms relating to these areas sends a signal, but they will only be effective if they can be enforced. Enforcement should not necessarily be the first response when issues are discovered: working with suppliers to improve the situation will have a better long-term impact.

- There are various approaches to pricing.
  - Schedules of rates set out definitive rates against precise deliverables. They are very detailed and auditable, but can be resource intensive to manage. There are risks if not all future needs can be anticipated.
  - Fixed-fee approaches are useful where the delivery is standard and never changes, but can also be used where the variations are such that an overall balance will be achieved.
  - Cost-plus pricing ensures that the supplier will make a profit despite changes in its input costs (raw materials, components, labour), thus reducing the buyer's risk of supplier failure or poor performance in the event of falling profits. However, it means that the buyer is taking on a greater share of the risk of such cost increases.
- Cost control and speed of delivery (as well as many other aspects of contractual compliance) can be incentivised positively by the use of bonus payments and gain-share/pain-share schemes, where the benefits accruing to the purchaser are shared with the supplier. Other mechanisms, such as penalties, liquidated damages and the like, act as disincentives to non-performance. Both approaches need to be supported by contractual key performance indicators and targets, with agreed contractual responses (benefits or remedies) when such targets are not met, are met or are exceeded.
- Clauses relating to payment terms should cover the following.
  - Documentation required (any particular information that needs to be included on invoices, any supporting documentation for cost-plus payments)
  - How VAT and other taxes are to be treated
  - The payment period (i.e. the date between invoice and payment) and how it is calculated (calendar days, working days, issue date, receipt date, etc.)
  - What will happen in the event of an invoice being disputed, including processes for part-payment if only part of the claim is disputed
  - Whether retentions are to be held and if so how much, for how long and what needs to happen in order for them to be released
  - Supplier remedies in the event of late payments – usually a claim for interest on the debt. This is often set down in law.

End of Chapter Assessment

EXPLAIN — 1. Explain the differences between standard terms and model contracts. Describe the circumstances in which each is used appropriately.

DESCRIBE — 2. Describe the link between terms relating to liability and those covering indemnity. Analyse the connection between these and terms relating to insurance.

EXPLAIN — 3. How can labour standards be incorporated into contracts? Explain any issues that might arise from doing so.

DESCRIBE — 4. Describe the target cost model and explain how it is used to incentivise cost control.

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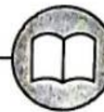

Glossary

Ad-hoc purchase
An item bought for a single and non-recurring use or purpose

Alternative dispute resolution (ADR)
Any method of resolving a dispute between two parties which does not involve court action, including escalation to higher levels of authority, mediation, adjudication and arbitration

Articles of incorporation
The legal document creating a commercial company and setting out its purpose

Base year
The starting point for an index, at which point the index is set to 100

Battle of the forms
A series of forms such as orders, delivery notes, etc., issued in sequence by purchaser and supplier, each containing terms that appear to override those on the previous document

Bespoke
Made or provided especially for a specific end user

Bribery
The promise, offer or giving of financial advantage to someone in the expectation that they will improperly perform their functions, or to reward them for having done so; also accepting such a promise, offer or advantage (whether or not the function is improperly performed)

Category
A group of goods or services that have shared characteristics

CISG
The Vienna Convention on Contracts for the International Sale of Goods, a United Nations treaty seeking to harmonise contract terms for the sale of goods between different countries

Closed system
A system or process that, once started, does not allow new entrants. A framework agreement might have multiple buyers and multiple suppliers, but once set up, no additional buyers or suppliers can be added to it

Code of practice (CoP)
A set of written rules explaining how people working in a particular profession should behave. Sometimes related to particular professions, they may equally relate to anyone working in a given environment or carrying out a particular function

Collusion
Where two or more potential suppliers (or the purchaser and one or more suppliers) secretly co-operate to undermine the competitiveness of a tender process

Conflict minerals
Metals and minerals sourced from areas where their mining is used to finance armed conflict and is linked to human rights abuses and corruption. The most commonly recognised ones are tin, tungsten, tantalum and gold

Contracting State
A country which has signed the Vienna Convention on CISG

Corruption
A wider term than bribery, includes any improper performance of function in return for some kind of advantage which may or may not be financial, e.g., facilitation payments, nepotism (favouring of family members), or career promotion. Both the providing and receiving of the advantage are corrupt practices

Debt-bondage
A person's pledge of labour or services as security for the repayment of a debt or other obligation, where there is no hope of actually repaying the debt

Defects
Any aspects of delivery that do not match the specification

Defendant
The person defending a claim brought against them

Developing economy
A national economy which is generally held to be still developing its industrial base, financial institutions and economic infrastructure

Diminished capacity
A person's inability to enter a contract, e.g., because they are a minor, are suffering from mental health issues, or are under the influence of drugs

Direct call off
The act of placing an order under a framework agreement without having further competition

Disincentive
Something which discourages a particular action or behaviour

Downstream
The supply chain that the organisation feeds into, from product to end user

Draft (a contract)
The formal drawing up of a contract, formulating the words and clauses

Drafter (of a contract)
The person(s) who design(s) and develop(s) the contract wording

Estimate
A supplier's best guess at what the price will be. It has no legal standing

Express terms
Contractual terms which are specifically stated in contract documents

Five Rights
The original 'Five Rights' of procurement are traditionally: the right **quantity**, the right **quality**, at the right **time**, from the right **place**, at the right **price**

Fixed cost
A cost that remains constant in the short term irrespective of production volumes

Force majeure
An exclusion clause that relates to things which are not only outside the control of the parties, but which by their nature are unforeseeable. The term normally includes such events as natural disasters, civil unrest and war – but where these things are frequent occurrences and/or could arguably be foreseeable, they may not be covered in a particular contract for that very reason

Forwarding agents
Specialists in organising the transportation of goods for others

Framework agreement
A formal agreement between two organisations that is intended to become legally binding in the event that a contract is created

GATS
General Agreement on the Trade in Services, an international agreement regulating barriers to the provision of services between different countries. Similar to GATT, but only applies to services, with the purpose of encouraging international trade in services

GATT
General Agreement on Tariffs and Trade, an international agreement regulating barriers to international trade, such as quotas and tariffs (a payment on goods being imported). Only applies to the trade in goods, with the purpose of encouraging international trade in goods

General Data Protection Regulation (GDPR)
European regulation which sets out how personal data must be managed, applying to any data relating to any person in the EU, whether they are a European citizen or not, and to all organisations doing business in Europe, regardless of the nationality of the business ownership

Geographic information system (GIS) mapping
A means of storing, retrieving, managing, displaying and analysing data in relation to its geographic or spatial context. It can be used for any kind of data (qualitative or quantitative) mapped in layers which can range from global/international down to precise locations within buildings, depending on the parameters set and the needs of the data users

Globally harmonized system for the classification and labelling of chemicals (GHS)
An international standard for labelling hazardous substances

Implied terms
Contractual terms that exist but are not written within the contractual documentation, i.e. the law of the land

Incentive
Something which encourages a particular action or behaviour

Incoterms®
Series of commercial terms published by the International Chamber of Commerce, covering the allocation of costs and transfer of risks between buyer and seller. The various options are abbreviated to three-letter codes

Indemnity
A security or protection against loss, usually by way of financial recompense

Indexation
The linking of a payment (be it a price, a salary or some other due payment) to an index and the adjustment of the payment in line with the movements of the index

Ineffective contract term
A term in a contract which cannot be legally enforced

Insurance
An arrangement where a fee is paid to one party (the insurance company) so that it will accept the risk and meet any costs that would normally fall

to the person who has the legal liability for them. Effectively the risk is transferred from the person with the legal liability to the insurer

Intention to create legal relations/to be legally bound
Intending that an agreement should be capable of being enforced via the courts

ISO
International Organization for Standardization (www.iso.org)

Legal certainty
The ability to predict how a court will decide a matter of dispute

Legalese
Complex legal language

Letter of intent
Letter issued by a purchaser indicating that they intend to accept a tender, usually subject to certain preconditions having been met, such as obtaining any legal or financial consents

Level the playing field
Take action to remove an advantage or disadvantage that only applies to some parties

Liability
Being legally responsible for something

Margin
Profit as a percentage of sales value

Mark-up
Profit as a percentage of costs

Market leverage
Another term for buying power, the ability of a purchaser to strongly influence the outcome of commercial negotiations

Mini-competition
A limited tender exercise, usually only on price, under the rules set out in a framework agreement; only suppliers appointed to the framework are able to take part

Non-disclosure agreement
A promise not to share information that could be useful to competitors and therefore harmful to the company that owns it. Also called a confidentiality agreement or memorandum of understanding

Off-the-shelf
A product or service which has been designed by the supplier and is delivered in standard form, with the purchaser unable to influence or change any aspect of the design or quality. Sometimes also called **out-of-the-box** solutions

Offeror
Person making an offer

Pay-less notice
A formal notice under a contract stating that an invoice will only be paid in part and giving the reasons why the lower amount is being paid

Plaintiff
The person bringing a legal claim

Precedent
A court judgment which is binding on future legal decisions

Price index
A way of showing the percentage change in prices over a given period, based on a starting year (the base) which is taken to be equivalent to 100%. Indices above 100 indicate a rise; indices below 100 indicate a fall

Price schedule
Sometimes this is called a 'fee schedule' when it applies to professional or consultancy services. It is an appendix to a contract setting out what the prices are

Pricing for risk
Increasing the price quoted for goods or services to include an element of insurance against having to remedy errors

Project management
Initiation, planning, execution and control of inter-related pieces of work, normally carried out by a team of people, to achieve a specified aim by a specified time

Public (or state) sector
Service organisations run by the government and usually funded by taxes

Quotation
Sometimes called a quote, this is a firm price offer obtained via a formal or informal process; normally it only relates to price on the basis of indicated quality

Rescission of contract
An equitable remedy that seeks to place both parties in their pre-contractual position, as though the contract had never existed

Retention
A sum of money withheld from payment for a fixed period of time to be used to cover any costs associated with remedying defects that are not corrected by the supplier

Right of set-off
The ability of a purchaser to deduct debts that are owed under one contract from payments that are due on a different contract

Rules of interpretation
In a legal context, a set of principles which have evolved over several hundred years, which define how law courts will interpret contracts. One of the primary rules is that words will have their normal everyday meaning, unless there is a specific definition provided within the contract itself. In commercial contracts where a level of legal and/or professional knowledge can be assumed (rather than between a business and a private individual), the courts may infer what a reasonably well-informed person of a given status in a given profession would have understood by the wording

Schedule of rates
An itemised list of component parts within a lump-sum contract, or a list of individual products, giving a price for each unit

Schedule of rates
An itemised list of component parts within a lump-sum contract, or a list of individual products, giving a price for each unit. Note that the rate may be different for different order volumes

Sector
A division of the national or international economy (e.g., manufacturing sector, health sector, financial services sector)

Service level agreement (SLA)
An agreement between the provider and the user of a service that details what performance and quality will be provided; this agreement is legally enforceable if it is referred to in a contract

Sharing ratio
Within a cost-plus incentive contract, the proportion of the cost/benefit which is allocated to the purchaser and the supplier

SME
Small- to medium-sized enterprise, normally defined by turnover or number of staff. For example, the EU definition is a firm with fewer than 250 employees and an annual turnover less than €50 million and/or a balance sheet of less than €43 million. A quick online search will reveal the parameters that apply in other parts of the world

Social value
The output from a contract that benefits society at large, rather than the purchaser or end user (sometimes also called community investment or corporate social responsibility)

Specific performance
This is where a court orders a party in breach of contract to perform exactly what it is required to do under the contract. Specific performance might be ordered in addition to damages. The remedy exists so that parties to a contract cannot simply get out of their obligations by accepting the financial cost of damages

Standard
A document which sets out agreed minimum technical parameters for a product or service

Standard terms and conditions
Basic terms and conditions of business governing transactions that do not have a definitive contract, usually designed to be included in form documents such as orders

Strict liability
A liability that exists without proof of wrongdoing

Subcontract
A contract that sits below, is directly linked to and is partly governed by a higher contract to deliver part of the requirements of that higher contract. There can be several layers of sub- and sub-subcontracts

Subject to contract
Heading used on letters, particularly in land transactions, to indicate that matters are still being discussed and that the letter must not be taken as a formal offer or an acceptance of any terms referred to within it

Supply base
The group of suppliers that a purchaser actually contracts with

Supply market
All potential suppliers capable of delivering a requirement

Target cost
Estimated cost of supply as agreed between contracting parties

Target fee
In a cost-plus incentive contract, the fee or profit element which will be paid if actual costs equal target costs

Tender
A bid obtained via a formal process; normally (not always) it includes quality variables as well as price aspects

Term contracts
Contracts written to last a period of time and include agreed terms

Time is of the essence
A legal term used in contracts to underline the importance of timely delivery. Time **is** of the essence if failure to supply in accordance with

ıe contract terms has a significant impact on the urchaser's ability to perform its normal functions. me is **not** of the essence if the late delivery has nited or no impact. On a purchaser's standard rms, time will almost certainly be stated to be 'of e essence'. In negotiated contracts, depending n the nature of the supply, suppliers may seek to gue that it is not of the essence

tle to goods
gally recognised ownership

ansitional economy
national economy which is moving from being a ate-controlled economy to a full market economy g., ex-Soviet Union countries)

ansparency
perating in such a way that everyone can see the tions performed

stream
e supply chain providing inputs to an ganisation's production, from raw materials ough to components, etc.

Utilities sector
Normally includes energy supplies, water and sewage, and telecoms networks

Variable costs
Costs that change directly in line with the output of the organisation

Version control table
List of dates of publication or agreement of each version of a specified document, together with the key changes since the previous edition

Vienna Convention
The United Nations Convention on the International Sale of Goods

Waiver
A considered and deliberate decision not to apply normal rules

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