

The Value of Contract Management Fundamentals for Every Project Manager

During the late 1910s and early 1920s, the Ford Motor Corporation constructed the world's largest industrial complex along the banks of the Rouge River in Dearborn, Michigan. Henry Ford's vision of mass production included not only the first production lines, but also the centralisation of the entire production chain. Iron ore and coal were shipped in by Great Lakes steamers and railroad, iron ore melted to produce iron, and then processed into steel. Rolling mills, forges and assembly workshops converted the steel into springs, axles and car bodies, foundries poured molten steel to produce engine blocks and cylinder heads. A massive glass factory manufactured the windscreens. The most basic of raw materials came in; cars rolled out. There was no place for suppliers or contracts – Ford basically owned the whole lot.

Fast forward to the 21st Century. A contract for a new tram system for a major Australian city has been awarded to a French company. The 2D drawings will be produced by a subcontractor in France, the 3D drawings by a contractor in Brazil, production will be contracted to 4 different companies in the EU and UK software will be customised by a Chinese company.

Companies can no longer do everything for themselves, or afford to do so, and almost, if not all, major companies depend on a wide range of suppliers for services and materials. As an example, consider BP: one of the UK's largest companies, with an annual turnover in 2008 of \$239 billion. In the same year more than 80% of their total expenditure was on contracted goods and services. Rolls-Royce are in a similar position, with over 60 suppliers of pre-assembled modules from Spain to Japan providing pre-built modules as components for the Trent series of jet engines, assembled in Derby, UK.

So what has changed in the last 100 years? Ever more complex technology with multiple components, overall specialisation beyond the economic competence of any individual company, ever increasing competition, a shrinking world, in terms of both suppliers and customers and competition, ever tighter timescales and margins. At the same time user requirements have not only become more complex, but also increasingly hard to define, especially within software or other business based systems.

The popular belief is that the subject of contract management may appear to be of interest only to lawyers and the commercial department. After all, the lawyers need to ensure legal protection for the company, and commercial specialists must ensure that the contracting process complies with competition and/ or procurement law, right?

Not necessarily! This is a common misunderstanding of the fundamental importance of contract formation and management: when a company contracts out the provision of any goods or services, the risk to them increases. Fundamentally risk increases because of the difficulty of communicating to the supplier exactly what it is that's required by the customer: easy enough if the contract is for the digging of a hole, but much harder if the requirement is for, say, a new customer relationship management system.

The objective in the development of any contract is simple: a clear understanding on the part of both parties as to what each will do, and a fair and well understood balance of risk and opportunity. The objective of contract management is equally simple: that is, to ensure compliance with the contract.

It's as simple as that: however, the difficulties of achieving this are considerable. This is why the skills of contract management are so important to business managers, if project and business objectives are to be met in a competitive environment.

So what does this mean for today's project manager and business manager? The manager of today must know about procurement and contracts. In short, there is a new tool in the managers' tool kits – contract management! Here are some of the components of procurement and contract management must be mastered – but not all.



- **Knowing the Legal Framework** – It should be understood that contracts exist in a legal framework.
 - It is not necessary for the manager to become a lawyer, nor even an expert in laws of his or her own country. That said, he or she does need to have an awareness of the legal concepts in order to be able to effectively use the resources of the company legal specialists to put the details into place.
 - In short, the manager needs to know the universally applied fundamentals of contract and procurement management that apply the world over and when (and how) to get the legal department involved. If a contract is set up and run correctly, there will be minimal need to get the lawyers involved. But if something doesn't go right – get the lawyers to help navigate the legal mine field.
- **Defining Requirements** - Have a systematic method of defining contract functional or technical requirements
 - Defining and communicating the tangible requirements may be difficult, but it is so much more difficult to ensure that the supplier understands the customer needs and expectations, including those that might be unstated or assumed, that sit behind the requirements.
 - Major risks exist where requirements are ambiguous or missing. It is a very naïve approach to assume that since the supplier is a specialist in this area that they also understand what it is that is required.
- **Establishing Clear Roles and Responsibilities** – know who is supposed to do what
 - It must be remembered that the supplier's horizon is the end of their delivery; this is usually different from the customer's product delivery. These two differing viewpoints may colour how each sees contract delivery.
 - The Contracting parties must be understood. In a world of joint ventures, partnerships, contractors and sub-contractors, it may not be clear exactly with whom you have a contract.
 - This is another example of an issue that normally only comes to the fore when something goes wrong and liabilities have been incurred. For example, you may have imposed strict safety requirements on your contractor. How can you be sure that they have imposed similar terms on their sub-contractor?
- **Managing Relationships** – building long term relationships
 - Contracting relationships are only successful where there is an equitable balance of risk and opportunity. This may be achieved partly by assigning liability within the contract, but is more commonly achieved by the choice of pricing mechanism (for example lump-sum, cost-re-imburement or a variation). The wrong type of mechanism motivates the wrong type of performance. This factor was held as a major factor in the escalation in the cost of the Scottish Parliament Building to £414 million from the £109 million original estimate.
 - Going through the effort of building a contract forces both parties to evaluate what is expected of each other in the relationship and how 'things will work'. Expending the effort to do the hard work early establishes the foundation (and documents what needs to happen) so that if things go awry, you know what to do and how to resolve the issues. As one colleague has said many times – 'Get the hard conversations done early and written down – the rest of the relationship will follow'.
- **Managing Risk** – Contracts can be used to transfer risk to a third party – but not all of it
 - The normal extent of a supplier's liability is rework in the event of failure; however, the customer may have suffered severe consequential loss through a contractor's failure.
 - In 2010 a contractor arrived at a remote gas field in western Kazakhstan to repair a faulty compressor. The contractor forgot to bring an essential tool, and because it was essential for the customer to have the compressor operating, the customer chartered a helicopter to bring the tool to site and allow the contractor to effect the repair. Who paid for the helicopter? The customer. This may seem unfair, but most contracts limit the supplier's liability to the work being done, and not consequential cost outside of this. Damages usually extend to re-work, and the customer may even have to pay for work that the contractor has done. Certainly a contract could be drawn allocating higher liability, but in that case the price would be higher. So the risk remains with the customer.

Contracts are formed with and managed by people – and those people are no longer just the lawyers. Today's managers are more frequently called to manage suppliers, vendors, contractors or even just procure the paper needed for the office. So contracts and contract management are new skills. Start your exploration of the world of contracting by focusing on the universally applied fundamentals that work in any region of the world first. Then work with your legal departments to understand the local laws.

Richard A. Graham, an instructor with ESI International, has more than 20 years' experience in project management. Richard has held senior roles at Astra Pharmaceuticals, Eli Lilly, International Minerals and Chemicals (IMC), and British Alcan. His most recent position was as a projects director at Bio-Flo Ltd where he was responsible for the project management, development, production, and distribution of downstream processing equipment, including the negotiation of UK, U.S., and European partnership agreements. For the past several years, Mr. Graham also has provided consulting services to various companies, with a particular focus on risk and contractual aspects of projects



Find out how ESI International can help organisations with their Contract Management.
To learn more, please contact ESI at enquiries@esi-intl.com or +44(0)20 7017 7100.