Types of Contracts

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Many different types of contracts can be used to acquire goods and services. The procurement manager selects the contract type for each procurement based on the following considerations:

- What is being purchased (a product or a service)
- The completeness of the statement of work
- The level of effort and expertise the buyer can devote to managing the seller
- Whether the buyer wants to offer the seller incentives
- The marketplace or economy
- Industry standards for the type of contract used

Keep in mind that although the buyer initially proposes the contract type, the final contract type is subject to negotiation with the seller. The best contract type meets the needs of the procurement, results in reasonable seller risk, and provides the seller with the greatest incentive for efficient performance.

The three broad categories of contracts are:

- Fixed-price (FP)
- Time and material (T&M)
- Cost-reimbursable (CR)

Fixed Price

A fixed-price contract should be used for acquiring goods, products, or services with well-defined specifications or requirements. In general, with a fixed-price contract, a clearly defined statement of work along with competing bids mean you're likely to get a fair and reasonable price. This is one of the most common types of contract, though it's more likely to be used in construction than in something like information technology.

If the costs are more than the agreed-upon amount, the seller must bear the additional costs. Therefore, the buyer has the least cost risk in this type of contract because the scope is well-defined. Note, however, that when fixed-price contracts are entered into and the statement of work is not sufficiently detailed, claims and disputes over what is in and out of the contract create higher risk of cost overruns or delay. The seller is most concerned with the procurement statement of work (SOW) in a fixed-price contract, since this will help them more accurately estimate time and cost for the work involved and determine a price that includes a fair and reasonable profit. The amount of profit is not disclosed to the buyer. Types of fixed-price contracts include firm fixed price, fixed price incentive fee, fixed price award fee, and fixed price with economic price adjustments. Purchase orders are also a type of fixed-price contract.

For the exam, be aware that even though the buyer may prefer a fixed-price contract as a way to control costs, it is not always the best choice, and in some cases, it may be inappropriate. Sellers in some industries may not have the detailed accounting records of past project activities required to accurately estimate future projects. Buyers may not have the expertise to prepare the clear and complete procurement statement of work required for a fixed-price contract.

Because many buyers are not knowledgeable about contracts, they often ask the seller to provide a fixed price even when the scope of work is not complete and accurate. Think about the following disadvantages if the procurement statement of work is not adequate for the seller to make a reasonable estimate:

- The seller is forced to accept a high level of risk.
- The seller needs to add significant reserves to their price to cover risk; therefore, the buyer pays more than they otherwise might have.
- The seller can more easily try to increase profits by cutting scope or claiming that work the buyer wants is outside the contract and thus requires a change order, and the buyer will not be able to state with certainty if it is within the scope of work or needs a change order. If the seller realizes they will not be able to make a profit they may try to take their best people off the project, cut out work that is specifically mentioned in the contract, cut out work that is not mentioned in the contract but is needed, decrease quality, or take other actions to save money.

Here are the most common fixed-price contracts.

Fixed-Price (FP)

In a FP contract, a fixed total price is set for the project, all requirements have been clearly described, and changes to scope should not occur.

Example: Fixed-Price Contract

Contract = $1,100,000

Fixed Price Incentive Fee (FPIF)

In a FPIF contract, profits (or financial incentives) can be adjusted based on the seller meeting specified performance criteria, such as getting the work done faster, cheaper, or better. The final price is calculated using a formula based on the relationship of final negotiated costs to the total target cost. (See more on incentives later in this section.)

Example: Fixed Price Incentive Fee Contract

Contract = $1,100,000. For every month early the project is finished, an additional $10,000 is paid to the seller.

Note: A variation on a FPIF is a FPIF Successive Target contract, in which the target for the incentive is changed after the first target is reached.

Fixed Price Award Fee (FPAF)

In a FPAF contract, the buyer pays a fixed price plus an award (a bonus) based on performance. This is a type of incentive contract. Procedures must be in place in advance for determining the award to avoid the subjective judgement of awards.

The cost to administer the award fee versus the potential benefits must be weighed in the decision to use this type of contract.

Example: Fixed Price Award Fee Contract

Contract = $1,100,000. For every month that performance exceeds the planned level by more than 15 percent, an additional $5,000 is awarded to the seller, with a maximum award of $50,000.

Note: This is similar to the FPIF contract except the total possible award amount is determined in advance. For example, the buyer might say there is a maximum $50,000 award, apportioned at the rate of $5,000 for every month production exceeds a certain amount.

Fixed Price with Economic Price Adjustments (FPEPA)

If a contract will cover a multiyear period, there may be uncertainties about future economic conditions. Future costs of supplies and equipment the seller might be required to provide may be unpredictable. In such cases, a buyer might choose a fixed-price contract with economic price adjustments.

Example: Fixed Price with Economic Price Adjustments Contract

Contract = $1,100,000, but a price increase will be allowed in year two based on the US Consumer Price Index report for year one.

Or

Contract = $1,100,000, but a price increase will be allowed in year two to account for increases in specific material costs.

Note: Think "economy" whenever you see this on the exam.

Graduated Fixed Price

An agile contract that shares some of the risk and reward associated with schedule variance between the customer and supplier. If the supplier delivers early, they get paid for fewer hours but at a higher rate. If the supplier delivers on time, they get paid for the hours worked at their standard rate. If they deliver late, they get paid for more hours but at a lower rate.

Example: Graduated Fixed Price

Finish early = $110/hour. Customer is happy because the work is done early and they pay less overall. The supplier is happy because they make a higher margin.

Finish on time = $100/hour. Both parties are happy.

Finish late = $90/hour. Both parties are somewhat unhappy since they are both making less money, but at a gradual, sustainable rate that hopefully will not lead to the contract being terminated.

Purchase Order

A purchase order is the simplest type of fixed-price contract. This type of contract is nor mally unilateral (signed by one party) instead of bilateral (signed by both parties). However, some buyers require the seller's signature on a purchase order before considering it official. In that case, the signature forms the acceptance needed for a contract.

Example: Purchase Order

Contract = 30 linear meters of wood at $9 per meter.

Note: A purchase order is usually used for simple commodity procurements. They become contracts when the buyer accepts the terms. The seller then performs or delivers according to those terms (for example, equipment or products).

Time and Material (T&M)

In this type of contract, the buyer pays on a per-hour or per-item basis. They are frequently used for service efforts in which the level of effort cannot be defined when the contract is awarded. It has elements of a fixed-price contract (in the fixed price per hour) and a cost-reimbursable contract (in the material costs and the fact that the total cost is unknown). Compared to other types of contracts, time and material contracts typically have terms and conditions that are simpler to allow for quick negotiations so that work can begin sooner.

If you were going to have to pay someone on a contract basis for every hour they worked, no matter how productive they were and no matter what they were doing, would you want to do this for a long period of time? Remember, the seller's profit is built into the rate, so they have no incentive to get the work done quickly or efficiently. For this reason, a time and material contract is best used for work valued at small dollar amounts and lasting a short amount of time. Knowing when it's best to use time and material contracts can help you get situational questions right on the exam.

To make sure the costs do not become higher than budgeted, the buyer may add a "Not to Exceed" clause to the contract and thus limit the total amount they are required to pay. With a time and material contract, the buyer has a medium amount of cost risk as compared to cost-reimbursable and fixed- price contracts.

Example: Time and Material Contract

Contract = $100 per hour plus expenses or materials at cost.

Or

Contract = $100 per hour plus materials at $5 per linear meter of wood.

Cost-reimbursable (CR)

A cost-reimbursable contract is used when the exact scope of work is uncertain and, therefore, costs cannot be estimated accurately enough to effectively use a fixed-price contract. This type of contract provides for the buyer to pay the seller allowable incurred costs to the extent prescribed in the contract. Such contracts also typically include an additional fee or award amount added to the cost to allow for seller profit. Types of cost-reimbursable contracts include cost, cost plus fixed fee, cost plus incen- tive fee, cost plus award fee, cost plus fee, and cost plus percentage of costs.

A cost-reimbursable contract requires the seller to have an accounting system that can track costs by project. With a cost-reimbursable contract, the buyer has the most cost risk because the total costs are unknown. The seller provides an estimate to the buyer; the buyer can use the estimate for planning and cost management purposes, but it is not binding. What is binding is the buyer's responsibility to compensate the seller for legitimate costs for work and materials as described in the contract. Research and development or information technology projects in which the scope is unknown are typical examples of cost- reimbursable contracts.

The following section describes some of the most common forms of cost-reimbursable contracts.

Cost Contract

A cost contract is one in which the seller receives no fee (profit). It is appropriate for work performed by nonprofit organizations.

Example: Cost Contract

Contract = Cost for work and materials.
There is no profit. The seller is reimbursed but does not make a profit.

Cost Plus Fixed Fee (CPFF)

A cost plus fixed fee contract provides for payment to the seller of actual costs plus a negotiated fee (the seller's profit, usually a percentage of the estimated cost) that is fixed before work begins. The fee does not vary with actual costs; thus, the seller does not have an incentive to increase or inflate costs.

Example: Cost Plus Fixed Fee Contract

Contract = Cost plus a fee of $100,000.

Note: The fee may be adjusted as a result of changes to the procurement statement of work.

Cost Plus Incentive Fee (CPIF)

A cost plus incentive fee contract provides for the seller to be paid for actual costs plus a fee that will be adjusted based on whether specific performance objectives stated in the contract are met. In this type of contract, an original estimate of the total cost is made (the target cost) and a fee for the work is determined (a target fee). The seller gets a percentage of the savings if the actual costs are less than the target costs, or shares the cost overrun with the buyer. The ratio is often 80 percent to the buyer and 20 percent to the seller. See more on incentives later in this section.

Example: Cost Plus Incentive Fee Contract

Contract = $500,000 target cost plus $50,000 target fee. The buyer and seller share any cost savings or overruns at 80% to the buyer and 20% to the seller.

Cost Plus Award Fee (CPAF)

In a cost plus award fee contract, the buyer pays all costs and a base fee plus an award amount (a bonus) based on performance. This is similar to the CPIF contract, except the incen- tive is a potential award, and there is no possibility of a penalty. The award amount in a CPAF contract is determined in advance and apportioned depending on performance.

This is a type of incentive contract. In some instances, the award paid out is judged subjectively. Therefore, procedures must be in place in advance for determining the award.

As with a FPAF contract, the cost to administer an award fee contract must be weighed against the potential benefits when deciding whether to use this type of contract.

Example: Cost Plus Award Fee Contract

Contract = Cost plus a base fee plus award for meeting buyer- specified performance criteria. Maximum award available is $50,000.

Cost Plus Fee (CPF) or Cost Plus Percentage of Costs (CPPC)

A CPF or CPPC contract requires the buyer to pay for all costs plus a percentage of costs as a fee.

In the United States, this type of cost-reimbursable contract is generally not allowed for federal acquisitions or procurements under federal acquisition regulations, and it is bad for buyers everywhere. Can you see why?

If profit is based on a percentage of costs billed to the buyer, what incentive is there to control costs? Say a seller must purchase materials from one of two suppliers, both of which meet quality requirements, but one charges $4 per unit and the other charges $40. A seller might be tempted to choose the $40 per unit charge to maximize profit.

Example: Cost Plus Fee or Cost Plus Percentage of Costs Contract

Contract = Cost plus 10 percent of costs as fee.

Note: It is possible to construct the contract so that the seller will need to prove they pursued the least expensive path in completion of the work when, for example, selecting materials or subcontracting portions of work. This contract type requires the buyer to carefully manage all invoices.

Advantages and Disadvantages of Each Contract Type

Do you understand what you just read? Can you answer the following questions?

- You do not have a finalized scope. Which contract type is best?
- You do not have a complete scope of work, but you have a fixed-price contract. What problems can you expect to run into?

TRICKS OF THE TRADE®

A trick for the exam is to realize that buyers must select the appropriate type of contract for what they are buying. The following exercise will test whether you really understand the different types of contracts and will help you select the appropriate type of contract.

Exercise

For each situation described in the table below, identify the most appropriate contract type to use from the choices listed below. Read each situation carefully to determine whether the information is sufficient to indicate only that some type of cost- reimbursable (CR) or fixed-price (FP) contract would apply, or whether the details of the situation suggest a more specific type of cost-reimbursable (CPF or CPPC, CPFF, CPIF) or fixed-price contract (FPIF, FPAF, FPEPA) should be used.

Your choices are FP, FPIF, FPAF, FPEPA, purchase order, T&M, CR, CPF or CPPC, CPFF, CPIF, or CPAF contracts

Situation
1. You need work to begin right away.
2. You want to buy expertise in determining what needs to be done.
3. You know exactly what needs to be done.
4. You are buying a programmer's services to augment your staff for a short period.
5. You need work done, but you don't have time to audit invoices.
6. You need to rebuild a bridge as soon as possible after a storm.
7. The project requires a high level of expertise to complete, and you want to have the best performance possible in the finished product.
8. You need to hire a contractor to perform research and development.
9. The scope of work is complete, but the economy is currently unpredictable.
10. You are buying standard commodities.

Answer

As you look over the answers, also try to think of other situations in which you would use each type of contract.

Type of Contract
1. T&M
2. CR
3. FP
4. T&M
5. FP
6. FPIF
7. CPIF or CPAF
8. CR
9. FPEPA
10. Purchase order

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