Contract Type Subcategories

This article covers additional variations of the three main category types (fixed price, time and material and cost-reimbursable). It supplements what you learned in the Rita Mulcahy's™ *PMP® Exam Prep* book, 11th edition (Prep Book), in the "Procurement" chapter (pages 327-331). These sub-categories of contract types can help you get more questions right on the exam.

Here is a reminder of the three broad categories of contracts covered in your Prep Book:

- Fixed price (FP)
- Time and material (T&M) (no variations are shown here)
- Cost-reimbursable (CR)

Fixed Price (FP) Contract Variations

In your Prep Book we cover the two most common types of fixed price (FP) contracts (FP contract and purchase order). Following are additional variations on FP contracts.

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) Contract

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) Contract

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" and "inflation" whenever you see this on the exam.

Graduated Fixed Price Contract

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.

Cost Reimbursable (CR) Contract Variations

The Prep Book covered the basic cost contract. Following are several variations of this type of contract.

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 = 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) Contract

In a cost plus incentive fee contract the seller is 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) Contract

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 incentive 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 = $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 Fee (CPF) or Cost Plus Percentage of Costs (CPPC) Contract

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.