# Types of contracts

TYPES OF CONTRACTS The risk shared between the buyer and seller is determined by the contract type. Although the firm-fixedprice type of contractual arrangement is typically the preferred type which is encouraged and often demanded by most organizations, there are times when another contract form may be in the best interests of the project. If a contract type other than fixed-price is intended, it is incumbent on the project team to justify its use. The type of contract to be used and the specific contract terms and conditions fix the degree of risk being assumed by the buyer and seller.

All legal contractual relationships generally fall into one of two broad families, either fixed-price or cost reimbursable. Also, there is a third hybrid-type commonly in use called the time and materials contract. The more popular of the contract types in use are discussed below as discrete types, but in practice it is not unusual to combine one or more types into a single procurement. Fixed price contracts. This category of contracts involves setting a fixed total price for a defined product or service to be provided.

Fixed-price contracts may also incorporate financial incentives for achieving or exceeding selected project objectives, such as schedule delivery dates, cost and technical performance, or anything that can be quantified and subsequently measured. Sellers under fixed-price contracts are legally obligated to complete such contracts, with possible financial damages if they do not. Under the fixed-price arrangement, buyers must precisely specify the product or services being procured. Changes in scope can be accommodated, but generally at an increase in contract price.

Firm Fixed Price Contracts (FFP). The most commonly used contract type is the FFP. It is favored by most buying organizations because the price for goods is set at the outset and not subject to change unless the scope of work changes. Any cost increase due to adverse performance is theresponsibilityof the seller, who is obligated to complete the effort. Under the FFP contract, the buyer must precisely specify the product or services to be procured, and any changes to the procurement specification can increase the costs to the buyer. Fixed Price Incentive Fee Contracts (FPIF).

This fixed-price arrangement gives the buyer and seller some flexibility in that it allows for deviation from performance, with financial incentives tied to achieving agreed to metrics. Typically such financial incentives are related to cost, schedule, or technical performance of the seller. Performance targets are established at the outset, and the final contract price is determined after completion of all work based on the seller's performance. Under FPIF contracts, a price ceiling is set, and all costs above the price ceiling are the responsibility of the seller, who is obligated to complete the work.

Fixed Price with Economic Price Adjustment Contracts (FP-EPA). This contract type is used whenever the seller's performance period ps a considerable period of years, as is desired with many long-term relationships. It is a fixed-price contract, but with a special provision allowing for pre-defined final adjustments to the contract price due to changed conditions, such as inflation changes, or cost increases (or decreases) for specific commodities. The EPA clause must relate to some reliable financial index which is used to precisely adjust the final price.

The FP-EPA contract is intended to protect both buyer and seller from external conditions beyond their control. Cost-reimbursable contracts. This category of contract involves payments (cost reimbursements) to the seller for all legitimate actual costs incurred for completed work, plus a fee representing seller profit. Cost-reimbursable contracts may also include financial incentive clauses whenever the seller exceeds, or falls below, defined objectives such as costs, schedule, or technical performance targets. Three of the more common types of cost-reimbursable contracts in use are

Cost Plus Fixed Fee (CPFF), Cost Plus Incentive Fee (CPIF), and Cost Plus Award Fee (CPAF). A cost-reimbursable contract gives the project flexibility to redirect a seller whenever the scope of work cannot be precisely defined at the start and needs to be altered, or when high risks may exist in the effort. Cost Plus Fixed Fee Contracts (CPFF). The seller is reimbursed for all allowable costs for performing the contract work, and receives a fixed fee payment calculated as a percentage of the initial estimated project costs. Fee is paid only for completed work and does not change due to seller performance.

Fee amounts do not change unless the project scope changes. Cost Plus Incentive Fee Contracts (CPIF). The seller is reimbursed for all allowable costs for performing the contract work and receives a predetermined incentive fee based upon achieving certain performance objectives as set forth in the contract. In CPIF contracts, if the final costs are less or greater than the original estimated costs, then both the buyer and seller share costs from the departures based upon a prenegotiated cost sharing formula, e. g. , an 80/20 split over/under target costs based on the actual performance of the seller.

Cost Plus Award Fee Contracts (CPAF). The seller is reimbursed for all legitimate costs, but the majority of the fee is only earned based on the satisfaction of certain broad subjective performance criteria defined and incorporated into the contract. The determination of fee is based solely on the subjective determination of seller performance by the buyer, and is generally not subject to appeals. Time and Material Contracts (T&M). Time and material contracts are a hybrid type of contractual arrangement that contain aspects of both cost-reimbursable and fixed-price contracts.

They are often used for staff augmentation, acquisition of experts, and any outside support when a precise statement of work cannot be quickly prescribed. These types of contracts resemble cost-reimbursable contracts in that they can be left open ended and may be subject to a cost increase for the buyer. The full value of the agreement and the exact quantity of items to be delivered may not be defined by the buyer at the time of the contract award. Thus, T&M contracts can increase in contract value as if they were cost-reimbursable contracts.

Many organizations require not-toexceed values and time limits placed in all T&M contracts to prevent unlimited cost growth. Conversely, T&M contracts can also resemble fixed unit price arrangements when certain parameters are specified in the contract. Unit labor or material rates can be preset by the buyer and seller, including seller profit, when both parties agree on the values for specific resource categories, such as senior engineers at specified rates per hour, or categories of materials at specified rates per unit.