Types of Procurement Contracts

In a perfect world, there would be a single contract type to use with everything to keep things simple and efficient for all parties involved.

Unfortunately, that's not the case, and in the procurement industry, there are multiple options to choose from.

Using the correct procurement contract is crucial to the success of any given project.

Understanding the nuances of each type of contract is important as they all come with their own advantages and disadvantages.

Project managers and procurement professionals who stay current on the different types of contracts available for use know which ones to use and when thus making it easier to successfully execute.

Contracts outline the basics of each bid or project. If you mistakenly use the wrong kind of contract, it could cost an organization more money over the long term.

Companies may have to spend more resources because they used the wrong type of contract – such as using a time and materials contract instead of a fixed-price contract for the project or may incur extra expenses because they have to take measures to ensure the other party remains compliant with the contract terms.

Want to learn more about the types of contracts to use and the best situations to use them? We'll take a closer look at some of the most commonly used procurement contracts and the best circumstances for using each of them.

Fixed Price Contracts

This is the best contract type when someone knows exactly what the scope of work is. Also known as a lump sum contract, this contract is the best way to keep costs low when you can predict the scope.

For instance, if an organization needs services from a vendor, and the scope is clearly defined, the contract makes sure the organization only pays a specified amount for the required work.

Benefits include:

- After both parties have signed the contract, the seller must perform the service within the stated timeframe. This does a great deal in ensuring the project is completed in a timely manner.
- Guesswork is removed from pricing, so controlling price is easier.
- The seller assumes the majority of the risk because of the legal obligation to project specifications.

This contract type is best for projects that are turnkey or outsourced.

There are three subtypes of fixed pricing contracts, each of which is best for specific situations.

Fixed Firm Price (FFP)

This is the simplest subtype, as it features both a fixed price and time frame.

The contract states the price and the deadline for the project, such as $5,000 and the end of the month. If the seller makes mistakes or otherwise causes the costs to increase, the price remains at $5,000 and the seller is responsible for the difference.

This is best used when the scope of work is clearly outlined with plenty of detail. Government offices generally prefer to use this kind of contract. It's easy for procurement teams to use because it makes evaluating bids easy.

Fixed Price Incentive Fee (FPIF)

This is the same as the FFP contract, with the addition of a monetary incentive so that the seller does a better job or completes the project ahead of schedule.

The contact can specify the fee along with the terms of when it is received, such as when the project is completed below the estimated cost, before the estimated completion date, or in the case of exemplary performance.

This contract is best used when you want to ensure the project will be completed on time or below cost.

Fixed Price with Economic Price Adjustment (FP-EPA)

This contract type is most often used when the project is expected to take a long time, to protect the seller from inflation that may occur over the duration.

For instance, this type of contract allows for a clause that gives the contractor a certain percentage increase after a predetermined amount of time.

Generally, organizations based on the percentage on the consumer price index or the CPI.

Possible Pitfalls of Fixed Price Contracts

For this to be the most effective contract type, you must have a clearly defined scope at contract signing.

If there is any ambiguity, the seller may ask for more money if it seems the scope has changed in any manner. This can easily cause projects to go over budget.

It's also worth noting that sometimes contractors will submit a low bid so that they get the contract, but attempt to add to the scope so they can increase the price. Pay close attention to any changes to the statement of work that the contractor makes so you can avoid this.

> *Even if you've chosen the right contract type, there are still negotiations that will take place, so it's important to plan for those.*

Cost Reimbursable Contracts

Cost reimbursable contracts, also known as cost dispersable contracts or cost-reimbursement contracts, are ideal when the project scope is not fully known or is likely to change.

It is designed to keep people on schedule and under budget. The idea is that the seller will be reimbursed for the cost of the project when it is completed, while also earning a fee for profit.

Businesses have flexibility in the contract when it comes to the fee portion. For instance, it's possible to be based on how well the seller meets (or exceeds) the project objectives, whether the project was completed on time, and how well the contractor was able to stay at or under budget.

Unless the project requirements are highly specific and clearly laid out in the contract, sellers may attempt to account for scope creep, to anticipate increasing costs.

To avoid scope creep, it's a good idea to cap the potential fee the contractor earns.

There are subtypes of this contract, as well. The four most common are:

Cost Plus Fixed Fee (CPFF)

This is often used when the project is considered as high risk and there is fear that the procurement team will not be able to attract bidders.

This type of contract protects sellers from risks because the procuring organization carries all of them.

There's a clause included that says the seller will be paid for all increased cost, plus a fee that's not based on cost performance.

For example, the contractor will have all his costs paid, plus a $5,000 fee.

Cost Plus Incentive Fee (CPIF)

With this type of contract, the buyer assumes the risk, but it is lower because an incentive offer is part of the terms.

The contractor gets reimbursed for their costs but will receive a fee that's based on their performance.

This fee is generally predetermined and is a percentage of the savings that the buyer gets as a result of the seller's performance. Typically, the savings are split between the two parties.

Cost Plus Award Fee (CPAF)

With this approach, the incentive fee is based on how well the buyer believes the seller met the performance objectives.

Because this is subjective, it is not open for change, so the language must be clear.

Use language that states the contractor will receive an award of up to a certain dollar amount if they either meet or exceed the job requirements that are outlined in the terms.

Cost Plus Percentage of Cost (CPPC)

This type of contract pays all of the seller's costs, along with a percentage of the costs as profit.

With this type of contract, there is an incentive for sellers to increase their actual costs so they get more profit.

Purchase Orders

Purchase orders (POs) are one of the most common documents within the procurement process of any organization.

These are often used to define relationships between companies and their vendors, and function much like a contract.

Should the buyer attempt to refuse payment, they are legally bound to pay the agreed-upon price.

When a company wants to purchase goods or services, they send a PO to vendors that contains the request for the order.

The PO includes the item type, number of items, and a price the two parties have agreed upon.

The more specific a PO is, the better. Buyers need to include as many details as possible to get the most benefit from the purchase order.

When both buyer and seller accept the purchase order, it functions as a legally binding contract.

This is why buyers must always use clear and explicit language.

It may mean there's more work upfront, but it can save time, money, and frustration in the long run because there is less potential for confusion while carrying out the order.

Time and Materials Contracts

The time and materials contract (T&M contract) is most often used when the seller provides labor. The risk is fairly even between both parties.

This contract is used to hire outside vendors and experts and lists the experience and qualifications desired.

Sellers submit an hourly rate for their bid. It's crucial to set a limit or you could find the project over budget.

Making the right choice for the contract type ensures your next project is most likely to be a success – finishing on budget and on time, while also serving company objectives and mitigating risk.

Proper contract management is also important for both efficient procurement management and project management.

What's your goal today?

1. Use Planergy to manage purchasing and accounts payable

We've helped save billions of dollars for our clients through better spend management, process automation in purchasing and finance, and reducing financial risks. To discover how we can help grow your business:

- Read our case studies, client success stories, and testimonials.
- Visit our "Solutions" page to see the areas of your business we can help improve to see if we're a good fit for each other.
- Learn about us, and our long history of helping companies just like yours.

Book a Live Demo

2. Download our guide "Indirect Spend Guide"

Download a free copy of our guide to better manage and make savings on your indirect spend. You'll also be subscribed to our email newsletter and notified about new articles or if have something interesting to share.

download a free copy of our guide

3. Learn best practices for purchasing, finance, and more

Browse hundreds of articles, containing an amazing number of useful tools, techniques, and best practices. Many readers tell us they would have paid consultants for the advice in these articles.

Related Posts