Cost Risk – *one driver for contract types*

In our recent Cost & Price workshop, we spoke briefly about selecting an appropriate contract type. Decisions about how a contract is structured, changes will be allowed (or not) and pricing adjusted are critical to creating a good contract. What we know, or don't know about the elements influencing a contract price can, at the least cause contractors to add expensive contingencies and at the worst can lead to lawsuits over changes. Buyers can mitigate unstable conditions by building price flexibility, incentives or controls into the contract.

Most of us prefer to use Firm Fixed Price (FFP) contracts. This shifts the risk of pricing variances or performance problems to the contractor. That is, if contractor costs change unexpectedly, there are unforeseen delays, or misunderstandings about the specification, the contractor is expected to hold the price, or submit a claim for a contract change. Contractors will protect themselves by adding contingencies to the price. The least risk of a price change (and presumably less price padding) would for a product or service the contractor sells regularly with well-known costs and variables.

On the opposite extreme, we can transfer all of the cost risk to the buyer by using a cost-type contract. That is, the contractor gets paid to complete the job and the buyer foots the bill for uncertainties in the original cost estimate or omissions in the specification. Offering a contract of this type might be the only way to convince a contractor to take a job with many unknown variables. Agreeing to pay a repair technician on an hourly basis plus the cost of any materials used (Time & Materials – T&M) is just one way to structure a cost-type contract when the time to complete the job cannot be reasonable estimated in advance.

Reviewing the factors driving a contractor's price as well as considering pricing uncertainties and performance risks will help us zero in on a contract type that preserves a contractor's incentive to perform while at the same time limiting the pricing risks to the buyer. As we discussed in our workshop, the more we understand about contractor costs and pricing structure, the more opportunities we can find to negotiate a creative, flexible, more complete and successful contract.

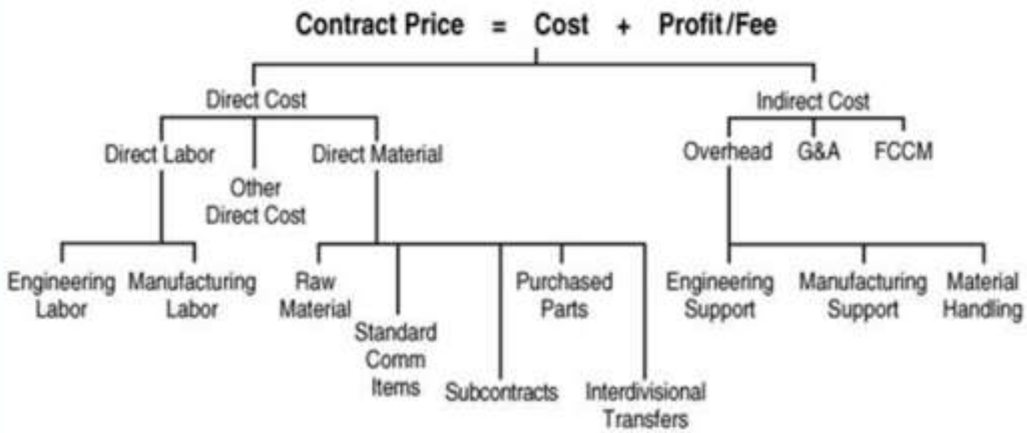
There are a number of good tools on the internet which describe various contract pricing structures and the advantages and disadvantages of each. We looked at one chart from the Defense Acquisition University which showed a typical contract cost structure and equated contract type selection to the type of project anticipated. These ranged from a straight forward production (PROD) contract to Research and Development. Nothing magic about the DAU choice for possible projects and I'm sure you can think of many more reasons to use different types of contracts. The DAU chart and contract-type discussion is linked below. You can also find a good explanation of many contract types in the DOE Acquisition Guide, chapter 16.

Cost – Price Seminar presentation and handouts on this page: http://www.mltweb.com/handouts/index.htm

DOE Guide:
http://energy.gov/sites/prod/files/16.1_General_Guide_to_Contract_Types_for_Requirements_Officials_0.pdf

DAU Contract type chart and glossary of acronyms used:

https://acc.dau.mil/CommunityBrowser.aspx?id=294489



TYPICAL CONTRACT TYPE BY PHASE

MSA	TD	EMD/ISD	EMD/SCMPD	PROD
CPFF, FFP	CPFF, FFP	FPI(F), CPFF, CPIF	CPIF, CPAF	FPI(F), FFP