Plan Procurement Management: Terms and Definitions

When it comes to contracts, there are two procurement roles to be aware of:

- The **buyer** is the party purchasing a product, service or result.
- The **seller** is the party providing the product, service or result.

In order to have a strong grasp of the procurements process, an understanding of the different contract types is essential. It's also important to understand who bears the risk with each contract type.

- [1]**Fixed-price contracts**: Agreements that set the fee that will be paid for a defined scope of work, regardless of the cost or effort to deliver it. This type of contract is good when the scope of work is known and is best for the buyer. The seller bears all the risk with this type of contract because, if it takes longer to complete the work or costs more than predicted, the seller still only gets paid the fixed price.

    - [2]**Firm fixed price contracts (FFP)**: When the buyer pays the seller a set amount (as defined by the contract), regardless of the seller's costs.
    - [2]**Fixed price incentive fee (FPIF)**: When the buyer pays the seller a set amount (as defined by the contract), and the seller can earn an additional amount if the seller meets predefined performance, cost, or schedule criteria. An example might be that the buyer agrees to pay the seller an additional $2,000 if the seller completes the predefined work a week early.
    - [2]**Fixed price with economic price adjustment (FP-EPA)**: Provides a special provision allowing for predefined final adjustments to the contract price due to changed conditions, such as inflation changes or cost increases (or decreases) for specific commodities. For example, the cost of fuel, steel, or interest rates.

- [1]**Cost-reimbursable contract**: A contract involving payment to the seller for the seller's actual costs, plus a fee typically representing seller's profit. This type is often used when the scope of work is likely to change during the execution of the contract. Cost-reimbursable contracts often include incentive clauses where, if the seller meets or exceeds selected project objectives, such as schedule targets or total cost, then the seller receives, from the buyer, an incentive or bonus payment.
    - [3]**Cost plus fixed fee (CPFF)**: When the buyer reimburses the seller for the seller's allowable costs (allowable costs are defined by the contract), plus a fixed amount of profit (fee). This type of contract is best for the seller, especially if the scope isn't well defined, as the buyer pays for cost overruns. The buyer bears the risks.
    - [3]**Cost plus incentive fee (CPIF)**: Where the buyer reimburses the seller's allowable costs (allowable costs are defined by the contract), and the seller earns a profit if it meets defined performance criteria. For example, if there are cost savings or the work is completed early. The Buyer and Seller both bear the risks.
    - [3]**Cost plus award fee (CPAF)**: Involves payments to the seller for all legitimate actual costs incurred for completed work, plus an award fee representing seller profit. This type of contract is based on the seller meeting broad subjective performance criteria. It is not subject to appeals.

- **Time and materials contracts (T&M)**: Also known as time and means, are a hybrid type of contract with both cost-reimbursable and fixed-price. This is where the seller charges for both time and cost of materials to complete the defined work. The buyer bears the risk in these types of contracts. This contract type is best for the seller. Typically, these are contracts where the statement of work is not well defined.

Point of total assumption is another term that may be asked about on the exam. There are several types of contracts where the risks are shared between the buyer and the seller. Point of total assumption is used especially in fixed-price incentive fee contracts.

A formula is used to calculate the point in which the seller takes on 100% of all cost overruns. The formula:
Target cost + (ceiling price – target price) / Buyer's % share of cost overruns

Here's an example:

Target cost of the project: $2,000,000
Target profit for seller: $200,000
Target price: $2,200,000 (Target cost + Profit for seller)
Ceiling price: $2,300,000 (the maximum the buyer will pay)

Share ratio: 80% buyer–20% seller for over-runs

PTA = $2,000,000 + ($2,300,000 – $2,200,000) / .80 = $2,000,000 + $100,000 /.80 =

$2,000,000 + $125,000 = **$2,125,000**

This is the point at which the seller would take on 100% of any cost overruns. There is a risk at this point for the buyer as the seller may not have incentive to finish the project earlier because of the cost overruns. It's best to keep track of the project costs through earned value to track if/when the project costs are reaching this point to avoid adding undue risks.

[1]These definitions are taken from the Glossary of Project Management Institute, *A Guide to the Project Management Body of Knowledge, (PMBOK® Guide)* – Sixth Edition, Project Management Institute Inc., 2017.

[2]Project Management Institute, *A Guide to the Project Management Body of Knowledge, (PMBOK® Guide)* – Sixth Edition, Project Management Institute, Inc., 2017, Page 471.

[3]Project Management Institute, *A Guide to the Project Management Body of Knowledge, (PMBOK® Guide)* – Sixth Edition, Project Management Institute, Inc., 2017, Page 472.