Fixed Price Plus Incentive Contract

Idea In Short

In the fixed price plus incentive fee contract, the service provider receives an incentive for exceeding some performance metrics [thresholds]. These thresholds are formally agreed upon by both, the client and the service provider in the contract.

A Fixed price incentive fee [FPIF] contract combines a fixed price contract with an incentive fee. Incentives motivate the service provider to exceed the performance thresholds. From a client perspective, this contract reduces the risk that the service provider fails to meet the expectations. An FPI contract may specify one or several target performance indicators, such as:

- Cost
- Profit
- Schedule
- Quality
- Technical performance

Advantages

Fixed price plus incentive fee contracts allow for a bit more flexibility for both the client and the service provider. With this type of contract, service providers have the ability to receive additional compensation for higher performance. The client and service provider should formally agree upon the criteria ahead of time in the contract.

Example

This contract allows adjusting profit and establishing the final price by applying a formula. Usually, this formula determines how the client and service provider split the difference between the final and target costs. When the client incentivizes cost performance, the client

and service provider establish a cost target, a target fee, and a share ratio, such as 80/20, 70/30, or something similar. Cost performance below the target cost earns an incentive fee. Cost performance above the target cost means the service provider relinquishes some of the target fee. When a contract has a share ratio for an incentive fee, the first number is what the buyer keeps. The second number is what the seller keeps. Both numbers must total 100%. A 70/30 share ratio means that if the actual cost comes in under-target by $20,000, the buyer keeps $14,000 (70% of 20,000), and the seller gets the remaining $6,000.

Price ceiling

The price ceiling is the maximum that the client pays the service provider. This compensation excludes adjustments specifically provided for under contract clauses. When the service provider completes the work, the client and service provider determine the final cost. They apply the final negotiated rates to the incurred costs using the Profit Adjustment Formula.

Profit Adjustment Formula [PAF]

When the final cost is less than the target cost, the service provider net a profit greater than the target profit. However, when the final cost is more than the target cost, the service provider nets a profit that is lesser than the target profit. If the final redetermined cost exceeds the ceiling, the supplier absorbs the difference. The profit varies inversely with the cost. Hence, this contract provides an incentive for the service provider to control costs.

Usage

Use a fixed price plus incentive contract when:

- The client wants to incentivize performance
- A fixed price contract is not suitable

The parties can establish an initial target cost, target profit, and profit-adjustment formula that will provide a fair and reasonable incentive, as well as a ceiling that provides for the service provider to assume an appropriate share of the risk.

Caveat

This contract type may be used only when adequate cost or pricing information for establishing reasonable firm targets is available at the time of initial contract negotiation. In addition, there is still a cap, or price ceiling, with an FPIF contract. Any accrued costs that exceed this cap are the service provider's responsibility. There are a number of different variations on the FPIF contract. The client and service provider should agree to these terms before work commences to avoid any future confusion or disputes.

Summary

The fixed price plus incentive contracts are most desirable where the client wants the service provider to assume some cost responsibility. It is also suitable when the client and service provider can agree on key metrics, such as target cost, target profit, and profit adjustment formula at the outset.