

Cost-Reimbursement Contracts

Introduction to Cost-Reimbursement Contracts

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Approximate Length: 30 minutes

Welcome to the Cost-Reimbursement Contracts Lesson. It is important for you to have a good understanding of cost-reimbursement contracts and their characteristics. This lesson provides you with basic information about each type of cost-reimbursement contract, the budgeting policies that affect them, and specific examples and exceptions to those policies.

Located throughout and at the end of this lesson are Knowledge Reviews, which are not graded but enable you to measure your comprehension of the lesson material.

Learning Objectives

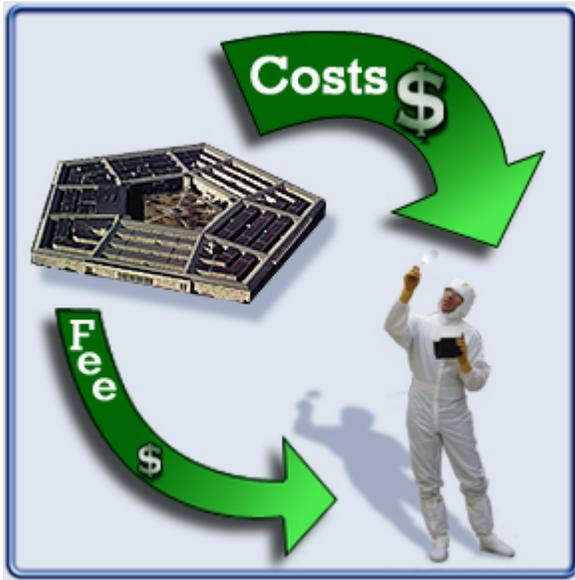
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By completing this lesson, you should be able to:

- Identify the characteristics of each of these types of cost-reimbursable contracts: cost plus fixed fee, cost plus award fee, and cost plus incentive fee.
 - Identify the budgeting policy for each of these types of cost-reimbursable contracts: cost plus fixed fee, cost plus award fee, and cost plus incentive fee.
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In cost-reimbursement contracts, the government promises to pay all allowable, allocable, and reasonable costs incurred in performing the contract work, as well as a fee that constitutes the contractor's profit. In turn, the contractor promises to exert its best efforts to perform the desired work. If the work turns out to need more money than originally estimated, the contractor notifies the government and the contractor may stop work when the money runs out (or perhaps earlier if so directed or authorized).

Cost-reimbursement contracts are appropriate when uncertainties regarding contract performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract.

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Under a cost-reimbursement contract, most of the risk is borne by the government. Consequently, the government conducts relatively high surveillance on this type of contract to ensure that efficient methods and effective cost controls are used.

There are three basic types of cost-reimbursable contracts:

- Cost Plus Fixed Fee
- Cost Plus Award Fee
- Cost Plus Incentive Fee

Cost Plus Fixed Fee (CPFF)

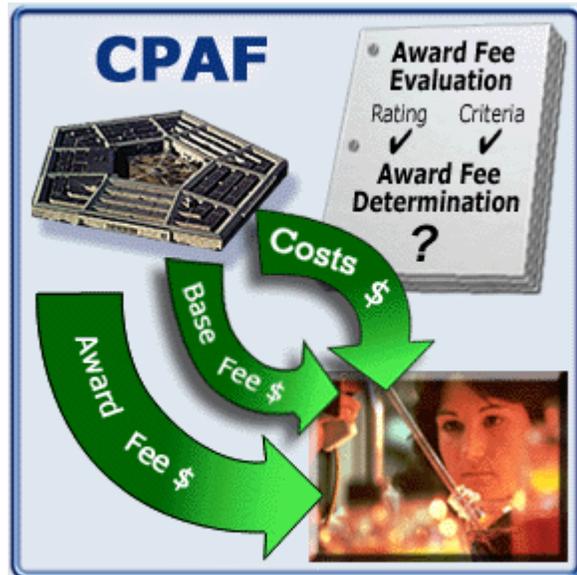
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A Cost Plus Fixed Fee (CPFF) contract is a cost-reimbursement contract that contains no incentives. The contractor is reimbursed for all allowable costs and is paid a set fee regardless of how well or poorly it performs. This is clearly the most risky type of contract for the government and the least risky for the contractor.

Cost Plus Award Fee (CPAF) (1 of 2)

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A Cost Plus Award Fee (CPAF) contract is a cost-reimbursement contract that provides for a fee consisting of a **base fee** and an **award fee**. The base fee is paid under all circumstances regardless of performance. The award fee portion may be earned in whole or in part based on the government's subjective evaluation of the contractor's performance relative to criteria established at the beginning of each award fee period. These criteria generally relate to the contractor's cost, technical, schedule, and/or quality performance. The award fee determination is made unilaterally by the government and is not generally subject to appeal by the contractor under the Disputes clause.

Long Description

Depiction of the Pentagon and contractor work. Three arrows going from the former to the latter labeled 'Costs \$,' 'Base Fee \$,' and 'Award Fee \$.' This last arrow alternates in size larger and then smaller. A clipboard is labeled 'Award Fee Evaluation' with two columns labeled 'Rating' and 'Criteria' with checkmarks underneath. The bottom of the clipboard is labeled 'Award Fee Determination' with a blank space. The entire graphic is labeled 'CPAF.'

Cost Plus Award Fee (CPAF) (2 of 2)

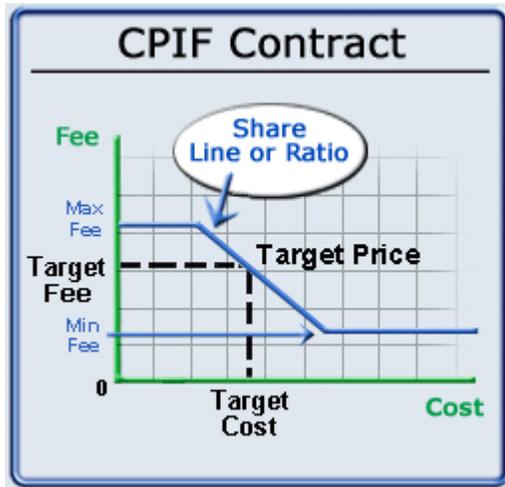
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CPAF contracts are suitable for contracts where the government wishes to incentivize contractor performance in areas other than just cost and where it is difficult to determine objective targets for cost, technical performance, or schedule in advance of contract award. The flexibility to change award fee criteria allows the government to focus incentives on different areas as needed during the contract.

Cost Plus Incentive Fee (CPIF)(1 of 2)

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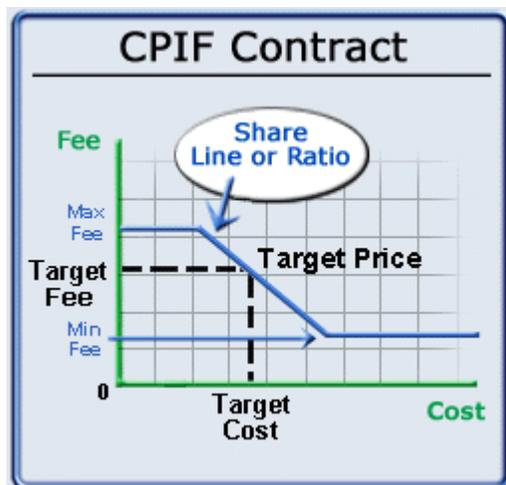
Under a Cost Plus Incentive Fee (CPIF) contract, a **target price** is negotiated, consisting of a **target cost** and a **target fee**. The target cost is the government and contractor's agreed-upon best estimate of the cost to be incurred in performing the contract requirements. The target fee is the amount of fee that the government and contractor have agreed should be earned by the contractor if it incurs costs exactly equal to the target cost.

Long Description

Graph depicting CPIF contract concept. Vertical axis is labeled Fee, and horizontal axis is labeled Cost. A vertical line from the horizontal axis (Target Cost) and a horizontal line from the vertical axis (Target Fee) intersect at a point labeled Target Price. A share line slopes downward from left to right, passing through the Target Price point, however, when the share line reaches the maximum fee value, it levels off to run parallel to the horizontal axis until it intersects the vertical axis. Also, when the share line reaches the minimum fee value, it levels off to run parallel to the horizontal axis indefinitely.

Cost Plus Incentive Fee (CPIF)(2 of 2)

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As an incentive to the contractor to control costs, the CPIF contract contains a negotiated government/contractor **share ratio** that indicates how cost overruns (or underruns) will be shared by the parties. For instance, a 70/30 share ratio indicates that, for every dollar that the final contract cost exceeds the target cost, the government will absorb 70 cents of the additional cost while the contractor absorbs 30 cents. This sharing is limited only by the **minimum fee** and **maximum fee** amounts agreed to in the contract. In addition to providing cost control incentives to the contractor, CPIF contracts may also include provisions to incentivize technical or schedule performance.

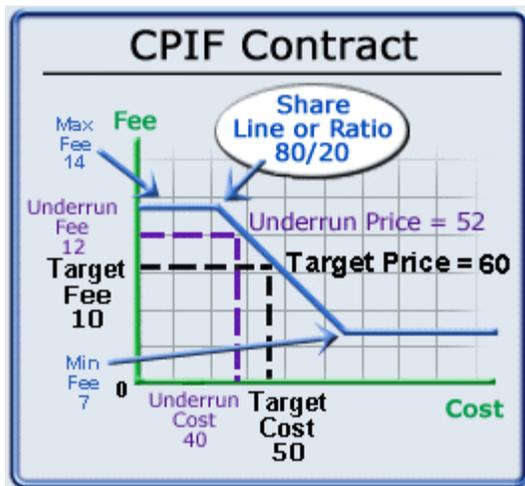
The final price paid by the government on a CPIF contract consists of the final contract cost plus the fee computed at that final cost using the share ratio, subject to the minimum and maximum fee limits.

Long Description

Graph depicting CPIF contract concept. Vertical axis is labeled Fee, and horizontal axis is labeled Cost. A vertical line from the horizontal axis (Target Cost) and a horizontal line from the vertical axis (Target Fee) intersect at a point labeled Target Price. A share line slopes downward from left to right, passing through the Target Price point, however, when the share line reaches the maximum fee value, it levels off to run parallel to the horizontal axis until it intersects the vertical axis. Also, when the share line reaches the minimum fee value, it levels off to run parallel to the horizontal axis indefinitely.

Cost Plus Incentive Fee (CPIF) Example (1 of 2)

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Assume that a CPIF contract has a target price of \$60 million, with a target cost of \$50 million and target fee of \$10 million. The share ratio is 80/20, with a minimum fee of \$7 million and a maximum fee of \$14 million.

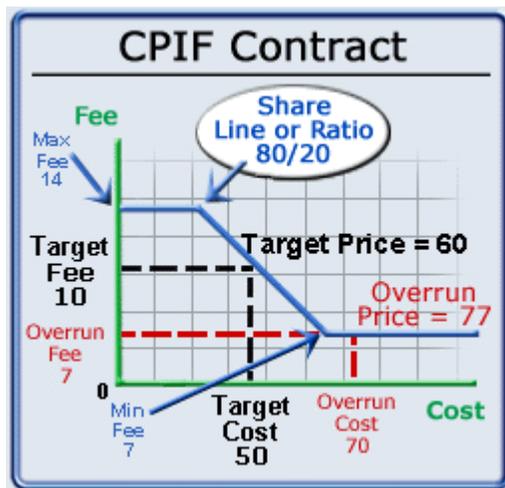
If the contractor is able to perform the work at a cost of \$40 million (\$10 million underrun relative to target cost), it gets to add 20% of the underrun (\$2 million) to its target fee, for

a total fee of \$12 million. The total price paid by the government is the final cost (\$40 million) plus the contractor's fee at the final cost (\$12 million), for a total of \$52 million, which is an \$8 million dollar savings relative to the target price.

Long Description

Graph depicting CPIF example. Vertical axis is labeled Fee, and horizontal axis is labeled Cost. A vertical line from the horizontal axis (where Target Cost is 50) and a horizontal line from the vertical axis (where Target Fee is 10) intersect at a point labeled Target Price (which is 60). An 80/20 share line slopes downward from left to right, passing through the Target Price point; however, when the share line reaches the maximum fee value of 14, it levels off to run parallel to the horizontal axis until it intersects the vertical axis. Also, when the share line reaches the minimum fee value of 7, it levels off to run parallel to the horizontal axis indefinitely. The point where a vertical line from the horizontal axis (Underrun Cost = 40) meets a horizontal line from the vertical axis (Underrun Fee = 12) represents the Underrun Price of 52, which also lies on the sloped portion of the share line.

Cost Plus Incentive Fee (CPIF) Example (2 of 2)



On the other hand, if the contractor's costs to perform the work are actually \$70 million (\$20 million overrun relative to target cost), the contractor should absorb 20% of the overrun (\$4 million) from its target fee, leaving a fee of \$6 million. However, since this is less than the minimum fee (\$7 million), the contractor's fee at this cost would actually be \$7 million. The total price to be paid by the government is the final cost (\$70 million) plus the contractor's fee at the final cost (\$7 million), for a total of \$77 million.

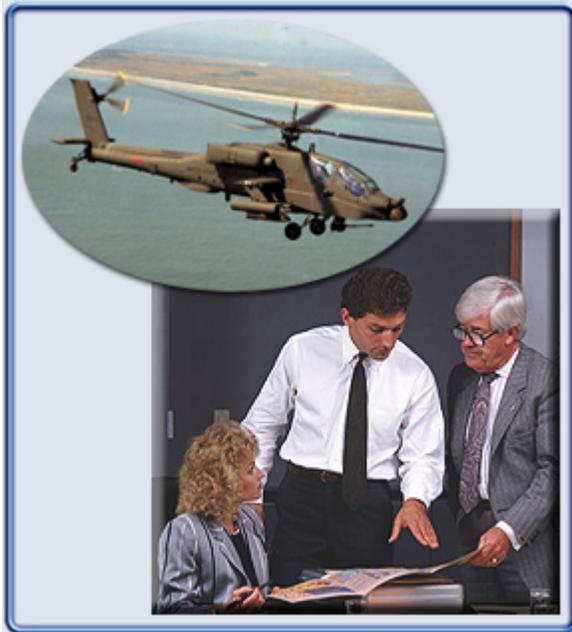
Long Description

Graph depicting CPIF example. Vertical axis is labeled Fee, and horizontal axis is labeled Cost. A vertical line from the horizontal axis (where Target Cost is 50) and a horizontal line from the vertical axis (where Target Fee is 10) intersect at a point labeled Target Price

(which is 60). An 80/20 share line slopes downward from left to right, passing through the Target Price point; however, when the share line reaches the maximum fee value of 14, it levels off to run parallel to the horizontal axis until it intersects the vertical axis. Also, when the share line reaches the minimum fee value of 7, it levels off to run parallel to the horizontal axis indefinitely. The point where a vertical line from the horizontal axis (Overrun Cost = 70) meets a horizontal line from the vertical axis (Overrun Fee = 7) represents the Overrun Price of 77, which lies on the lower flat portion of the share line.

Cost-Reimbursement Contract Budgeting Policies

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Although program managers (PMs) ideally would like to budget as much as possible for a contract to cover every contingency, the realities of limited defense budgets make this impossible. Instead, PMs are expected to **budget to the most likely price** of a contract, or the amount which the government is most likely to have to pay. This amount varies by contract type.

Budgeting Cost Plus Fixed Fee (CPFF) Contracts

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The most likely cost of a CPFF contract is the sum of the **cost expected to be incurred and the fixed fee**, so this is the amount that should be budgeted for this contract type.

Budgeting Cost Plus Award Fee (CPAF) Contracts

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CPAF contracts should be budgeted to their most likely cost, which is the sum of the **cost expected to be incurred plus the base fee plus the entire award fee** which can be earned (or paid) during the budget period. Although it is possible that the contractor may

not actually earn the entire award fee, the award fee criteria must be structured in such a way that the contractor **could** earn the full amount. Budgeting for less than this amount is tantamount to saying that the contractor cannot earn the entire award fee for that period, and may taint the evaluation process that determines the award fee earned.

Budgeting Cost Plus Incentive Fee (CPIF) Contracts

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Budget Cost Plus Incentive Fee (CPIF) contracts to the anticipated **target price** of the contract, which should represent the best estimate of contract cost plus the associated fee.

Knowledge Review

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The following Knowledge Reviews are matching questions. Select a letter associated with the answers, and type that letter in the space next to the best corresponding phrase or statement. Then, select the Check Answers button and feedback will appear.

Match each cost-reimbursable contract type to its appropriate description.

- a. Cost Plus Fixed Fee (CPFF)
- b. Cost Plus Award Fee (CPAF)
- c. Cost Plus Incentive Fee (CPIF)

1. Includes a target price that consists of a target cost and a target fee.

2. Includes both a base fee and a fee that varies depending on how well the contractor achieves certain specific criteria.

3. Includes a fee that does not change, regardless of contractor performance.

Correct! The correct answers are: 1 - c., 2 - b., 3 - a. A CPFF contract includes a fee that does not change, regardless of contractor performance. A CPAF contract includes both a base fee and a fee that varies depending on how well the contractor achieves certain specific criteria. Finally, a CPIF contract includes a target price that consists of a target cost and a target fee.

Knowledge Review

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Match each cost-reimbursable contract type to its appropriate budgeting policy.

- a. Cost Plus Fixed Fee (CPFF)
- b. Cost Plus Incentive Fee (CPIF)
- c. Cost Plus Award Fee (CPAF)

- 1. Budget to the sum of the cost expected to be incurred plus the set fee.**
- 2. Budget to the sum of the cost expected to be incurred plus the base fee plus the entire variable portion of the fee which can be earned (or paid) during the budget period.**
- 3. Budget to the anticipated target price of the contract.**

Correct! The correct answers are: 1 - a., 2 - c., 3 - b. A CPFF contract is budgeted to the sum of the cost expected to be incurred plus the set fee. A CPAF contract is budgeted to the sum of the cost expected to be incurred plus the base fee plus the entire variable portion of the fee which can be earned (or paid) during the budget period. Finally, a CPIF contract is budgeted to the anticipated target price of the contract.

Lesson Summary (1 of 2)

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Congratulations! You have completed the Cost-Reimbursement Contracts Lesson. The following topics were presented in this lesson:

- Cost-reimbursement contracts: Used for contracts where costs cannot be estimated with sufficient accuracy for a fixed-price contract. The government assumes most of the risk with this contract type, promising to pay all allowable, allocable, and reasonable costs incurred. The contractor promises to exert its best efforts to accomplish the work

- Cost Plus Fixed Fee (CPFF) contracts: These contain no incentives; the contractor is paid a set fee regardless of performance.
- Cost Plus Award Fee (CPAF) contracts: These provide for a fee consisting of a base fee and an award fee. The award fee is earned in whole or in part based on government subjective evaluation of contractor performance.
- Cost Plus Incentive Fee (CPIF) contracts: These include a negotiated target price consisting of a target cost and a target fee. The government and contractor share in cost overruns and underruns relative to target cost according to the negotiated share ratio. The contractor's share is deducted from or added to the target fee, subject to the limitations of the contract's minimum fee and maximum fee provisions.

Lesson Summary (2 of 2)

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The following topics were also presented in this lesson:

- Cost-Reimbursement Contract Budgeting Policies:
 - Budget to the most likely contract price.
 - CPFF contracts are budgeted to the sum of the cost expected to be incurred and the fixed fee.
 - CPAF contracts are budgeted to the sum of the cost expected to be incurred plus the base fee plus the entire award fee which can be earned (or paid) during the budget period.
 - CPIF contracts are budgeted to the anticipated target price of the contract.

This page completes the lesson. Select a lesson from the Table of Contents to continue.