

## **Fixed Price Contracts**

# Introduction to Fixed-Price Contracts

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Approximate Length: 40 minutes

Welcome to the Fixed-Price Contracts Lesson. An understanding of fixed-price contracts and their characteristics is important in the acquisition field. This lesson provides you with basic information about each of the major types of fixed-price contracts, 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.

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## Learning Objectives

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**By completing this lesson, you should be able to:**

- Identify the characteristics of each of these types of fixed-price contracts: firm fixed-price, Fixed-Price- economic price adjustment, and fixed-price incentive (firm target).
- Identify the budgeting policy for each of these types of fixed-priced contracts: firm fixed-price, Fixed-Price- economic price adjustment, and fixed-price incentive (firm target).

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## Introduction to Fixed-Price Contracts (1 of 3)

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In a fixed-price contract, the government agrees to pay an agreed-upon price for goods or services. This price may be truly fixed or may be subject to a limited amount of adjustment based on the provisions of the contract. The fixed price encompasses both the contractor's expected cost to produce the goods or services as well as the contractor's expected profit.

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## Introduction to Fixed-Price Contracts (2 of 3)

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In fixed-price contracting, the contractor promises to deliver on time and to meet the contract specifications. If a contractor is late, or his product does not meet the specifications for acceptance, the government may terminate the contract for default and not pay the contractor. In some circumstances, the government may reprocure the items from another source and, if more expensive, charge the first contractor the difference. Clearly, the contractor bears a tremendous risk in fixed-price contracting, particularly with respect to product cost, since any cost overruns will reduce the company's profit. Therefore, the higher the perceived cost risk, the higher the contractor will set the price.

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## Introduction to Fixed-Price Contracts (3 of 3)

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There are three basic types of fixed-price contracts:

- **Firm Fixed-Price (FFP) Contract.** A contract where the buyer pays a set amount to the seller regardless of that seller's cost to complete the work.
- **Fixed-Price- Economic Price Adjustment (FP-EPA) Contract.** A fixed-price contract with economic price adjustment provides for upward and downward revision of the stated contract price upon the occurrence of specified contingencies.
- **Fixed-Price Incentive, Firm Target (FPIF) Contract.** A fixed-price contract that provides for adjusting profit and establishing the final contract price by a formula based on the relationship of final negotiated total cost to total target cost.

Note that there is also a contract type known as Fixed-Price Incentive, Successive Targets (FPIS) that is beyond the scope of this lesson.

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## Firm Fixed-Price (FFP) Contract Concept and Terms

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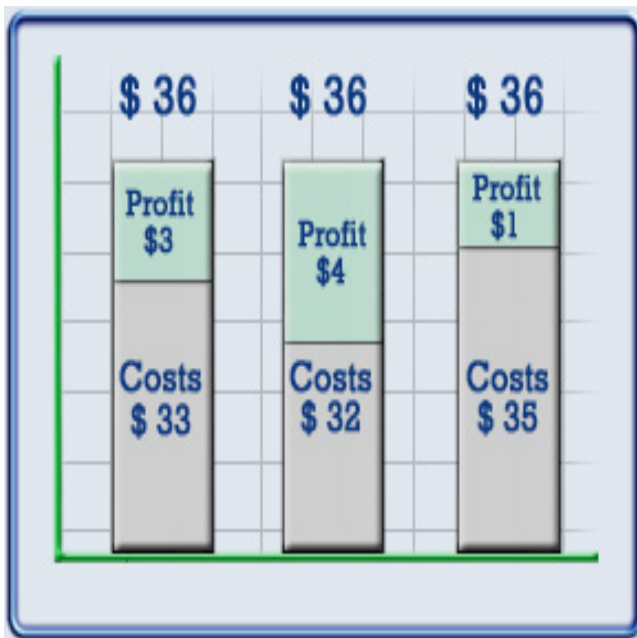


In a FFP contract, the price is truly fixed: the government will pay the **negotiated price**, regardless of what it costs the contractor to produce the good or service. The contractor's profit is built into the price. FFP contracts are commonly used for commercial items or services where there are multiple vendors and little risk of significant contractor cost increases (e.g., office supplies, janitorial services, consulting services, etc.). FFP contracts are also widely used for production of major end-items such as tanks, aircraft, etc.

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### Firm Fixed-Price (FFP) Contract (Example)

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A vendor has been awarded a FFP contract to supply paper to the government at \$36 per case. In its bid, the vendor assumed that it would incur average costs of \$33 per case, leaving an expected profit of \$3 per case. If the vendor's costs decrease to \$32 per case, the vendor actually will earn \$4 profit on each case. However, if the vendor's costs increase to \$35 per case, the vendor's profits will be reduced to just \$1 per case. In either event, the government continues to pay \$36 per case of paper.

#### Long Description

Bar graph with 3 bars. Each bar represents \$36. The first bar is divided into \$33 Costs and \$3 Profit. The second bar is divided into \$32 Costs and \$4 Profit. Finally, the third bar is divided into \$35 Costs and \$1 Profit.

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### Fixed-Price - Economic Price Adjustment (FP-EPA) Contract Concept and Terms

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A FP-EPA contract includes a **negotiated price** and an **economic price adjustment (EPA) clause**. The negotiated price is based on certain assumptions regarding economic prices of materials or labor that go into producing the goods or services. If these assumptions turn out to be significantly incorrect, then the contract's EPA clause will become active, and the price will be adjusted upward or downward as called for in the clause specifications, based on agreed-to escalation amounts or pricing indexes.

FP-EPA contracts are appropriate for goods or services where there may be significant cost risks for certain inputs due to supply or demand fluctuations (such as items containing rare metals like platinum). The contractor's profit is built into the FP-EPA contract's negotiated price, but unlike a FFP contract, the profit is protected to some extent by the EPA clause.

Also, in this case, the government gets to share in cost savings arising from significantly lower than anticipated costs.

### Long Description

Bar graph with one bar representing the negotiated price at the left side of the graph. An arrow labeled "EPA Clause Triggered" points to the right side of the graph, representing the final contract price.

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## Fixed-Price - Economic Price Adjustment (FP-EPA) Contract (Example)

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A contractor has been awarded a FP-EPA contract to build a prototype facility to contain radioactive material. The negotiated price of the contract is \$10 million, of which 10% (\$1 million) is expected profit. This facility will use the rare material unobtainium, whose price fluctuates significantly in the world market, depending on political conditions in the countries in which it is mined. At the time of the contract award, the contractor's best estimate of the cost of the unobtainium required for the contract was \$2 million, which was included in the contract price. However, since the price of the unobtainium could vary by as much as 50% (i.e., from \$1 million to \$3 million), the contractor's profit could range from zero to \$2 million. This amount of risk is excessive, so the contract's Economic Price Adjustment clause calls for adjustments of the contract price if the actual price of unobtainium, based on an independent unobtainium price index, increases or decreases by more than 15% during contract execution.

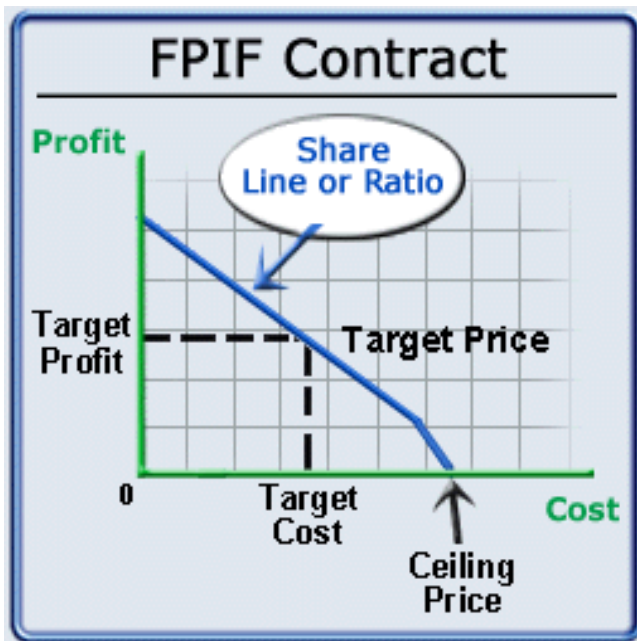
### Long Description

Depiction of radioactive material management. Bar graph with one bar representing the negotiated price at the left side of the graph. An arrow labeled "EPA Clause Triggered" points to the right side of the graph, where two bars representing the final contract price alternate being shown: one is taller than the original negotiated price bar, the other is shorter.

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## Fixed-Price Incentive, Firm Target (FPIF) Concept and Terms

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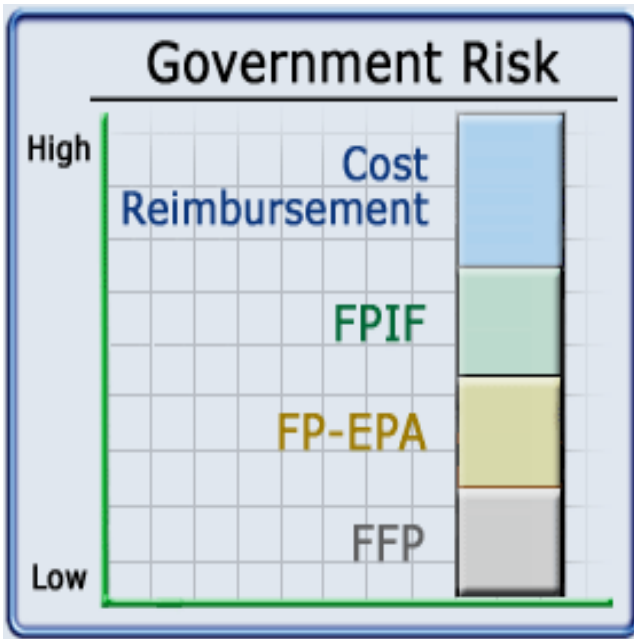
Under a FPIF contract, the price to be paid by the government is not truly fixed. Instead, a firm **target price** is negotiated, consisting of a **target cost** and a **target profit**. As an incentive to the contractor to control costs, the FPIF contract contains a negotiated government/contractor **share ratio**. 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. However, this sharing is limited, as the government will never pay more than the **ceiling price** established in the FPIF contract. Any cost overruns that would cause the contract to exceed the ceiling price must be completely absorbed by the contractor.

### Long Description

Graph displaying FPIF contract concept. Vertical axis is labeled Profit, Horizontal axis is labeled Cost. Target Profit is marked on the Cost axis. These intersect on the Share Line (or Ratio) at a point labeled Target Price. Ceiling price is annotated where the Share Line intersects the Cost axis.



# Fixed-Price Incentive, Firm Target (FPIF) Concept and Terms

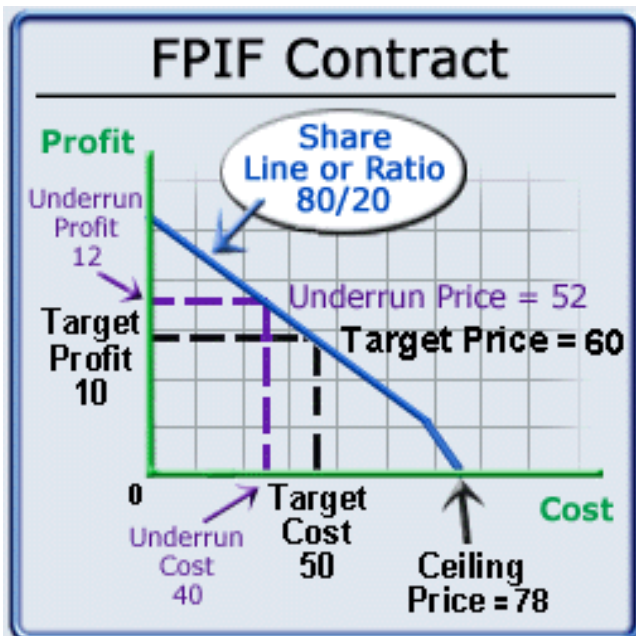


FPIF contracts are most appropriate when the risk associated with the work is high enough to make contractors unlikely to agree to a firm fixed price contract but still low enough not to merit a cost-reimbursement type contract.

The final price paid by the government on a FPIF contract consists of the final contract cost plus the profit computed at that final cost using the share ratio, up to the ceiling price.

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## Fixed-Price Incentive, Firm Target (FPIF) Contract Example (1 of 2)



Assume that a FPIF contract has a target price of \$60 million, with a target cost of \$50 million and target profit of \$10 million. The share ratio is 80/20, with a ceiling price of \$78 million.

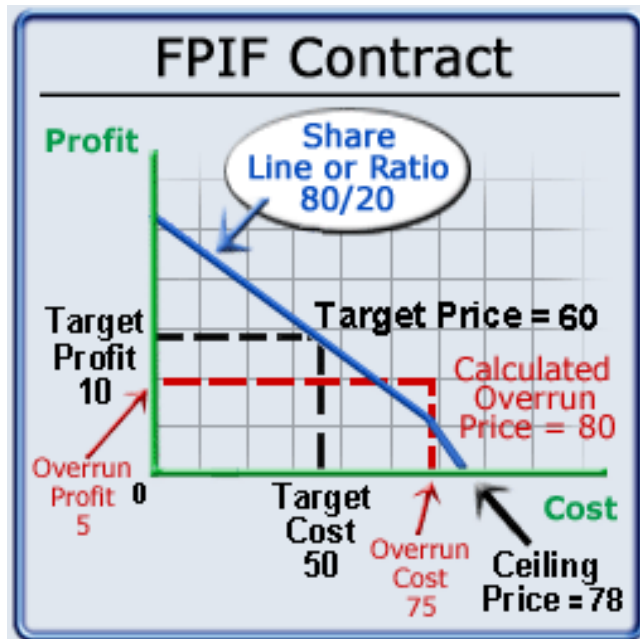
If the contractor is able to perform the work at a cost of \$40 million (\$10 million underrun relative to target cost), it gets to add 20% of the underrun (\$2 million) to its target profit, for a total profit of \$12 million. The total price paid by the government is the final cost (\$40 million) plus the contractor's profit 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 FPIF example. Vertical axis is labeled Profit, and the horizontal axis is labeled Cost. Share Line or Ratio is 80/20, with the line intersecting both axes. Target Price is 60, which is shown along the Share Line at the intersection of a vertical line from the horizontal Cost axis (where target Cost is 50) and a horizontal line from the vertical Profit axis (where Target Profit is 10). Shown in a like manner, Underrun Price is 52, reflecting an Underrun Cost of 40 with an Underrun Profit of 12. Ceiling Price is 78.

## Fixed-Price Incentive, Firm Target (FPIF) Contract Example (2 of 2)

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On the other hand, if the contractor's costs to perform the work are actually \$75 million (\$25 million overrun relative to target cost), the contractor must absorb at least 20% of the overrun (\$5 million) from its target profit, leaving a maximum profit of \$5 million. This would initially indicate that the total price to be paid by the government is the final cost (\$75 million) plus the contractor's profit at the final cost (\$5 million), for a total of \$80 million. However, the government will only pay up to the ceiling price of \$78 million, so the contractor is left with a total profit of just \$3 million in this case.

### Long Description

Graph depicting FPIF example. Vertical axis is labeled Profit, and the horizontal axis is labeled Cost. Share Line or Ratio is 80/20, with the line intersecting both axes. Target Price is 60, which is shown along the Share Line at the intersection of a vertical line from the horizontal Cost axis (where Target Cost is 50) and a horizontal line from the vertical Profit axis (where Target Profit is 10). Shown in a like manner, Overrun Price is 80, reflecting an Overrun Cost of 75 with an Overrun Profit of 5. Ceiling Price is 78.

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## Knowledge Review

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The following Knowledge Review is a matching question. Select a letter associated with the answers below 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.

- a. Firm Fixed-Price Contract
- b. Fixed-Price - Economic Price Adjustment Contract
- c. Fixed-Price Incentive, Firm Target Contract

**1. If assumptions on which the price is based are significantly incorrect, then a clause in the contract allows for adjustment of the price.**

**2. The government pays the negotiated price regardless of what it costs the contractor to produce the good or service.**

**3. The price is not truly fixed; a negotiated government/contractor share ratio is included to promote cost control by the contractor.**

*The correct answers are: 1 - b., 2 - a., 3 - c. In a Firm Fixed-Price Contract, the government pays the negotiated price regardless of what it costs the contractor to produce the good or service. In a Fixed-Price - Economic Price Adjustment Contract, if assumptions on which the price is based are significantly incorrect, then a clause in the contract allows for adjustment of the price. Finally, in a Fixed-Price Incentive, Firm Target Contract, the price is not truly fixed, and a negotiated government/contractor share ratio is included to promote cost control by the contractor.*

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## Fixed-Price 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.

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## Budgeting Firm Fixed-Price (FFP) Contracts

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The program manager should budget to the anticipated final **negotiated price** of the FFP contract. Since the price is truly fixed, this is the best estimate of the amount the government will pay.

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## Budgeting Fixed-Price - Economic Price Adjustment (FP-EPA) Contracts

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The program manager should budget to the anticipated final **negotiated price** of the FP-EPA contract, which does not include any economic price adjustments.

The EPA clause represents a contingency, which should not occur under the most likely scenario if the contract has been appropriately negotiated. During contract execution, if it becomes evident that the EPA clause will be invoked, the budget will be adjusted, and the contract will be modified to add or delete funding as appropriate.

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## Budgeting Fixed-Price Incentive, Firm Target (FPIF) Contracts

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The program manager should budget to the anticipated **target price** of the FPIF contract, which should represent the best estimate of combined contract cost and profit. Some programs may attempt to budget to the ceiling price of the contract, but doing so indicates that the program office does not believe the incentives provided in the contract will do anything to change contractor performance.

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### Knowledge Review

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The following Knowledge Review allows for multiple correct answers. Select all of the answers that are correct, then select the Submit button and feedback will appear.

When budgeting for a contract, the program manager should budget to the anticipated final negotiated price of the contract. Select each contract type to which this statement applies.

- a. Firm Fixed-Price (FFP)
- b. Fixed-Price - Economic Price Adjustment (FP-EPA)
- c. Fixed-Price Incentive, Firm Target (FPIF)

*Correct! The program manager should budget to the anticipated final negotiated price for both FFP and FP-EPA contracts. Economic price adjustments are not included in the budget for FP-EPA contracts. For FPIF contracts, the program manager should budget to the anticipated target price.*

## Knowledge Review

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The following Knowledge Review is a True or False question. Select the best answer and feedback will immediately appear.

The price that the government will actually pay for goods and services under a fixed-price contract is always truly fixed.

**a. True**

**b. False**

*Correct!*

*The price the government will actually pay for goods and services is only truly fixed for the Firm Fixed Price contract. For the Fixed Price-Economic Price Adjustment and Fixed Price Incentive-Firm Target contract types, the price may be subject to a limited amount of adjustments, based on the provisions of the contract.*

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## Knowledge Review

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The following Knowledge Review allows for multiple correct answers. Select one or more answers that best correspond, then select the Check Answers button and feedback will appear.

Select each of the following characteristics that apply to fixed-price contracts:

**a. High financial risk to the contractor.**

**b. High financial risk to the government.**

**c. Contractor promises to deliver on time and meet contract specifications.**

**d. Profit is fixed regardless of cost incurred to produce the goods or services.**

*Correct! Fixed-price contracts are characterized by high financial risk to the contractor, and the fact that the contractor promises to deliver on time and meet contract specifications. However, fixed-price contracts do not pose high financial risk to the government. Also, profit on a fixed-price contract is not fixed, but varies based on the cost incurred to produce the goods or services.*

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## Knowledge Review

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The following Knowledge Review is a matching question. Select a letter associated with the answers below 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 the appropriate fixed-price contracts with their budgeting policies.

- a. Budget to the anticipated final negotiated price.
- b. Budget to the anticipated target price.

### 1. Firm Fixed-Price (FFP) Contracts

### 2. Fixed-Price - Economic Price Adjustment (FP-EPA) Contracts

### 3. Fixed-Price Incentive, Firm Target (FPIF) Contracts

*Correct! The correct answers are: 1-a., 2-a., 3-b. Both Firm Fixed-Price (FFP) and Fixed-Price - Economic Price Adjustment (FP-EPA) contracts are budgeted to the anticipated final negotiated price of the contract. Fixed-Price Incentive, Firm Target (FPIF) contracts are budgeted to the anticipated target price of the contract.*

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## Knowledge Review

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The following Knowledge Review allows you to type the best answer or answers into the appropriate spaces. Type carefully and watch your spelling. Then, select the Check Answers button and feedback will appear.

A fixed-price incentive, firm target contract has a target cost of \$95 million, a target profit of \$9 million, a ceiling price of \$120 million, and a 75/25 share ratio. In accordance with the applicable policy, how much should be budgeted for this contract? Enter your answer in millions of dollars (for example, 100 for \$100 million).

[Open Calculator](#)

*The correct answer is \$104 million. Budget policy for a FPIF contract calls for budgeting to the target price of the contract, which is the sum of the target cost (\$95 million) and the target profit (\$9 million), for a total of \$104 million.*



## Lesson Summary (1 of 3)

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**Congratulations!** You have completed the Fixed-Price Contracts Lesson. The following topics were presented in this lesson:

- **Fixed-Price Contracts:** The government and contractor agree to a fixed price that includes both the contractor's expected costs and expected profit. The fixed price may be truly fixed or be subject to limited adjustment based on specific contract provisions. The contractor agrees to deliver on time and to specification, assuming most of the financial risk.
- **Firm Fixed-Price Contracts:** The negotiated price is all that the government will pay under these contracts; the price is truly fixed. These contracts are typically used for major end items and when there are multiple vendors and little risk of significant cost increases.

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## Lesson Summary (2 of 3)

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The following topics were also presented in this lesson:

- **Fixed-Price- Economic Price Adjustment (FP-EPA) Contracts:** These include a negotiated price and an economic price adjustment (EPA) clause. The negotiated price is based on economic assumptions; if these are incorrect, the EPA clause activates and the price is adjusted. Contractor profit is protected to a limited extent if costs rise significantly, while the government shares in cost savings if costs go down significantly. These contracts are appropriate where there may be significant cost risks due to supply and demand fluctuations.
- **Fixed-Price Incentive, Firm Target (FPIF) Contracts:** These include a ceiling price, as well as a negotiated target price consisting of a target cost and a target profit. The government and contractor share in cost overruns or underruns relative to target cost according to a negotiated share ratio. The government's share of cost overruns is limited by the contract's ceiling price. These contracts are appropriate when risk is high enough to make a firm fixed-price contract unattractive to contractors.

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## Lesson Summary (3 of 3)

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Finally, the following topics were also presented in this lesson:

- **Fixed-Price Contract Budgeting Policies:**

- Budget to the most likely contract price.
- FFP contracts should be budgeted to the anticipated final negotiated price of the contract.
- FP-EPA contracts should be budgeted to the anticipated final negotiated price of the contract. Economic price adjustments should not be included in the budgeted amount until the EPA clause is invoked.
- FPIF contracts should be initially budgeted to the anticipated target price of the contract. The budgeted amount should be adjusted when contract overruns or underruns appear likely.

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