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# Procurement Contracting Strategies

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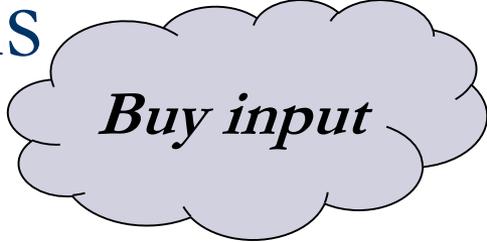
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# Roadmap

- The main factors influencing the choice of the most appropriate procurement contract
- Moving from input-based to performance-based contracts
- How to deal with quality

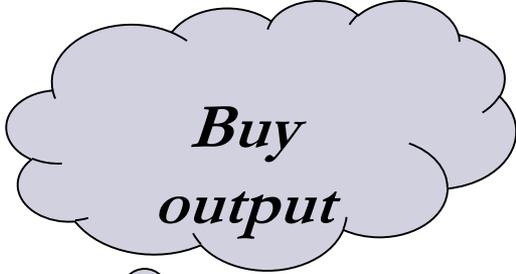
# Problem: How to Heat Schools



*Buy input*

## ■ Solution 1:

Select a contractor to supply oil for heating according to schools' needs. As a consequence, it is likely that high consumption patterns would be observed from December to February, while demand would drop in October and March. This commonly known as a ***cost reimbursement contract*** (CRC)



*Buy output*

## ■ Solution 2

Adopt an “energy services” approach. The basic idea is to select a contractor that would take all necessary measures in order to keep temperature inside school buildings at an agreed level – say 19 C degrees – from 8am until 5pm. Such a contractual agreement is known as ***fixed price contract*** (FPC)

# Main Economic Dimensions

*Procurement Risk*

*Tightness of contractor's  
incentives*

*Transaction Costs*

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# Main Economic Dimensions

## ❖ Procurement risk

- Risks due to events – not accurately predictable by the parties – that may cause discrepancies between planned and actual costs, or that may affect the complete realisation of the procurement contract

## ❖ Incentives

- Contractor's interest in undertaking actions to keep production costs as low as possible

## ❖ Transaction costs

- Mainly, contract enforcement-related costs: monitoring, procedures to levy penalties, legal suits, *ex post* renegotiations, etc.

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# Comparing Two Alternatives From the Contractor's Viewpoint

## **Solution 1 (Buying input through a CRC)**

- Low procurement risk: full insurance is provided against, say, “crazy weather”
- Low incentives: no profit from fixing broken windows

## **Solution (Buying output through a FPC)**

- High procurement risk: no insurance against “bad events”
- High incentives: positive profit from investment against “bad events”

# Policy Guidelines: Cost Reimbursement Contracts

*Contracting authorities should favour cost reimbursement contracts when most of the following circumstances arise:*

- High complexity of the project
- Unforeseen contingencies, that is, events out of control of contracting parties that may lead to serious project disruptions
- High renegotiation costs
- Need for contract flexibility
- Relevance of quality dimensions difficult to measure (e.g. pro-activeness of management consultant, user-friendliness of a computer software)

# Warnings on Cost Reimbursement Contracts

*When favouring cost reimbursement contracts, public buyers should pay much attention to the following aspects:*

**Public contract managers'/engineers' expertise should at least match the contractor's**

Contractors should never be selected using a standard competitive mechanism, since the latter is unable to screen bad firms from good firms

Contract management may be stressful and costly in terms of human resources

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# Policy Guidelines: Fixed Price Contracts

*Contracting authorities should favour fixed price contracts when the following circumstances are hold:*

- The buyer wishes to purchase a good/service satisfying only a minimum level of technical specifications
- The contractor has full control over most of the events affecting production costs
- The buyer's needs remain unchanged during the execution of the contract

# Warnings on Fixed Price Contracts

*When favouring fixed price contracts, public buyers should pay much attention to the following aspects:*

Renegotiations should be Avoided unless something truly unpredictable happens

**Performance should be measured objectively and in a relatively easy way**

Performance should greatly depend on the contractor's effort and not on exogenous events

Minimal quality standards should be made as clear as possible

# Quality Incentive Contracts (QIC)

- Quality incentive contracts normally set a baseline quality level and an improvement schedule, specifying how much the buyer is willing to pay for quality targets above the baseline level

MODULE  
A

Introduction  
and principles

PART  
3

The economics  
of public procurement

## A Simple Quality Incentive Contract

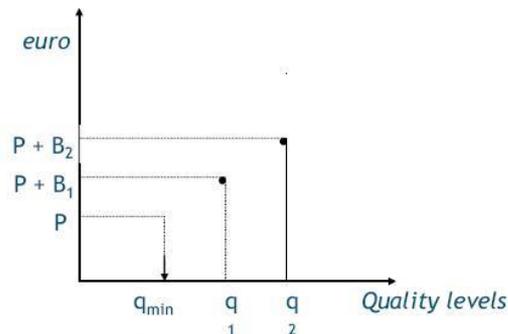


Figure 1: A quality incentive scheme

For instance, a QIC may specify a base payment  $P$  for minimum performance  $q_{\min}$ , typically a quality measure, and additional higher target level  $q_1, \dots, q_n$  with corresponding bonuses  $B_1, \dots, B_n$

*Figure 1 illustrates a simple quality incentive scheme with two quality levels higher than the minimum performance*

# Two Main Classes of Quality Dimensions

## *Verifiable vs. non-verifiable quality*

- Quality is verifiable to the extent that contracting parties are able to define objective performance measures – that is, quality targets that are not only observable by themselves, but that can also be checked by third parties (e.g. courts of law).
- Examples of verifiable quality dimensions:

Time of delivery of a product

Speed of problem resolution  
in a help-desk service

Network size of cafeterias that are willing  
to accept a given restaurant voucher  
as a means of payment

Number of petrol stations  
owned by an oil company

# Example of a QIC

## *Quality incentive schedule for software maintenance*

- When public agencies plan to purchase sophisticated software, maintenance clauses are among the most sensitive dimensions of the procurement contract
- A standard contract would in principle specify a maximum delay (say, 3 hours) for restoring the software after any breakdown occurs. A baseline payment (EUR 1 000) is established accordingly
- Procurement officials can also determine more than one additional delay threshold and corresponding bonuses – for instance, a bonus of EUR 100 if recovery occurs within 2 hours, and EUR 200 if recovery occurs within 1 hour.

# Warnings on Quality Incentive Contracts

All activities related to the management of an incentive contract in fact constitute transaction costs

Sizeable transaction costs may undermine the feasibility of incentive contracts