
Procurement Contracting Strategies

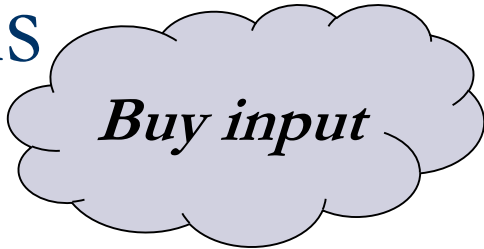
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Roadmap

- 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

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.

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. proactiveness 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

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

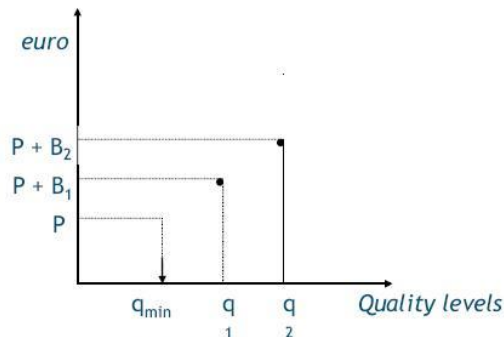


Figure 1: A quality incentive scheme

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