CHAPTER 1

Types of Contracts

Assessment criterion and indicative content

1.1 Identify types of contracts and agreements

- Spot purchases
- Term contracts
- Framework agreements (or blanket orders/panel agreements)
- Call-offs

Section headings

1 Spot purchases
2 Blanket orders, call-off and systems contracts
3 Term contracts
4 Framework agreements

Introduction

In this chapter we cover the main types of contractual agreements made between organisations as buyers and their suppliers.

The syllabus only requires you to be able to identify the main types of agreements, so we won't go into too much financial or legal detail. The important thing is to know what type of contract might be appropriate for a particular purchase, and to appreciate the main features of each type of arrangement.

We start with one-off purchases or standard contracts for the purchase of goods, focusing on the distinction between a one-off ('spot') purchase and a standing order ('term contract').

The next sections cover scenarios where a contract covers recurring, multiple or periodic supply over time, including framework agreements.

1 Spot purchases

1.1 The basics of a contract

A **contract** is an **agreement** between two or more parties which is intended to be enforceable by law. This is different from a social agreement, such as arranging to borrow a friend's car for the day: if one party does not carry out their part, they will not be taken to court by the other to enforce the agreement.

3.4 Sample CSFs and KPIs

A range of KPIs and other measures should be incorporated for each CSF in the supplier's performance that the buyer wants to evaluate. For a general supply contract, measures may be applied to CSFs such as:

- cost management
- quality
- delivery performance
- service performance.

Each CSF can be measured in a number of ways.

- By a specific agreed standard or KPI, set out in the contract
- By an established industry norm, standard or benchmark, referenced in the contract
- By past performance (eg using a year-on-year improvement percentage)
- By the benchmark performance of other suppliers, including former suppliers of the same product or service (eg in measuring an outsourced service provider against the previous in-house provision of the service).

Some typical CSFs and KPIs incorporated in a contract for a generic standard supply are listed in Table 2.1.

Table 2.1 *General KPIs for supplier performance*

CSF	*SAMPLE KPIs*
Cost management	• Value or percentage of cost reductions obtained • Number of cost reduction initiatives proposed or implemented • Percentage range of acceptable cost variance from budgeted costs
Quality performance, conformance or compliance	• Percentage or volume of rejects and returns, errors or scrapped items delivered • Number of customer complaints (eg from users or end customers) and/or returns • Certification under quality management standards (eg ISO 9000) and/or environmental management standards (eg ISO 14001)
Timeliness and delivery	• Frequency or percentage of late, incorrect or incomplete deliveries • Percentage of On Time In Full – OTIF – deliveries • Range of acceptable schedule variance (deadline +/– X hours or days)
Service	• Promptness in dealing with enquiries and problems
Resources	• Minimum number of staff or resources of specified grades to be allocated to the project (eg for service provision or outsourcing)

KPIs are usually expressed as **targets** which define acceptable performance. A basic example, again for a generic standard supply, is as follows: Table 2.2.

2.4 Fixed and variable costs

There is one other very important way of classifying costs, and that is by how they behave in relation to levels of activity. **Cost behaviour** is the way in which the costs of output are affected by fluctuations in the level of activity (typically, the volume of items produced).

- **Fixed costs** do not vary at all as activity increases or decreases. If an organisation is paying rent on a factory, or paying employees a salary that is not directly linked to output, it will have to pay the same amount for a given period, whether the factory is operating or not, and however much it is producing. This type of cost is called a *fixed* cost.
- **Variable costs** vary directly in line with activity levels.

To illustrate how **total costs** are affected as activity varies we can use a simple example.

When 10,000 units of a product are produced in a period, a company's total production costs are $9,000, but when 20,000 units are produced total costs are $13,000.

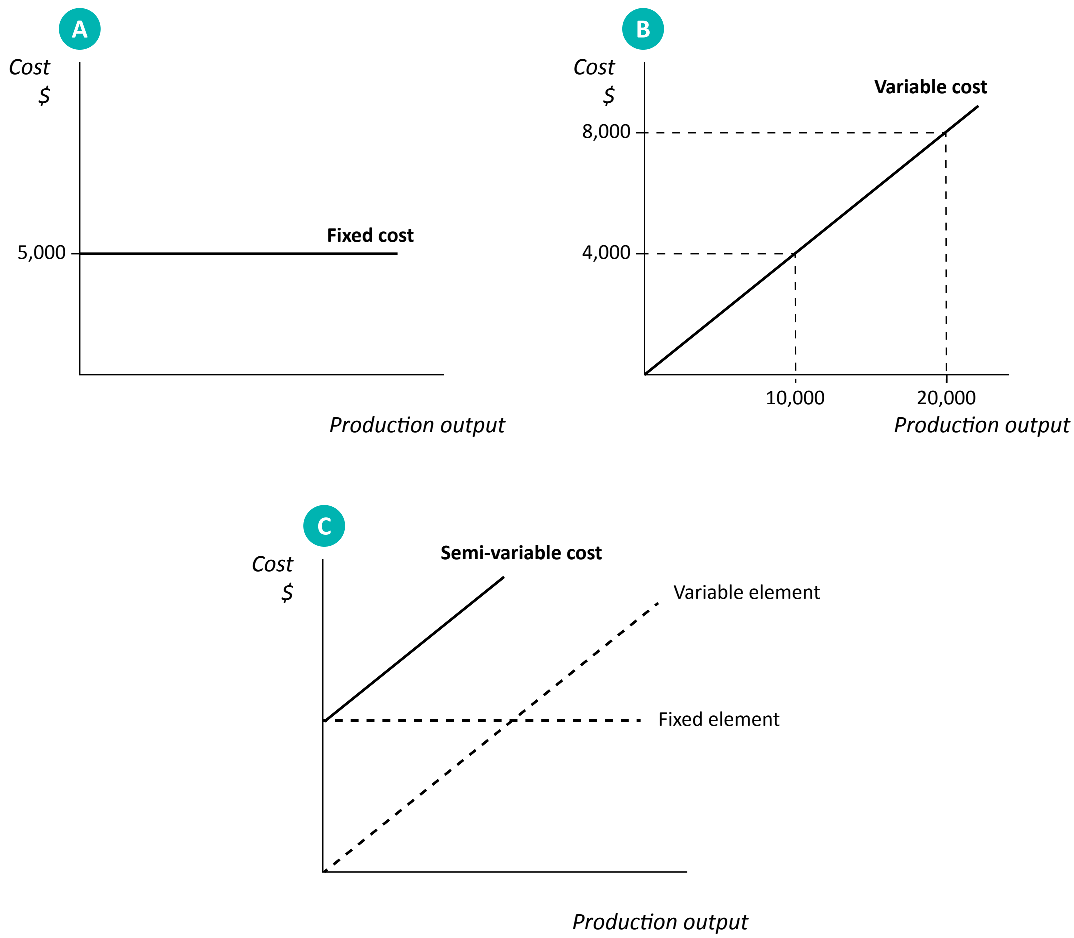
Total costs have increased by less than 50% even though production has doubled. This is because some costs do not rise in relation to the increase in volume. In this case the production costs include just:

- Rental of a fully equipped factory, $5,000 for the period
- Raw materials, $0.40 per unit

When production doubles, the raw materials cost increases from $4,000 to $8,000. This is a **variable cost**. However, the factory rental is unchanged at $5,000. This is a **fixed cost**.

The way in which costs behave as production output changes is a key element in the way prices are set by suppliers. Consider Figure 7.3.

Figure 7.3 *Patterns of cost behaviour*



Chapter summary

- The tendering process is affected by a variety of regulations at individual, national and international levels which together seek to ensure value for money, competition and ethical behaviour.
- Free trade occurs between organisations in different countries which have no barriers to trade between them so they can trade freely with each other. Often free trade is protected by the rules of trading blocs
- Protectionism occurs when countries put up barriers to trade with other countries, in an effort to protect their home industries.
- Barriers to trade include: quotas; embargoes, tariffs; subsidies; unbalanced regulations; red tape; exchange controls.
- International frameworks have a particular focus on ethical trading, public sector procurement and the protection of human rights.
- General principles that apply to procurement using tendering are non-discrimination (on the grounds of nationality), equality and transparency.
- Regulations also protect certain pillars of free trade: free movement of goods; freedom to provide services; freedom of establishment.
- In support of non-discrimination and free trade, regulations on mutual recognition ensure that similar compliance or conformity standards are applied throughout the world.
- Codes of ethics help businesses and buyers determine the 'right' thing to do, usually by engaging with and applying principles or values rather than by applying a tickbox, compliance-based approach.

Self-test questions

Numbers in brackets refer to the sections, tables or figures where you can check your answers.

1. What are the general aims of regulations over procurement? (1)
2. What are the advantages of free trade? (2.1)
3. List the fundamental principles of ethical labour practices. (2.2)
4. What are the purposes of the UK's public procurement regulations? (2.3)
5. What are the five different types of human rights as set out in the Universal Declaration of Human Rights (UDHR)? (Table 9.1)
6. Distinguish between direct and indirect discrimination. (3.1)
7. How can transparency be ensured during a tender process? (3.3)
8. Name five freedoms that underlie free trade. (4.1)
9. Why is mutual recognition important? (5)
10. What behaviour is expected of procurement professionals by the CIPS Code of Conduct? (6)