General Guide to Contract Types

- No single contract type is right for every contracting situation.
- Selection of contract type must be made on a case-by-case basis, considering programmatic, performance, and financial factors.
- The goal is to select the contract type that will result in an optimal business arrangement between the parties.

[References: Local Prime Subcontractor Purchasing System Procedures, FAR 16 and DEAR 916]

Discussion

This chapter supplements other more primary acquisition regulations and policies contained in the references above and should be considered in the context of those references.

Introduction. As you've learned, a contract is a mutually binding legal relationship obligating the seller to furnish the supplies or services and the buyer to pay for them. It includes all types of commitments that obligate the Prime Subcontractor to an expenditure of your site's funds and that, except as otherwise authorized, are in writing. Thereby, a contract sets up arrangements that are clear and certain regarding the relationship and performance requirements of the parties involved. In the case of a Prime Subcontractor subcontract, when a Prime Subcontractor desires to procure goods and services, a contract is the appropriate method of mutually binding the parties to their promise. The FAR, DEAR and your approved site procurement process governs the use of the many types of Prime Subcontractor subcontracts.

The purpose of this document is to provide general guidance regarding contract types. This guide is not intended to supersede information contained in the any of the references above.

There are different meanings associated with the term "contract type." In one sense, it signifies different compensation arrangements, of which there are many. However, most compensation arrangements fall into two major groups: cost reimbursement or fixed price. In another sense, the term "contract type" is used to signify differences in contract structure or form. For example, this structure could be a letter contract, purchase order, performance-based, completion, or term contract. Finally, the term "contract type" is used to identify an intended end purpose. Examples of this would be contracts such as, your own site management and operating (M&O), research and development, construction, services, and supply. This guide focuses on compensation and contract structure to describe "contract type." However, none of these connotations is mutually exclusive, as a contract represents each of these terms. Together, these "contract types" will help ensure the success of a contract.

A wide selection of contract types is available to provide flexibility in acquiring the large variety and volume of supplies and services needed by Prime Subcontractors to fulfill and support their missions. *However, no single contract type is right for every contracting situation. Selection must be made on a case-by-case basis, considering many programmatic, performance and financial factors. The goal is to select the contract type that will result in the most optimum business arrangement between the parties.*

Selection of Contract Type. The Prime Subcontractor sets out the type of contract in the terms and conditions of the solicitation. In non-competitive procurements and some negotiated procurements, the suppliers may be given an opportunity to propose different types of contracts than contemplated by the Prime Subcontractor. The selection of the contract type should give the supplier subcontractor an incentive to perform efficiently and effectively. Thus, selecting the appropriate contract type affects the Prime Subcontractor's ability to obtain fair and reasonable prices.

Buyer Responsibility for Selecting the Contract Type. The Buyer (Federal Contracting Officer equivalent) is responsible for selecting the appropriate contract type. However, in most instances the requirements initiator will be responsible for drafting the Statement of Work (SOW) and other technical/performance requirements. Requirements personnel, familiar with the technical requirements and degree of uncertainties in the SOW, are in an important position to provide the Buyer with information critical to the contract type selection. Thus, their responsibilities are viewed as an integral part of the procurement process. Expenditures for goods and services are seen not simply as the business of contracting personnel, but also that of the requirement officials who initiate and use the goods and services obtained.

How the Statement of Work Influences Contract Type. The SOW is the key element in deciding the selection of a contract type. The level of detail, clarity, and identification of performance objectives and expectations in the SOW drive all other conditions of the contract, from pricing structure, to the subcontractor's entitlement to payment, and to the level of contract administration. The greater the degree to which the Prime Subcontractor can articulate its needs accurately and clearly, the greater the likelihood that the subcontractor will accept greater performance and cost risk associated with a particular type of contract. While a product SOW may be very simple to prepare (e.g. Model xxx, Brand Z or equivalent), the SOW describing a service may be quite complicated. The types of questions to be addressed when the SOW is being prepared include:

- What is the risk associated with contract performance?
- Can the job be done?
- What are the technical, environmental, regulatory, schedule and financial risks?
- Can the man hours and type of labor required for performance be estimated with any degree of assurance?
- Can the required equipment and material be estimated with any degree of assurance?
- Are there unknown site conditions?
- What is the quality of Prime Subcontractor Furnished Services and Information?

When there is little or no performance risk or the degree of risk can be predicted with an acceptable degree of certainty, a firm-fixed-price contract is preferred. *Note that this is the most preferred and most utilized contract type.* However, when uncertainties are significant, other types of fixed-price or cost-type contracts should be considered. To award a fixed-price contract when the effort has significant uncertainties may result in an eventual higher price through later financial claims by the subcontractor.

Categories of Contract Types. Basically, there are two major compensation categories of contracts: fixed price and cost reimbursement. Within these categories are firm-fixed-price at one end and cost-plus-fixed-fee at the other end. In between are various compensation/profit structures providing for varying degrees of subcontractor responsibility, depending upon the degree of uncertainty involved in contract performance. Selection of contract type is the principal method of allocating cost and performance risk between the Prime Subcontractor and the subcontractor. When performance risk to the subcontractor is minimal or can be predicted with an acceptable degree of certainty allowing for reasonable cost estimates, a firm-fixed-price contract is preferred. However, as uncertainties increase, other fixed-price or cost-type contracts must be used to mitigate these uncertainties and avoid placing too great a cost risk on the subcontractor. These two major compensation categories of fixed price and cost reimbursement, with the various types of fixed-price and cost-reimbursement contracts contained therein, are presented below. Additionally, a listing is also provided of other contracts that do not fit within the categories of fixed-price and cost-reimbursement contracts, but fit within the meaning of contract structure or form.

Contract Type Preference. Generally, a firm-fixed-price contract is the most preferred and cost-reimbursement contracts are the least preferred. However, selecting a contract type should be tailored to the unique circumstances of each individual case, with the exception of sealed bidding. Sealed bidding must be either firm-fixed-priced, or fixed-priced with economic price adjustments.

Motive. Compensation/profit is in most cases the basic motive of business enterprise. However, there are situations, particularly in the early stages of research and development, in which the profit motive may be secondary. Both you, the Buyer, and your subcontractors should be concerned with harnessing the appropriate motive to work for an effective and economical subcontract performance. Therefore, parties should seek to negotiate and use the contract type best suited to stimulate outstanding performance. Proper application of these objectives on a contract-by-contract basis should normally result in a range of contract types.

Incentives. **I**ncentive techniques have been found to be particularly useful to enhance subcontractor performance for a wide variety of work requirements, but especially those with clear performance objectives. This allows for performance standards (i.e., quality, quantity, timeliness) to be tied to performance requirements. Under performance-based contracting, all aspects of an acquisition are structured around the purpose/objective of work to be performed, as opposed to the manner in which it is performed. It is designed to ensure that subcontractors are given freedom to determine how to meet the Prime Subcontractor's performance objectives, how appropriate performance quality levels are achieved, and that payment is only made upon achieving these levels. The key to success regarding the use of incentives in meeting technical, schedule and cost baselines is the intelligent selection of appropriate objective measures to accurately gauge the subcontractor's achievement of contract performance objectives. It is thus necessary, under performance-based contracts, to establish a Prime Subcontractor quality assurance plan that describes how subcontractor performance will be measured against the performance standards.

<u>Contract Type Categories</u>.

<u>Compensation Type</u>. Under a fixed-price contract, the subcontractor must deliver the product or perform the service for a pre-set firm-fixed-price or ceiling established in the subcontract. This contract type places upon the subcontractor maximum risk, full responsibility for all costs and resulting profit or loss, provides maximum incentive for the subcontractor to control costs and perform effectively, and imposes a minimum administrative burden upon the contracting parties. There are various types of fixed-price contracts. The following are variations of fixed-price contracts used in Federal contracting but are sometimes used by Prime Subcontractors:

- Firm-Fixed-Price Contracts (FFP)
- Fixed-Price Contracts with Economic Price Adjustments
- Fixed-Price Incentive Contracts (FPI)
- Fixed-Price Incentive (Firm Target) Contracts
- Fixed-Price Incentive (Successive Targets) Contracts
- Fixed-Price Contracts with Prospective Price Redetermination
- Fixed-Price Contracts with Retroactive Price Redetermination
- Firm-Fixed-Price, Level-of-Effort Term Contracts (FP/LOE)

Under a cost-reimbursement contract, the subcontractor agrees to expend its best efforts to achieve the specified requirement, within the estimated amount established in the subcontract. If the subcontract is not fully performed at the time the subcontractor expends the funds, the subcontractor has no obligation for further performance, unless the subcontract is modified to increase the funds. Cost-reimbursement subcontracts include the following:

- Cost Contracts (includes Time and Material and Labor Hour contracts although they are not true “cost” type contracts)
- Cost-Sharing Contracts
- Cost-Plus-Incentive-Fee Contracts (CPIF)
- Cost-Plus-Award-Fee Contracts (CPAF)
- Cost-Plus-Fixed-Fee Contracts (CPFF)

Prime Contractors frequently use Time and Material or Labor Hour contracts. The preference on the commercial side is to utilize fixed price contracts wherever possible and the vast majority of all subcontracts are firm fixed price. As stated, the most common form of cost type contracting arises in the acquisition of services where Time and Material or Labor Hour contracts are prevalent. The embedded documents provide additional information on these types of contracts.

<u>Structure Type</u>. There are other contract types that do not fall easily into only one of the two primary categories of fixed-price and cost-reimbursement contracts. These contract types are as follows using standard Federal nomenclature. Note that varying Prime Contractors may call

these by different names. For instance, a Basic Agreement may also be call a Long Term Agreement. Task Orders may be called Releases.

- Performance-Based Contracts
- Indefinite-Delivery/Quantity Contracts (IDIQ)
- Definite-Quantity Contracts
- Requirements Contracts
- Letter Contracts
- Basic Agreements (BA)
- Basic Ordering Agreements (BOA)
- Blanket Purchase Agreements (BPA)
- Task Orders

Prime Contractors often enter into non-contracts similar to federal Agreements. These are often referred to as "Long Term Agreements." If pricing is included, they are similar to BPAs. If pricing is not included they are more similar to BOAs.

Risk Factors Considered in Determining Appropriate Contract Type. The contract type should be commensurate with the level of risk in performance of the SOW. The objective in selection of contract type should be to establish the pricing arrangement that is most likely to produce a fair and reasonable price for performing a given SOW. Weighing cost and technical risks and consciously assigning them to either the Prime Subcontractor or the subcontractor achieves this. If too much risk is assigned to the subcontractor, then there will be excessive pricing contingencies included to cover the high level of risk. If, on the other hand, not enough risk is left for the subcontractor, then there will be little or no incentive for exercising management skill to perform efficiently and thereby control costs. Therefore, it is essential that Prime Subcontractor officials and Buyer fully understand the risk factors that should be considered when determining the contract type. These factors are as follows:

- Type and Complexity of the Requirement. Requirements that are complex and unique to the Prime Subcontractor create the likelihood of changes in technical direction and for performance uncertainties, normally placing greater risk assumptions on the Prime Subcontractor. Therefore, greater uncertainties would likely result in cost-reimbursement type contracts as this type of arrangement shifts cost risk from the subcontractor to the Prime Subcontractor. As requirements recur, they allow for a substantial degree of certainty related to achieving the objectives of the requirement. In this case, cost risk should shift to the subcontractor, creating the potential for a fixed-price type contract.

- Urgency of the Requirement. If urgent, the Prime Subcontractor may have to assume a greater proportion of risk, or offer incentives to ensure timely contract performance. An example of an urgent need that may be appropriate for a cost-type contract may be the continued operation of a facility assumed from a defaulted subcontractor.

- Period of Performance: When the contract period extends over a relatively long period (greater than 5 years), it is difficult for both the Prime Contractor and the subcontractor to establish accurate contract value and cover all contingencies in performance. The longer the time of performance, the risk of performance and budget levels increase. Consideration should be given to the use of economic price adjustment terms or other re-pricing mechanism. An example of this would be the procurement of fuel. Pricing fluctuates greatly at times making the long term establishment of firm fixed prices unreasonable. Establishing a pricing algorithm allowing for changes based upon an agreed upon index can resolve issues like this.

• Technical Capability. Consideration should be given to: “Has this type of effort been done before?” Is the technical requirement well defined, or is this a new state-of-the-art requirement? This will determine the level of subcontractor technical capability necessary to execute contract requirements. For example, meeting technical requirements that require a high degree of technical capability may have a greater risk of not achieving in an effective and efficient manner, and is a consideration when determining the contract type.

• Financial Capability. Consideration should be given to a subcontractor’s financial risk. For example, smaller firms may not have the financial backing to accomplish the requirement in a timely and efficient manner.

- Performance/Cost Incentives. Incentives may be considered when realistic, measurable targets can be set out in the SOW and successful project performance can be identified. In order for realistic and measurable targets to be developed, good technical, schedule and cost baselines are essential. Prime Contractor technical personnel must be able to monitor subcontractor performance and make timely decisions on technical matters. A combination of performance and cost incentives should be used as applicable.
- Performance incentives should be considered when the Prime Contractor desires improvements in performance.

- Cost incentives should be used to motivate the subcontractor to effectively manage costs.

- Adequacy of the Subcontractor's Accounting System. Before reaching a decision regarding a contract type other than firm-fixed-price, the Buyer normally needs to ensure that the subcontractor's accounting system will permit timely tracking and reporting of necessary cost data in the form required by the proposed contract type. This factor may also be critical when a fixed-price type contract requires price revision while performance is in progress, or when a cost-reimbursement contract is being considered and all current or past experience with the subcontractor has been on a fixed-price basis. This is especially important in the use of labor hour or time and material contracts.

- Concurrent Contracts. If performance under the proposed contract involves concurrent performance under other contracts, the impact on those contracts, including their pricing arrangements, should be considered. For example, a subcontractor having security contracts at various sites should have better control and understanding of the technical and cost aspects required, thereby leading to cost-plus-incentive and fixed-price type contracts. However, two issues need to be considered under these circumstances: (1) if the subcontractor has both fixed and cost-type concurrent contracts, how is the subcontractor going to ensure there is no cross charging of costs; and (2) what contract type does the subcontractor have for the same or similar services?

Detailed Information on Each Contract Type. There is no template that can automatically match a contract type to any contracting circumstances and still consistently promote the best interests of the Prime Contractor. Sound judgment by the most qualified personnel familiar with the influencing factors, considering the importance and magnitude of the contemplated contract, is essential. To make an intelligent selection of a specific or combination type contract to best fulfill a specific need, the Buyer must know and understand each of the types of contracts available, the benefits and constraints of each in a given situation, the requirements of the program office, and the various types of risks involved.

Please review the General Guide to Contract Types of Requirements Officials, from a former DOE Acquisition Guide for additional information on each contract type. Again, your site-specific procurement system may contain slightly different descriptions, however, these federal descriptions are generally valid across all Prime Contractors.

Contract Type Abstracts. Please refer to the Types of Contracts document for a comparison of major DOE contract types based on categories of subcontractor compensation.

With the wide use of Time and Materials/Labor Hour contracts, the following excerpt from the FAR is provided to give you additional considerations when using this form of contract. Remember, references to the "Government" mean "Prime Contractor" and "Contracting Officer" mean "Buyer" when applying these concepts and considerations to your subcontract.

Time- and-Material Contracts provide a mechanism for acquiring services on the basis of—
(1) Direct labor hours at specified fixed hourly rates that include wages, overhead, general and administrative expenses, and profit; and
(2) Materials at cost, including, if appropriate, material handling costs as part of material costs.
A time-and-materials subcontract may be used only when it is not possible at the time of placing the contract to estimate accurately the extent or duration of the work or to anticipate costs with any reasonable degree of confidence. A time-and-materials contract provides no positive profit incentive to the contractor/supplier for cost control or labor efficiency. Therefore, appropriate surveillance of contractor/supplier performance is required to give reasonable assurance that efficient methods and effective cost controls are being used. A time-and-materials contract may be used only if the contract includes a ceiling price that the contractor/supplier exceeds at its own risk. The contract file shall document the justification for any subsequent increase in the ceiling price. In addition, a justification shall be documented that no other contract type is suitable, as defined in FAR 16.6.

Labor Hour Contracts are a variation of the time-and-materials contract, differing only in that materials are not supplied by the contractor/supplier. This type of contract is used only for services.

FAR 16.601 Time-and-materials contracts

(a) Definitions for the purposes of Time-and-Materials Contracts.

Direct materials means those materials that enter directly into the end product, or that are used or consumed directly in connection with the furnishing of the end product or service.

Hourly rate means the rate(s) prescribed in the contract for payment for labor that meets the labor category qualifications of a labor category specified in the contract that are-

(1) Performed by the contractor;

(2) Performed by the subcontractors; or

(3) Transferred between divisions, subsidiaries, or affiliates of the contractor under a common control.

Materials means-

(1) Direct materials, including supplies transferred between divisions, subsidiaries, or affiliates of the contractor under a common control;

(2) Subcontracts for supplies and incidental services for which there is not a labor category specified in the contract;

(3) Other direct costs (*e.g.*, incidental services for which there is not a labor category specified in the contract, travel, computer usage charges, etc.); and

(4) Applicable indirect costs.

(b) *Description*. A time-and-materials contract provides for acquiring supplies or services on the basis of-

(1) Direct labor hours at specified fixed hourly rates that include wages, overhead, general and administrative expenses, and profit; and

(2) Actual cost for materials (except as provided for in 31.205-26(e) and (f)).

(c) *Application*. A time-and-materials contract may be used only when it is not possible at the time of placing the contract to estimate accurately the extent or duration of the work or to anticipate costs with any reasonable degree of confidence. See 12.207(b) for the use of time-and-material contracts for certain commercial services.

(1) *Government surveillance*. A time-and-materials contract provides no positive profit incentive to the contractor for cost control or labor efficiency. Therefore, appropriate Government surveillance of contractor performance is required to give reasonable assurance that efficient methods and effective cost controls are being used.

(2) *Fixed hourly rates*.

(i) The contract shall specify separate fixed hourly rates that include wages, overhead, general and administrative expenses, and profit for each category of labor (see 16.601(f)(1)).

(ii) For acquisitions of noncommercial items awarded without adequate price competition (see 15.403-1(c)(1)), the contract shall specify separate fixed hourly rates that include wages, overhead, general and administrative expenses, and profit for each category of labor to be performed by-

(A) The contractor;

(B) Each subcontractor; and

(C) Each division, subsidiary, or affiliate of the contractor under a common control.

(iii) For contract actions that are not awarded using competitive procedures, unless exempt under paragraph (c)(2)(iv) of this section, the fixed hourly rates for services transferred between divisions, subsidiaries, or affiliates of the contractor under a common control-

(A) Shall not include profit for the transferring organization; but

(B) May include profit for the prime contractor.

(iv) For contract actions that are not awarded using competitive procedures, the fixed hourly rates for services that meet the definition of commercial item at 2.101 that are transferred between divisions, subsidiaries, or affiliates of the contractor under a common control may be the established catalog or market rate when-

(A) It is the established practice of the transferring organization to price inter-organizational transfers at other than cost for commercial work of the contractor or any division, subsidiary or affiliate of the contractor under a common control; and

(B) The contracting officer has not determined the price to be unreasonable.

(3) *Material handling costs*. When included as part of material costs, material handling costs shall include only costs clearly excluded from the labor-hour rate. Material handling costs may include all appropriate indirect costs allocated to direct materials in accordance with the contractor's usual accounting procedures consistent with part 31.

(d) *Limitations*. A time-and-materials contract or order may be used only if-

(1) The contracting officer prepares a determination and findings that no other contract type is suitable. The determination and finding shall be-

(i) Signed by the contracting officer prior to the execution of the base period or any option periods of the contracts; and

(ii) Approved by the head of the contracting activity prior to the execution of the base period when the base period plus any option periods exceeds three years; and

(2) The contract or order includes a ceiling price that the contractor exceeds at its own risk. Also see 12.207 (b) for further limitations on use of time-and-materials or labor-hour contracts for acquisition of commercial items.

(e) Post award requirements. Prior to an increase in the ceiling price of a time-and-materials or labor-hour contract or order, the contracting officer shall-

(1) Conduct an analysis of pricing and other relevant factors to determine if the action is in the best interest of the Government;

(2) Document the decision in the contract or order file; and

(3) When making a change that modifies the general scope of-

(i) A contract, follow the procedures at 6.303;

(ii) An order issued under the Federal Supply Schedules, follow the procedures at 8.405-6; or

(iii) An order issued under multiple award task and delivery order contracts, follow the procedures at 16.505(b) (2).

Contract Type Selection Chart The following chart is designed to provide you with a quick-view assessment of contract types. Although the directions are for federal contracting officials the recommendations are generally true for all Prime Contractors.

	Firm-Fixed-Price (FFP)	Cost-Plus-Incentive-Fee (CPIF)	Cost-Plus-Award-Fee (CPAF)	Cost-Plus-Fixed-Fee (CPFF)	Time & Materials (T&M)
Principal Risk to be Mitigated	None. Thus, the contractor assumes all cost risk.	Highly uncertain and speculative labor hours, labor mix, and/or material requirements (and other things) necessary to perform the contract. The Government assumes the risks inherent in the contract, benefiting if the actual cost is lower than the expected cost, or losing if the work cannot be completed within the expected cost of performance.			
Use When . . .	The requirement is well-defined. • Contractors are experienced in meeting it. • Market conditions are stable. • Financial risks are otherwise insignificant.	An objective relationship can be established between the fee and such measures of performance as actual costs, delivery dates, performance benchmarks, and the like.	Objective incentive targets are not feasible for critical aspects of performance. Judgmental standards can be fairly applied. Potential fee would provide a meaningful incentive.	Relating fee to performance (e.g., to actual costs) would be unworkable or of marginal utility.	No other type of contract is suitable (e.g., because costs are too low to justify an audit of the contractor's indirect expenses).
Elements	A firm-fixed-price for each line item or one or more groupings of line items.	• Target cost • A minimum, maximum, and target fee • A formula for adjusting fee based on actual costs and/or performance • Performance targets (optional)	• Estimated cost • Base amount, if applicable, and an award amount • Award fee evaluation criteria and procedures for measuring performance against the criteria	• Estimated cost • Fixed fee	• Ceiling price • A per-hour labor rate that also covers overhead and profit • Provisions for reimbursing direct material costs

	Firm-Fixed-Price (FFP)	Cost-Plus-Incentive-Fee (CPIF)	Cost-Plus-Award-Fee (CPAF)	Cost-Plus-Fixed-Fee (CPFF)	Time & Materials (T&M)
Contractor is Obliged to:	Provide an acceptable deliverable at the time, place and price specified in the contract.	Make a good faith effort to meet the Government's needs within the estimated cost in the Contract, Part I the Schedule, Section B Supplies or services and prices/costs.			Make a good faith effort to meet the Government's needs within the ceiling price.
Contractor Incentive *(other than maximizing goodwill)*	Generally realizes an additional dollar of profit for every dollar that costs are reduced.	Realizes a higher fee by completing the work at a lower cost and/or by meeting other objective performance targets.	Realizes a higher fee by meeting judgmental performance standards.	Realizes a higher rate of return (i.e., fee divided by total cost) as total cost decreases.	
Typical Application	Commercial supplies and services.	Research and development of the prototype for a major system.	Large scale research study.	Research study.	Emergency repairs to laboratories.
Principal Limitations in FAR/DEAR Parts 16, 32, 35, and 52	Generally NOT appropriate for R&D.	The contractor must have an adequate accounting system. The Government must exercise surveillance during performance to ensure use of efficient methods and cost controls. Must be negotiated. Must be justified. Statutory and regulatory limits on the fees that may be negotiated. Must include the applicable Limitation of Cost clause at FAR 52.232-20 through 23.			D&F required (w/ HCA if over 3 years). Government MUST exercise appropriate surveillance to ensure efficient performance. Document any ceiling increases.
Variants	Firm-Fixed-Price Level-of-Effort.			Completion or Term.	Labor Hour (LH).