Part I Chapter 08
Selecting Type of Contract

A. General.

1. The selection of an appropriate type of contract and contract costs are related and should be considered together. The objective is to negotiate a contract type and price that includes reasonable contractor risk and provides the contractor with the greatest incentive for efficient and economical performance. When there is a need for using other than a firm fixed-price contract, it must be determined, before award of the contract, whether the contractor's accounting system will permit timely development of all necessary cost data in the form required by the specific contract type contemplated and is adequate to allocate costs in accordance with generally accepted accounting principles. This may be particularly critical where a cost-reimbursement type of contract is being considered and all current or past experience with the contractor has been on a fixed-price basis.

2. A contract may be one of the following types or a combination of the types identified below. COST-PLUS-A-PERCENTAGE-OF-COST CONTRACTS ARE PROHIBITED.

B. Firm, Fixed-Price Contracts. Firm, fixed-price contracts are of several types designed to facilitate proper pricing under varying circumstances.

1. Established-Price Types. The established-price type of contract provides for a firm price or, under appropriate circumstances, may provide for an adjustable price for the supplies, services, or construction which are being procured. In providing for an adjustable price, the contract may fix a maximum or minimum price. Unless otherwise provided in the contract, any such maximum or minimum price is subject to adjustment only if required by the operation of any contract clause which provided for equitable adjustment, escalation, or other revision of the contract price upon the occurrence of an event or contingency. Established-price contract types are generally created through line item specific bid pricing or established catalog bid pricing. See Part I Chapter 02, Definitions, for the definitions of established catalog price and line item specific pricing.

a. Basic Established-Price Contract. The basic established-price contract provides for a price which is not subject to an adjustment by reason of the cost experience of the contractor in the performance of the contract. This type of contract places maximum risk upon the contractor. Because the contractor assumes full responsibility, in the form of profits or losses, for all costs under or over the firm fixed-price, he or she has a maximum profit incentive for effective cost control and contract performance. Use of the basic established-price contract is suitable for use in procurements when reasonably definite work statements, specifications, and performance requirements are available and whenever fair and reasonable costs can be established at the outset.

b. **Established-Price Contract With Escalation.** The established-price contract with escalation provides for the upward and downward revision of the stated contract price upon the occurrence of certain contingencies which are specifically defined in the contract. The risks in a basic established-price contract are reduced by the inclusion of escalation provisions in which the parties agree to revise the stated price upon the happening of a prescribed contingency. Where escalation is agreed upon, upward adjustments shall be limited to the establishment of a reasonable ceiling, and provisions will be included for downward adjustments in those instances where the prices or rates shall fall below the base levels provided in the contract. The escalation generally covers the increase in labor costs due to an increase in the minimum wage or union contract negotiations, or other costs such as fuel, which are beyond the direct control of the contractor.

c. **Established-Price Plus Incentive Contract.** The established-price plus incentive contract is a firm, fixed-price type of contract with provisions for adjustment of profit and establishment of the final contract price by a formula based on the relationship which final negotiated total cost bears to total target costs. Established-price plus incentive contracts are appropriate when the supplies, services, or construction being procured are of such a nature that assumption of a degree of cost responsibility by the contractor is likely to provide him with a positive profit incentive for effective cost control and contract performance.

d. **Prospective Price Redetermination at a Stated Time or Times During Performance Contract.** This type of contract provides for an established-price for an initial period of contract performance and for prospective price redetermination either upward or downward at a stated time or times during the performance of the contract. This type of contract is appropriate in the procurement of supplies, services, or construction where it is possible to negotiate fair and reasonable established prices for an initial period but not for subsequent periods of contract performance.

This type of contract should not be used unless:

(1) It has been established through negotiations that a basic established-price contract does not fulfill the requirements established by the conditions surrounding the procurement.

(2) The contractor's accounting system is adequate for price redetermination purposes.

(3) The prospective pricing period can be made to conform with the operations of the contractor's accounting system.

(4) Reasonable assurance exists that price redetermination action will be taken promptly at the time or times specified.

2. **Time and Materials Contract.** The time and materials contract provides for the procurement of supplies, services, or construction on the basis of:

a. Direct labor hours at specified fixed hourly rates (which rates include direct and indirect labor, overhead, and profit).

b. Material at cost which could include handling and administrative expenses. This type of contract does not afford the contractor any positive profit incentive to control the cost of the materials or to manage his labor force effectively. The time and materials contract is used only where it is not possible at the time of placing the contract to estimate the extent or duration of the work or to anticipate costs with any reasonable degree of confidence. This type of contract is usually used for procurement of repairs, maintenance or overhaul work, and work to be performed in emergency situations. If this type of contract is used, the contract should show a ceiling price which the contractor exceeds at his own risk.

3. **Labor-Hour Contract.** The labor-hour type of contract is a variant of the time and materials type of contract differing only in that materials are not supplied by the contractor.

4. **Unit Price Contract.** The unit prices for the supplies, services, or construction to be provided are established in the contract with an estimated total amount. The contractor is paid in accordance with the unit price.

5. **No-Fee Contract.** A contract where supplies, services, or construction are provided at no cost to the Commonwealth.

C. **Cost-Reimbursement Contract.** The cost-reimbursement type of contract provides for payment to the contractor of allowable costs incurred in the performance of the contract to the extent prescribed in the contract. This type of contract establishes an estimate of total cost for the purpose of obligation of funds and a ceiling which the contractor may not exceed (except at his own risk) without prior approval and subsequent amendment of the contract. The cost-reimbursement contract is suitable for use only when the uncertainties involved in contract performance are of such magnitude that cost of performance cannot be estimated with sufficient reasonableness to permit use of any type of fixed-price contract. In addition, it is essential that the contractor's cost accounting system is adequate for the determination of costs applicable to the contract and appropriate surveillance by agency personnel during performance will give reasonable assurance that inefficient or wasteful methods are not being used.

1. **Cost-Sharing Contract.** A cost-sharing contract is a cost-reimbursement type contract under which the contractor receives no fee but is reimbursed only for an agreed portion of its allowable costs. A cost-sharing contract is suitable for those procurements which cover research projects which are jointly sponsored by the Commonwealth and the contractor with benefit to the contractor in lieu of full monetary reimbursement of costs. In consideration of this benefit, the contractor agrees to absorb a portion of the costs of performance. This type of contract is used for jointly sponsored research and development work with nonprofit educational institutions or other nonprofit organizations or other research and development work where the results of the contract may have commercial benefit to the contractor.

2. **Cost-Plus-Incentive-Fee Contract.** The cost-plus-incentive-fee contract is a cost-reimbursement type contract with provisions for a fee which is adjusted by formula in accordance with the relationship which total allowable costs bear to target costs. Under this type of contract, there is negotiated initially a target cost, a target fee, a minimum and maximum fee, and a fee adjustment formula. After performance of the contract, the fee payable to the contractor is determined in accordance with the formula. The provision for increase or decrease of fee is designed to provide an incentive for maximum effort on the part of the contractor to manage the contract effectively.

3. **Cost-Plus-A-Fixed-Fee Contract.** The cost-plus-a-fixed-fee contract is a cost reimbursement type of contract which provides for the payment of a fixed fee to the contractor. The fixed fee, once negotiated, does not vary with actual cost, but may be adjusted as a result of any subsequent changes in the work or services to be performed under the contract. Because the fixed fee does not vary in relation to the contractor's ability to control costs, the cost-plus-a-fixed-fee contract provides the contractor with only a minimum incentive for effective management control of costs. This type of contract is usually used for the performance of research or preliminary exploration or study where the level of effort required is unknown. The fixed fee shall not exceed 10 percent of the estimated cost of the contract, exclusive of the fee, as determined at the time of entering into such contract. Payment schedules for reimbursing contractors will be designed to provide the Commonwealth with a measure of assurance that contractor performs the work or services satisfactorily before complete payment is made.

D. **Performance Based Contract.** The performance based contract is one which incorporates an incentive to the contractor to surpass stated performance targets by providing for increases in fee or profit to the extent such targets are surpassed and for decreases to the extent such targets are not met. The incentive feature (providing for increases or decreases, as appropriate) is applied to performance targets rather than performance requirements. The incentive should relate to specific performance areas or milestones which have been very carefully established and specified in the contract. Performance incentives present complex problems in contract administration and should be approached with caution.

References:

1. Part I Chapter 02, Definitions