Contract Formation

Activity 10: Types of Contracts

Description of the available contract types and factors to consider when selecting the appropriate contract type.

Related Flow Charts: Flow Chart 10

Tasks	FAR Reference(s)	Additional Information
1. Determine the appropriate contract type based on the requirements, pertinent factors, and potential risks.	FAR 16.103(d) Negotiating contract type. FAR 16.104 Factors in selecting contract types.	Based on FAR 16.2 through FAR 16.6, there are 11 different permissible contract vehicles. These vehicles can be subdivided into three different families: fixed-price, cost-reimbursement, and other contract vehicles. Consider the following factors when selecting and negotiating a type of contract: • Price competition; • Price analysis; • Cost analysis; • Type and complexity of the requirement; • Combining contract types; • Urgency of the requirement; • Period of performance or length of production run; • Contractor's technical capability and financial responsibility; • Adequacy of the contractor's accounting system; • Concurrent contracts; • Extent and nature of proposed subcontracting; and • Acquisition history. A cost-plus-percentage-of-cost contract is prohibited. This prohibition applies to both cost-reimbursement and fixed-price

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		contracts. In *Muschany v. United States*, 324 U.S. 49 (1044), the Supreme Court explained: “The evil of such contracts is that the profit of the other party to the contract increases in proportion to that other party’s costs expended in the performance.”
2. Consider if one of the fixed-price contracts is appropriate for the requirement.	FAR 16.2 Fixed-price contracts.	Fixed-price contracts are beneficial because: • The contractor bears the full responsibility for the performance costs and resulting profit or loss; • Contractor must deliver the product or perform the service for a pre-set firm fixed price or ceiling established in the contract. No price adjustments regardless of performance costs; and • Places least administrative burden on contracting officer.
2a. Determine if a firm-fixed-price contract is appropriate for the requirement.	FAR 16.103(b) Negotiating contract type. FAR 16.202 Firm-fixed-price contracts [fixed-price contracts].	A firm-fixed price-contract, which best utilizes the basic profit motive of business enterprise, must be used when the risk involved is minimal or can be predicted with an acceptable degree of certainty. A firm-fixed-price contract is suitable for acquiring commercial items or other supplies or services when there are reasonably definite specifications, and fair and reasonable prices can be established at the outset.
2b. Determine if fixed-price contract with economic price adjustment is appropriate for the requirement.	FAR 16.203 Fixed-price contracts with economic price adjustment [fixed-price contracts].	Used when the stability of market or labor conditions during an extended period of contract performance is uncertain, and contingencies that would otherwise be included in the contract price can be identified and separately addressed in the contract. The contracting officer must not use a fixed-price contract with economic price adjustment unless he or she determines that a price adjustment clause is necessary to protect the contractor and Government against significant fluctuations in costs, or to provide for price adjustment in the event of changes in the contractor’s established prices.

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2c. Determine if fixed-price incentive contract is appropriate for the requirement.	FAR 16.204 Fixed-price incentive contracts [fixed price contracts]. FAR 16.403 Fixed-price incentive contracts [incentive contracts].	Fixed-price incentive contract provides incentive for efficiency and economy in performance in the following ways: • High profit for outstanding performance: • Modest profit for mediocre performance; and • Low profit or loss for below-average performance Two types of fixed-price incentive contracts are: • Fixed-price incentive (firm target) contracts: The firm target cost, target profit, and profit sharing formula are negotiated and included in the contract, and the profit is adjusted upon completion of the contract. • Fixed-price incentive (successive targets): The initial cost and profit are negotiated into contract, but the final cost target (firm) cannot be negotiated until during performance. There are production points at which either a firm target and final profit formula, or a firm fixed price contract can be negotiated. A few constraints of these contract types are: • It is difficult to evaluate performance; • The contracting officer must determine that this contract type is the least costly; and • No other contract type is practical.
2d. Determine if a fixed-price contract with an award fee is appropriate for the requirement.	FAR 16.401(e)(1) Application [incentive contracts]. FAR 16.404 Fixed-price contracts with award fees [incentive contracts].	Award-fee provisions may be used in fixed-price contracts when the Government wishes to motivate a contractor and other incentives cannot be used because contractor performance cannot be measured objectively. Such contracts must establish a fixed price (including normal profit) for the effort. This price will be paid for satisfactory contract performance. Award fee earned (if any) will be paid in addition to that fixed price.
2e. Determine if a fixed-price contract with price redetermination is the appropriate for the requirement.	FAR 16.205 Fixed-price contracts with prospective price redetermination [fixed-price contracts].	Two types of fixed-price contracts with price redetermination are fixed-price contract with prospective price redetermination and fixed-ceiling-price contract with retroactive price redetermination.

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	FAR 16.206 Fixed-ceiling-price contracts with retroactive price redetermination [fixed-price contracts].	Fixed-price contract with prospective price redetermination: • Use this contract type when it is possible to negotiate a fair and reasonable price for an initial period of performance but not the entire contract period. • The contract is fixed-price for an initial period (redetermination periods are generally 12 months in duration). • The terms are expressed in units delivered or as calendar date(s). • The contract price is redetermined up or down at a specific time during performance. • Ceiling price, if applied, is negotiated and included in the initial contract. • A few major constraints of this contract type are: ○ The Government assumes part of the cost risk; and ○ The Government has a relatively heavy burden of contract administration. Fixed-ceiling-price contract with retroactive price redetermination contract: • This contract type is appropriate for research and development contracts estimated at $150,000 or less when a realistic fixed price cannot be negotiated initially, or when the contract amount is so small or time is so short that any other contract type would be impractical. • This contract type provides for a price ceiling and a retroactive price redetermination within the ceiling upon completion of the contract. • This contract type includes fair and reasonable billing price for interim payments and a price ceiling. • A few major constraints of this contract type are: ○ Aside from the price ceiling, there is minimal

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		incentive for the contractor to control costs; and ○ The Government has a weak bargaining position at redetermination because the contract is complete.
2f. Determine if a firm-fixed-price, level-of-effort term contract is the appropriate for the requirement.	FAR 16.207 Firm-fixed-price, level-of-effort term contracts [fixed-price contracts].	A firm-fixed-price, level-of-effort term contract is suitable for investigation or study in a specific research and development area estimated at $150,000 or less. This contract type may only be used when: • The work required cannot otherwise be clearly defined; • The required level of effort is identified and agreed upon in advance; and • There is reasonable assurance that the intended result cannot by achieved by expending the stipulated effort; and • The contract price is A few major constraints of this contract type are: • There is no guarantee that desired results will be achieved; and • There is a heavy technical administration burden to ensure that the contractor makes the best possible effort to achieve the desired results within specified level of effort.

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3. Consider if one of the cost-reimbursement contracts is appropriate for the requirement.	FAR 16.3 Cost-reimbursement contracts.	In a cost-reimbursement contract, the contractor agrees to expend its best efforts to achieve the specified requirement, within the estimated amount established in the contract. If the contract is not fully performed at the time the contractor expends the funds, the contractor has no obligation for further performance, unless the contract is modified to increase the funds. Cost-reimbursement contracts typically are very costly to administer. Use cost-reimbursement contracts only when: • Circumstances do not allow the agency to define its requirements sufficiently; and • The uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract.
3a. Determine if a cost-sharing contract is appropriate for the requirement.	FAR 16.303 Cost-sharing contracts [cost-reimbursement contracts].	A cost-sharing contract is a cost-reimbursement contract in which the contractor receives no fee and is reimbursed only for an agreed-upon portion of its allowable costs. Little or no upfront funding is required of the agency. A cost-sharing contract may be used when the contractor agrees to absorb a portion of the costs, in the expectation of substantial compensating benefits. This contract type is typically used for IT improvements, to recover bad debts, and for facility improvements. A few major constraints of this contract type are: • The contract must have measurable, clear goals; • There is significant administrative monitoring required from technical personnel; and • The ceiling amount on the cost must be established at time of award.

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3b. Determine if a cost-plus-incentive-fee contract is the appropriate contract for the requirement.	FAR 16.304 Cost-plus-incentive-fee contracts [cost-reimbursement contracts]. FAR 16.405-1 Cost-plus-incentive-fee contracts [cost-reimbursement incentive contracts].	A cost-plus-incentive-fee contract is a cost-reimbursement contract that provides for the initially negotiated fee to be adjusted later by a formula. This contract type specifies a target cost, a target fee, minimum and maximum fees, and a fee adjustment formula. The fee adjustment formula provides for increases and decreases in the target fee, within limits. After contract performance, the fee payable to the contractor is determined using this formula. This increase or decrease provides incentive for the contractor to effectively manage the contract. Use this contract type when: • Fixed-price-incentive contract is not possible because of technical and cost uncertainties; • Performance objectives are known; and • Confidence in achieving objectives is high. This contract type is typically used with major system development and other development programs. A few major constraints of this contract type are: • The heavy burden on both the contracting and technical personnel to administer; and • Weight factors must be identified and applied to performance, delivery, and cost objectives.

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3c. Determine if a cost-plus-award-fee is the appropriate cost reimbursable contract for the requirement.	FAR 16.305 Cost-plus-award-fee contracts [cost-reimbursement contracts]. FAR 16.405-2 Cost-plus-award-fee contracts [cost-reimbursement incentive contracts].	A cost-plus-award-fee contract is a cost-reimbursement contract that provides for a fee consisting of a base amount fixed at inception of the contract, and an award amount that the contractor may earn in whole or in part during performance and that is sufficient to provide motivation for excellence in the areas of cost, schedule, and technical performance. The contractor's performance is measured against an award fee plan that contains evaluation criteria. Use this contract type when level of effort is known, mission feasibility is established but measurement of achievement must be subjective rather than objective. A few major constraints are: • The significant contract monitoring and administration required by the Government; and • The criteria for evaluating contractor performance and the achievable performance ranges must be included in the contract for the award fee to be earned.
3d. Determine if a cost-plus-fixed-fee is the appropriate cost reimbursable contract for the requirement.	FAR 16.306 Cost-plus-fixed-fee contracts [cost-reimbursement contracts].	A cost-plus-fixed-fee contract is a cost-reimbursement contract that provides payment to the contractor of a negotiated fee that is fixed at the inception of the contract. The fee is not changed unless there is a change in work or term of the contract. This contract type substantially reduces the risk to the contractor as it provides only minimal incentive to control costs. It is the least preferred contract type and should normally not be used in the development of major systems when there is a high probability that the development is achievable and the Government establishes reasonably firm performance objectives and schedules. A few major constraints are: • The contractor has minimal incentive to control costs; and • This contract type is very costly to administer.

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4. Consider if one of the indefinite-delivery contracts is appropriate for the requirement.	FAR Subpart 16.5 Indefinite-delivery contracts.	There are three types of indefinite-delivery contracts: definite-quantity contracts, requirements contracts, and indefinite-quantity contracts. The appropriate type of indefinite-delivery contract may be used to acquire supplies and/or services when the exact times and/or exact quantities of future deliveries are not known at the time of contract award. All three types permit: • Government stocks to be maintained at minimum levels; and • Direct shipment to users. Indefinite-quantity contracts and requirements contracts also permit: • Flexibility in both quantities and delivery scheduling; and • Ordering of supplies or services after requirements materialize. Indefinite-quantity contracts limit the Government's obligation to the minimum quantity specified in the contract. Requirements contracts may permit faster deliveries when production lead time is involved, because contractors are usually willing to maintain limited stocks when the Government will obtain all of its actual purchase requirements from the contractor.
4a. Determine if a definite-quantity contract is appropriate for the requirement.	FAR 16.502 Definite-quantity contracts [indefinite-delivery contracts].	A definite-quantity contract is a type of indefinite-delivery contract that provides for the delivery of a definite quantity of specific supplies or services at fixed prices for a fixed period, with deliveries or performance to be scheduled at designated locations upon order. Use this contract type when it can be determined in advance that: • A definite quantity of supplies or services will be required during the contract period; and • The supplies or services are regularly available or will be available after a short lead time.

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4b. Determine if an indefinite-quantity contract is appropriate for the requirement.	FAR 16.504 Indefinite-quantity contracts [indefinite-delivery contracts].	An indefinite-quantity contract is a type of indefinite-delivery contract that provides for an indefinite quantity, within stated limits, of supplies or services during a fixed period. Quantity limits may be stated as number or units or as dollar values. The contract must require the Government to order and the contractor to furnish at least a stated minimum quantity of supplies or services. Any additional quantities ordered must not exceed the stated maximum. Use this contract type when: • The Government cannot predetermine, above a specified minimum, the precise quantities of supplies or services it will require during the contract period; • It is inadvisable for the Government to commit to more than a minimum quantity; and • A recurring need is anticipated. One major constraint of this contract type is the terms and provisions of an agreement may be changed only by modification of the agreement and not by a contract incorporating the agreement.
4c. Consider whether a requirements contract is appropriate for the requirement.	FAR 16.503 Requirements contracts [indefinite-delivery contracts].	A requirements contract is a type of indefinite-delivery contract that provides for filling all actual purchase requirements of designated Government activities for supplies or services during a specified contract period from one contractor, with deliveries or performance to be scheduled by placing orders with the contractor. A requirements contract must state a realistic estimated total quantity for each item. However, the Government is not obligated to order this estimated quantity. Use this contract type when a recurring need of specific supplies or services is anticipated but the precise quantities needed cannot be predetermined. One major constraint of this contract type is that calculated savings may be inaccurate because of uncertainty of costs factored into the contractor's price.

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5a. Consider whether a time-and-materials (T&M) contract is appropriate for the requirement.	FAR 16.601 Time-and-materials contracts.	A T&M contract is not a fixed-price contract. This contract type requires a price ceiling that the contractor may not exceed except at its own risk. It provides for acquiring supplies or services typically on the basis of: • Director labor hours at specified fixed hourly rates that include wages, overhead, general and administrative expenses, and profit; and • Actual cost for materials. Use this contract type only when no other contract type is suitable and it is possible to estimate labor rates, including overhead and profit, but not the number of hours or material required to complete the contract. Two major constraints of this contract type are: • The heavy burden on technical personnel to perform surveillance to avoid inefficiency; and • The absence of a profit incentive for the contractor to control costs.
5b. Consider whether a labor-hour contract is appropriate for the requirement.	FAR 16.602 Labor-hour contracts.	A labor- hour contract is a variation of a T&M contract. It requires a price ceiling, which the contractor may not exceed except at its own risk. Use this contract type instead of T&M contract when no materials are required and only when no other contract type is suitable. A few major constraints of this contract type are; • The heavy burden on technical personnel to perform surveillance to avoid inefficiency; and • The absence of a profit incentive for the contractor to control costs.
6. Document the rationale for the contract type selection.	FAR 16.103(d) Negotiating contract type.	Prepare all required documentation, including any necessary determination and findings.