EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
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THE DIRECTOR

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M-21-11

MEMORANDUM TO THE HEADS OF EXECUTIVE DEPARTMENTS AND AGENCIES

FROM: Russell T. Vought
Director

SUBJECT: Increasing Attention on Federal Contract Type Decisions

This memorandum reminds agencies of the importance of being vigilant in their consideration of contract type, especially when considering cost-reimbursement contracts for mission support outside of research and certain development work. Cost-reimbursement contracts require only that the contractor provide its best efforts to deliver the service or product at the negotiated price. They do not require delivery of a finished product or service without any price adjustments, as is required under a fixed-price contract. While there is a legitimate role for cost-reimbursement contracts in supporting research, early development, and development in a non-commercial, non-competitive environment, the significant annual contract spend through this contract type, <u>especially for work outside of these situations</u>, suggests a need for greater management attention. By managing contract types effectively, agencies have better leverage to ensure timely, efficient, and cost-effective completion of contractor work supporting critical and high priority goals.

Background

The selection of contract type is an important decision. Contract type establishes the relative levels of risk the taxpayer and contractor are assuming. It establishes the level of risk the government is willing to assume when the contract is signed, including whether the government is entitled to a finished product or service for a fixed-price or just the contractor's best efforts subject to a cost ceiling. Consistent with long-standing policy, competitively awarded fixed-price contracts are preferred for minimizing risk and maximizing value for the taxpayer because they provide the contractor with the greatest incentive for efficient and effective performance while minimizing the administrative burden on both parties.[1]

Law and regulation prohibit the use of cost-type contracts for the acquisition of commercial products and services.[2] The Federal Acquisition Regulation (FAR) further restricts

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[1] Office of Management and Budget, Capital Programming Guide (CPG), Version 3.1, § I.5.5.2 ("The agency should strive to use fixed price or fixed price incentive contracts to the maximum extent possible.")
[2] FAR 12.207.

the use of cost-type and time and material/labor hour contracts to circumstances where requirements are not clear enough to allow for a fixed-price contract or uncertainties regarding the requirements or performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract.[3] Such circumstances might include situations where there is considerable uncertainty about the resources that will be necessary to achieve the government's objective, thus making it difficult to negotiate an affordable fixed price (e.g., research in advanced technology applications, leading edge innovation, or early conceptual work on a complex project).

Agencies may select from a variety of fixed-price and cost-type contracts that reflect differing degrees of risk sharing between the government and contractor.[4] This allows agencies to select the best contract structure and incentive based on the nature of the desired program outcomes and other factors.[5] See the Attachment for common types of fixed-price and cost-reimbursement contracts.

The government's ability to rely on fixed-price contracts is dependent, in large part, on a series of decisions that occur prior to the selection of contract type. These decisions, in many cases, are made by an integrated team of program, budget, acquisition, information technology, and other personnel who give shape to the agency's strategic goals, programs, and projects, and to procurements during requirements development and market research.[6] Their actions are subject to several policies and practices designed to mitigate the need for, or duration of, cost-reimbursement contracts and shift more risk to the contractor. These policies and practices include:

(i) relying on commercial solutions when they are available to meet the agency's requirements;[7]
(ii) breaking work into smaller pieces, or modules, with more clearly defined deliverables and more predictable pricing;[8]
(iii) satisfying requirements through the use of more mature technologies;[9]

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[3] FAR 16.301-2

[4] T&M contracts are also available for consideration. T&M contracts are considered to be high risk because the contractor is paid a fixed loaded labor rate for the number of hours worked plus actual material costs incurred, so there is little incentive to control cost. However, if fixed-price contracts are not suitable, a T&M contract may increase competition by encouraging participation by more small businesses and non-traditional government contractors who can bring innovation into the federal marketplace but are unable or unwilling to invest in the systems required to perform work under a cost-reimbursement contract. T&M contracts can be useful for research studies, open and inspect type repair efforts and investigative efforts which cannot be predicted with certainty.

[5] See FAR Subparts 16.2 and 16.3.

[6] To support development of requirements and desired outcomes that are affordable and reflect the needs of all key stakeholders, some agencies use tools like the acquisition requirements roadmap tool (ARRT), available at https://www.dau.edu/tools/Documents/SAM/resources/ARRT_Home.html, that guide structured planning and integrated analysis of needs, train individuals to facilitate cross-functional dialogues, or stand up liaison units within their management divisions to improve the flow of information between acquisition, program, budget, and other offices. In addition to ensuring a fuller consideration of risks, these helpful actions promote efficiency by lessening the need for time-consuming rework of requirements and promote a more frictionless acquisition environment.

[7] FAR 12.101.

[8] Capital Programming Guide, note 1, at § I.5 (Choosing the Best Capital Asset), FAR 39.103.

[9] See note 8.

(iv) using cost histories from prior contract performance to negotiate a fixed price for future work;[10] and

(v) watching market activities and trends to determine where contractors may be willing to accept greater levels of risk to innovate.[11]

For example, the Navy's decision to rely on mature technologies by using a modified version of an existing ship design has been cited as a contributing factor in its ability to award a fixed-price incentive contract for the detailed design and construction of the lead ship for its *Constellation*-class Guided Missile Frigate Program rather than using a cost-type contract for lead ship construction, as has been done in other circumstances.

Management actions

To strengthen agency attention to consideration of contract type and contract risk reduction strategies, agencies are asked to take the following steps:

a. <u>Document contract type rationales in business cases</u>. When developing business cases required by OMB Circular A-11 for capital investments contemplating the use of cost-reimbursement contracts, agencies should document the rationale for why other contract types are not suitable and the steps planned for migrating to more balance risk-sharing during the life of the acquisition.[12] Agencies should be prepared to consult with their Resource Management Offices prior to making a final determination to use cost-reimbursement contracts to support agency priority goals other than for requirements involving research, early development, and development in a non-commercial, non-competitive environment. OMB will work with agencies on appropriate revisions to Circular A-11 to support this consultation process, including tracking the ratio of cost to fixed-price work for these acquisitions.

b. <u>Review and clarify policies</u>. As part of their internal management reviews, agencies should look for opportunities to strengthen or to clarify agency policies that support reduction of risk in association with contract type decisions. This includes internal investment review processes, program and budget planning, and acquisition planning and execution. Agencies are also encouraged to work with Office of Federal Procurement Policy (OFPP) and their OMB Resource Management Office in identifying government-wide policies and processes for review including, but not limited to, relevant policies in the Capital Programming Guide, other parts of Circular A-11 and the FAR.

As one step, OFPP will evaluate, in consultation with the Federal Acquisition Regulatory Council, how best to encourage greater consideration and use of hybrid contracts that allow for work to go from cost-type to fixed-price as cost histories are established that allow for greater stability in requirements.[13] A number of agencies have found success with this practice. For

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[10] See discussion on hybrid contracts under paragraph c.

[11] By carefully watching market signals and industry willingness to share in risk with the Federal Government in order to tap into revenue streams associated with space transport, the National Aeronautics and Space Administration was able to successfully award a fixed-price contract for human space flight.

[12] Business cases are required by A-11 for IT (see Part 55.6), and non-IT (see 25.5, Table 1).

[13] FAR 16.104(e) currently recognizes the practice of combining contract types ("If the entire contract cannot be firm-fixed-price, the contracting officer shall consider whether or not a portion of the contract can be established on a firm-fixed-price basis.")

example, the Department of Commerce's (DOC) use of hybrid contracting over a 10-year period has contributed to its ability to reduce its reliance on high-risk contracts substantially.[14] Under its "end state" contracting initiative, the Department of Energy's Environmental Management Office has moved away from long-term cost-plus award fee contracts that have not created sufficient incentives for contractors to complete critical environmental clean-up projects. The end state model instead uses a form of hybrid contracting where a contractor is awarded a task order contract so work can be broken into manageable chunks and priced according to risk with incentives for getting work completed, which may include firm-fixed-priced tasks for projects with well-defined requirements.

c. Support exploration of tools to assist agency program, budget, and acquisition officials in making decisions on contract type. The President's Management Agenda includes Cross Agency Priority (CAP) Goals designed to leverage data as an asset, modernize technology, and shift to higher value work. Agencies are encouraged to use these processes to support better knowledge management for planning activities, including knowledge management that can help agencies compare their strategies to those of other agencies with similar program goals that may have successfully used lower risk contract types to support their mission outcomes.

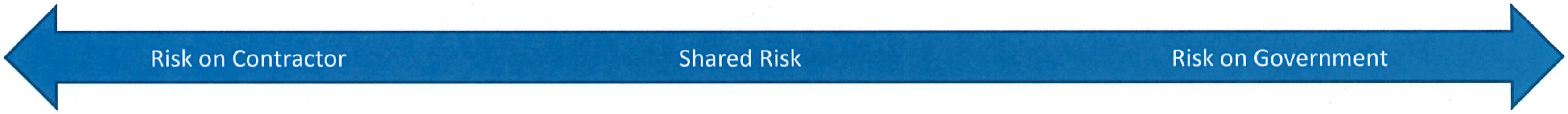
Questions regarding this memorandum may be directed to Mathew Blum, Associate Administrator for Federal Procurement Policy (Mathew_c._blum@omb.eop.gov).

Attachment

[14] DOC has initiated steps to stand up an acquisition program management innovation lab to promote and coach its workforce and collaborate with agencies on strategies that can reduce high-risk cost-reimbursement contracting and support smart program management. When its lab becomes operational, agencies will be able to consult with DOC on its use of hybrid and other related strategies for contract risk reduction

Attachment

Contract Type & Risk Distribution



	Firm-Fixed Price	Fixed-Price with Economic Price Adjustment	Fixed-Price Incentive Fee	Cost Plus Incentive Fee	Cost Plus Award Fee	Cost Plus Fixed Fee
Key features	• Contractor must produce finished product or service • Generally less regulated • Generally well suited for work with commercial contractors			• Contractor must provide best efforts towards provision of a product or service • More regulated, barrier to entry for small businesses • Well suited for large-scale research & early development efforts		
Adjustments to Government Share of Risk	Negotiated price is firm & unaffected by contractor's cost experience	Revisions in price are made based on actual or indices of costs for labor and material	Total payment subject to price ceiling but final amount varies based on target cost and adjusted based on share line establishing how cost overruns/underruns are shared between the government and contractor (e.g., 50/50)	Total payment includes allowable costs plus fee based on objective formula measuring contractor's achievement of cost, schedule, or technical goals.	Contractor reimbursed for allowable costs plus partially variable fee based on subjective assessment of factors such as contractor responsiveness & technical ingenuity	*No adjustment*. Contractor reimbursed for allowable cost plus a negotiated fee that doesn't change based on contractor's cost experience or other performance metrics.

Recommended Use	Commercial supplies & services or development of major systems in areas with commercial interest and/or competition.	Long-term supply contracts during period of inflation or uncertainty	Production of a major system based on a prototype where there is no competition.	R&D of the prototype for a major system if there is no commercial interest and a lack of competition.	Large scale research studies or when performance targets cannot be identified at the outset of the contract	Research studies