SECTION 3 – Types of Contracts

SECTION 3

TYPES OF CONTRACTS

3.1 Introduction

This manual addresses contracts that fall into two broad categories: Non-Cost-Related and Cost-Related. The appropriate fiscal or contracting office will determine whether a prospective service would be more appropriately handled through a non-cost-related or cost-related contract. However, the Department encourages non-cost-related contracting wherever possible. The following is a discussion of these two types of contracts, their characteristics, situations in which one or the other is more appropriately used, and some advantages and disadvantages of each.

3.2 Non-Cost-Related Contracts

Non-Cost-Related contracting is the preferred method of contracting. It offers the maximum incentive for the provider to perform efficiently, it contains fewer administrative requirements for the provider and fewer corresponding administrative tasks for the Department, and it provides for certainty of the cost for the service purchased. This method should be used wherever the Department's prior experience with the provider is such that there is reasonable assurance that: (1) the provider agency can deliver the quantity and quality of service specified in the contract; and (2) the provider agency is fiscally sound. In addition, it can be used when the Department is not a primary user of the service purchased and sufficient competition exists to encourage the provider to maintain reasonable prices, or when a rate for the contracted service has been set by the Department.

In non-cost-related contracts the value of the contract is determined by price analysis. Price analysis is an evaluation of data (without analysis of the separate cost components) to arrive at an amount to be paid for contract services. Under this type of contract, the price is fixed regardless of the provider agency's actual costs of performing the work of the contract. Price analysis should include an evaluation of amounts charged by other providers for services substantially identical to those being purchased. This information is used to determine the reasonableness of the proposed per unit or aggregate price for contract services.

<u>Determining Contract Value</u>

A contract budget is not required for price analysis and the determination of contract value is frequently based on such indicators as past experience with the provider agency or the "going price" for the services in question. An established price for services is generally acceptable provided that:

1. The provider sells the <u>same</u> service in substantial quantities to the general public or other users;

2. The price does not exceed that charged to the provider's most favored customer (including a division, subsidiary, or affiliate of the provider under common control) for a like quantity of the same services under comparable circumstances; and

3. The price does not exceed the prevailing charges in the locality for comparable services under comparable circumstances.

Certain situations may necessitate adjustments in the price usually charged by the provider agency. As examples, additional/special services required by the Department may increase the price above normal; usual service elements that are omitted for Department clients may lower the price; or the relative quantity of the services purchased under the contract in comparison to the amounts purchased by other users may have a downward or upward effect on the usual price. In addition, provider agency financial participation in the value of the contract may be required by the Department under certain circumstances, such as Social Services Block Grant service contracts, or when the Department's payment or negotiated rate is less than the provider agency's established price for the service delivered. (Refer to Section 4.2, pages 3 and 4 for a detailed description of provider agency cost sharing.)

Contracting Requirements

The Department's acceptance of a fixed price is predicated on the following:

1. The provider agency must possess sufficient documentation, in the form of work paper files, to demonstrate that the price charged for contract services was developed in accordance with sound fiscal management practices and applicable federal and State rules and regulations.

2. The provider's most current published financial statements must indicate adequate capability to provide the services.

3. The Department may have other specific criteria relating to the level of Departmental participation and the provider agency's total activities, dollar volume, and/or number of clients served.

Payment Methodologies

Non-cost-related contracts are always fixed price contracts inasmuch as a permanent price is established either for each eligible unit of service or for aggregate contract services. Payment methodologies used for non-cost-related contracts are the same as those used for cost-related fixed price contracts:

1. Fixed Rate

   The fixed rate method of payment is appropriate for contracts with an agreed upon ceiling or for "open purchase" contracts when the total number of service units to be purchased under the contract is indeterminate. The rate is usually established in the price analysis process discussed above and is paid to the provider agency for every eligible unit of service delivered during the contract term and billed to the Department at the intervals specified in the contract.

2. Installment Payments

   Installment payments, unlike fixed rate, may be used only for contracts in which a fixed amount is established for aggregate contract services. This ceiling amount is generally prorated over the number of desired payment intervals in the contract term to determine the installment payment amount.

For-Profit Contracts

While a for-profit provider agency may make a profit on a non-cost-related contract, it is not allowable to add a profit factor to the "going price" for a service. Profit may only be earned when the provider's charge, including profit, for the service is no more than the reasonable "going price" determined through price analysis. A separate accounting of profit or actual cost is not necessary.

3.3 Cost-Related Contracts

In Cost-Related Contracts the value of the contract is determined by an analysis of projected contract costs as reflected in a detailed budget. This is known as a "cost analysis" process. Cost analysis is generally performed when: (1) the Department has little or no experience in contracting with a particular provider agency or for the particular service; and/or (2) the Department is a primary or only user of this service, and the resultant lack of competition makes a valid price analysis impossible. Cost analysis involves the evaluation of cost information in order to estimate contract costs to be incurred and reimbursed or prices to be paid. The information evaluated in the cost analysis process includes data concerning the cost of labor, materials, indirect costs and other cost components expected to be incurred by the provider agency in delivering contract services.

Determining Contract Value

Cost analysis and the determination of contract value (i.e., the total amount payable to the provider agency for aggregate contract services and/or per unit of service) are performed by the appropriate Departmental fiscal or contract office. This is done to ensure that the value established is reasonable and allocable to the service purchased under the contract.

Contracting Requirements

Cost analysis procedures require that the provider agency complete and submit to the Department an Annex B: Contract Budget, and all supporting schedules. The information furnished must comply with the principles for determining cost contained in this manual, and the amount charged for the contract services may not exceed the provider’s customary charges for the same services.

All cost data furnished to the Department in the annexes and supporting schedules must be based on: (1) the provider agency's financial and statistical records; and (2) an approved method of cost finding. All cost data must be accurate, sufficiently detailed, and capable of verification by qualified independent auditors. These requirements are consistent with good business concepts and with the effective, efficient management of any organization, whether operated for-profit or on a non-profit basis.

In order to ensure comparability, provider agency financial and statistical records should be maintained, to the maximum extent feasible, in a consistent manner from one period to another. This does not preclude, however, reasonable changes in accounting procedures made to improve the provider's system or to accommodate changing circumstances and needs.

Payment Methodologies

Subsequent to determining the value of a cost-related contract, it is the responsibility of the appropriate Departmental fiscal or contracting office to select the most suitable method of paying the provider for contract services.

This section addresses several approaches to contract payment for cost-related contracts. It does not contain detailed information (e.g., timing requirements, specific forms to be used, where reports are to be sent) regarding the payment process. This information is contained in the contract annexes and/or attachments.

It should be stressed that while the methods discussed here are the most common, other methods do exist and may be used when judged to be more appropriate.

Payment in cost-related contracts may take the form of: (1) payment of a fixed price, agreed to prior to contract execution, either for each unit of service delivered or for aggregate contract services; or (2) reimbursement for actual costs incurred in the delivery of services. Generally, fixed price contracts are preferred when the Department has adequate experience with the provider agency to have confidence in both the reasonableness of the contract price and the fiscal and administrative condition of the provider agency. Conversely, cost-reimbursement contracts are appropriate when the Department has little or no experience in contracting with the particular provider agency for the particular service.

The common payment methodologies applicable to fixed price and cost reimbursement situations are described below. Regardless of the methodology employed, contract expenditure reports are generally required and must be submitted to the Department on Department-approved forms and in accordance with contract specifications. Additionally, all payments made are subject to revision on the basis of audit findings.

1. Fixed Price

   A fixed price is a permanent price - either per unit of service delivered at a fixed rate or for aggregate contract services - which is negotiated and agreed to for a specific future period, generally for the term of the contract. Fixed prices for cost-related contracts are established when there is reasonable certainty on the part of the Department, normally based on past experience, that: (1) a reliable projection of a provider agency's future level of activity can be made; and (2) the price agreed to will be equal to or less than the provider agency's actual cost. Although fixed price contracts, like all others, are subject to audit, it is only in very unusual circumstances that a price adjustment is made either during or after the contract term. In fixed price contracts, the primary purpose of the audit is not to determine actual costs incurred for reimbursement purposes but to verify the accuracy and completeness of the data used to determine the contract value.

   Fixed price contracts are generally paid in one of the two following ways:

   a. Fixed Rate

      For cost-related contracts, the agreed-upon rate is paid to the provider agency for every eligible unit of service which is delivered during the contract term and billed to the Department at the intervals specified in the contract, not to exceed the reimbursable ceiling.

b. Installment Payments

For cost-related contracts, installment payments are generally computed by prorating the reimbursable ceiling over the number of desired payment intervals in the contract term.

2. Cost-Reimbursement

Cost-reimbursement contracts are generally paid in one of the three ways enumerated below. In all cases, the maximum amount payable is the lower of (1) total allowable reported expenditures or (2) the Reimbursable Ceiling specified in the Annex B: Contract Budget.

a. Provisional Rate/Final Rate

A provisional rate is calculated by dividing the reimbursable ceiling by the Budgeted Units of Service. The rate so determined is paid to the provider agency for every eligible unit of service delivered during the contract term and billed to the Department at the intervals specified in the contract.

Payments made by means of a provisional rate are subject to downward-only adjustments on the basis of a final rate. The final rate is calculated in the same manner as the provisional rate but the figures used are derived from the final expenditure report rather than from the Annex B: Contract Budget.

A refund is due the Department when the final rate is lower than the provisional rate. The amount of the Department's overpayment to the provider agency is calculated by multiplying the difference between the provisional and final rates by the number of service units paid at the provisional rate. If the final rate equals or exceeds the provisional rate, no adjustment or further action takes place. No additional reimbursement to the provider can result from the establishment of a final rate**.** The only possibility for an upward adjustment in the rate of payment is by means of a formal contract modification during the contract term. Refer to Department Policy P1.10, Contract Modification.

The provisional rate/final methodology is generally chosen rather than a fixed rate when lack of adequate prior experience with the provider agency and/or the particular service makes it difficult to project levels of service and expenditures.

b. Installment Payments with Adjustments

When used in cost-reimbursement contracts, installment payments are initially calculated by prorating the contract's reimbursable ceiling over the number of desired payment intervals (e.g., months, quarters) in the contract term. In such cases, interim expenditure reporting should be no less frequent than quarterly, and adjustments are made during the contract term to reconcile payments to reported expenditures. A final adjustment may also be needed to reconcile payments to the final expenditure report.

c. Periodic Payment of Reported Expenditures

Providers may be reimbursed at intervals - usually monthly or quarterly - for allowable contract expenditures incurred and reported to the Department.

For-Profit Contracts

Any profit included in a cost-related contract must be a fixed amount which, when added to any budgeted amount for interest applicable to depreciable capital assets, may not exceed 10% of the contract net cost. Any amount to be included for profit must be a fixed amount, agreed to prior to contract execution, and added to the net cost to determine the contract's reimbursable ceiling. Payment of profit is allowable only in the case of for-profit provider agencies. "Cost-plus-a-percentage-of-cost" is not a permissible type of contract. Such an arrangement allows an agency to add a profit margin based on a percentage of actual contract costs incurred and thereby provides no incentive to keep expenditures to the minimum necessary level. As a general rule, the amount negotiated for profit is only subject to adjustment (upward or downward) when a change in the contract's net cost is major enough to alter the profit ratio sufficiently.

The following factors should be considered when determining the amount of profit appropriate for a particular contract:

1. Record of Performance

   The Department's appraisal of a provider agency's past contract performance should at a minimum consider programmatic quality, management capabilities, cost efficiency, reliability of cost estimates, and timeliness and accuracy of required reporting.

2. Difficulty of Contract Task

   Greater reward should go to a provider agency undertaking more difficult work requiring a higher skill level.

3. Programmatic and Financial Data

   Various data and information contained in pre-award accounting and programmatic surveys, audit reports, and provider agency financial statements may be important in determining the appropriate profit amount.

4. Degree of Risk

   A provider agency that takes calculated cost risks in an effort to minimize contract costs should be rewarded in the profit determination process.

Table
SUMMARY OF CONTRACT TYPES

TYPE OF CONTRACT:	NON-COST-RELATED	COST-RELATED	
	FIXED PRICE	COST-REIMBURSEMENT	FIXED PRICE
METHOD OF DETERMINING CONTRACT VALUE:	PRICE ANALYSIS	COST ANALYSIS	
BUDGET:	NOT REQUIRED	REQUIRED	
EXPENDITURE REPORT(S):	NOT REQUIRED*	REQUIRED*	
		Cost-Reimbursement Contracts	Fixed Price Contracts
PAYMENT METHODOLOGY:**	Same as cost related Fixed price contracts	1. Period payment of Reported expenditures 2. Installment payments with adjustment(s) based on reported expenditures 3. Provisional rate paid per unit of service delivered; any appropriate downward adjustment made using final rate based on reported expenditures	1. Fixed rate paid per unit of service delivered 2. Installment payments

* Exceptions may exist in certain circumstances.
** While other methodologies exist, these are most common.
Note: For-Profit Contracts may be either Non-Related or Cost-Related.