



ACQUISITION LETTER

This Acquisition Letter is issued under the authority of the DOE and NNSA Procurement Executives.

Subject: Management Reserve and Contingency

References: FAR Subpart 15.4
FAR Part 31
FAR 31.205-7
DEAR 915.404-4-70-2
DOE Order 413.3A
DOE Acquisition Guide
Chapter 15.4-2
Contract Pricing
Contract Cost Principles and Procedures
Contingencies
Weighted Guidelines System
Program and Project Management for
the Acquisition of Capital Assets
Weighted Guidelines

When is this Acquisition Letter (AL) effective?

This AL is effective upon issuance.

When does this AL Expire?

This AL remains in effect until superseded or canceled.

Whom do you Contact for More Information?

For Department of Energy (DOE) contracts, contact Michael Righi, Office of Procurement and Assistance Policy, MA-61, at (202) 287-1337 or at Michael.Righi@hq.doe.gov. For National Nuclear Security Administration (NNSA) contracts, contact Mr. Stephen Law, Office of Acquisition and Supply Management, NA-63, at (202) 586-4321 or at Stephen.Law@nnsa.doe.gov.

What is the Purpose of this AL?

The purpose of this AL is to provide contract cost/pricing guidance for pre-award and contract administration actions to contracting officers on the distinctions between the Federal Acquisition Regulation (FAR) term “contingency” and the program/project management terms “management reserve” and “contingency.” In addition, this AL addresses the profit/fee as it relates to FAR contingency.

What is the Background Information You Need to Know?

- I. Definitions
 - a. DOE Order 413.3A (July 28, 2006) defines management reserve and contingency as follows:
 - i. Management Reserve: “An amount of the total contract budget withheld for management control purposes by the contractor. Management Reserve is not part of the Performance Measurement Baseline.”

- ii. Contingency: “Contingency is the portion of the project budget that is available for risk uncertainty within the project scope, but outside the scope of the contract. Contingency is budget that is not placed on the contract, and is included in the Total Project Cost.”
- b. FAR 31.205-7(a) defines contingency as follows:
 - i. Contingency: as used in this subpart, means a possible future event or condition arising from presently known or unknown causes, the outcome of which is indeterminable at the present time.
 - ii. The FAR does not have a definition for “management reserve” nor does it define contingency the same way as DOE Order 413.3.

II. The DOE 413 Series Of Directives

- a. The DOE 413 series of directives, consistent with applicable Office of Management and Budget circulars and industry standards such as ANSI/EIA-748-A, identifies the term “management reserve” as a project management tool. As such, management reserve is calculated by the contractor after the Government and the contractor have agreed to the contract price to facilitate project management discipline. Often a contractor will initially calculate the amount of management reserve by considering the potential cost impact of uncertain events, i.e., risks that may be realized during contract/project performance and that, once realized, will affect the cost to perform the contract requirement. Examples of this practice would be the recent price volatility in construction materials such as steel and concrete or less than anticipated productivity. Depending on its analysis of risk, the contractor may decide to hold back a certain amount of funding from its construction cost centers in order to cover the uncertainty of performance or overruns.
- b. Similarly, the DOE 413 series of directives defines “contingency” as a Federal budgetary construct and addresses another category of uncertain, potential project performance cost to facilitate DOE budgetary management purposes but is outside the costed scope of the contract. Therefore, contingency is developed for budget purposes only. DOE Order 413.3 contingency is the federally withheld amount used to fund requests for equitable adjustments with entitlement and changes under all contracts and contractor overruns on cost reimbursable contracts.
- c. These two terms are established in the DOE 413 series of directives for capital asset program/project management and budget identification purposes. As such, they do not apply to the contracting officer’s pre-award position of contract (and modification) pricing and award.

III. FAR 31.205-7 Contingencies.

- a. FAR Part 31 provides guidance to contracting officers regarding treatment of various types and categories of cost, including costs for “contingencies” as defined at FAR 31.205-7. FAR 31.205-7(c) states that in connection with estimates of future costs, contingencies fall into two categories:
 - i. Those that may arise from presently known and existing conditions, the

effects of which are foreseeable within reasonable limits of accuracy, e.g., anticipated costs of rejects and defective work. Contingencies of this category are to be included in the estimates of future cost so as to provide the best estimate of performance cost. (FAR 31.205-7(c)(1))

- ii. Those that may arise from presently known and unknown conditions, the effect of which cannot be measured so precisely as to provide equitable results to the contractor and to the Government. Contingencies of this category are to be excluded from cost estimates under the several items of cost, but should be disclosed separately (including the basis upon which the contingency is computed) to facilitate the negotiation of appropriate contractual coverage. FAR cites as examples severance pay, insurance and indemnification, and maintenance and repair costs. (FAR 31.205-7(c)(2))

- b. Thus, in the case of FAR 31.205-7(c)(1), when the underlying sources and causes of performance uncertainty are known and the most likely cost effects of such uncertain events/conditions can be projected within reasonable limits of accuracy, they should be included in the contracting officer's estimate of fair and reasonable cost. Another example of this practice, in addition to the one cited in section (a)(i) above, would be direct labor/material escalation in accordance with standard estimating procedures. Normal escalation costs can be reasonably and accurately projected and therefore meet the definition of an allowable contingency cost which is priced into the applicable cost element.
- c. For a proposed contingency cost (as with any proposed cost), the contractor has the burden of proof in demonstrating its proposed cost is reasonable, which includes demonstrating the reasonableness of any estimating method. Contracting officers should categorically reject any proposed cost or estimating technique that the contractor does not prove is reasonable and should give no credence to any estimating technique--regardless of its sophistication, complexity, or former use--that is not fully explained, reasonable, and appropriate to the circumstances of the acquisition.
- d. The FAR 31.205-7(c)(1) allowable contingency is limited to presently known and existing conditions whose effects are foreseeable within reasonable limits of accuracy and should be interpreted very narrowly and as part of a discrete cost element that can be accurately priced as discussed above. FAR 31.205-7(c)(1) does not provide for contingency to be priced as a separate element of cost or cost objective.
- e. Contingency that is not covered under FAR 31.205-7(c)(1) is covered by FAR 31.205-7(c)(2). FAR 31.205-7(c)(2) contingency should not be priced into the contracting officer's fair and reasonable estimate of contract cost either as part of a cost element such as direct labor or material or as a separate contingency cost element. FAR 31.205-7(c)(2) provides that the contracting officer may provide contractual coverage of contractor specifically identified contingencies. For instance, in a period of economic uncertainty, the contracting officer might decide that it is not practical to estimate a fair and reasonable material escalation factor. In this case, FAR 31.205-7(c)(2) would allow the contracting officer to exclude

any amount for material escalation in the negotiated contract price and to include an economic price adjustment clause in the contract. This is separate from the determination of the appropriate fee. DOE's Weighted Guidelines System includes seven "Profit Factors" contracting officers must use in determining profit objectives. See the discussion below.

IV. Profit/Fee

- a. In the Department of Energy there are often a number of uncertainties inherent in the type of work the Department asks contractors to perform. Examples are the type and extent of contamination, the quantity of soil or groundwater requiring remediation, changes in the regulatory environment, availability of waste disposal sites, etc. Contingencies for these types of uncertainties, however, should not be priced into contract actions to the extent that such contingencies are addressed by the terms and conditions of the contract (for example, the Changes clause and the Differing Site Conditions clause) that provide the proper basis for providing contractual relief to the contractor or a credit to the Government. In addition, contracting officers should not include in the contract price any management reserve, contingency, or other similar amount with or without profit/fee to cover any prospective requests for equitable adjustments, changes, or risks that might or might not occur during performance. If such events materialize, to the extent the contractor can establish entitlement, the contracting officer may negotiate appropriate adjustments to the contract price in accordance with the applicable contract clauses.
- b. There is always a certain amount of risk in the performance of any contract. A large part of the sharing of these risks between the contractor and the Government is normally established by the contract type. Regardless of the contract type, the contractor always assumes a certain amount of risk in contract performance. The contractor assumption of normal risk is recognized in the profit/fee that the Government pays the contractor. Thus the contracting officer should not attempt to provide contractual coverage for all contingencies that a contractor may identify. When using DOE's Weighted Guidelines System (Department of Energy Acquisition Regulation (DEAR) 915.404-4-70-2(d)) in establishing the appropriate profit/fee, the contracting officer is directed to provide for the recognition of contract risk. The DEAR has established the range of 0 to 8% for contract risk. The DOE Acquisition Guide provides that the contract cost risk range for firm-fixed-price contracts for equipment and supplies to be 6 to 8%. This reflects the fact that the effect of any risk/contingency that is realized during contract performance will be the responsibility of the contractor unless the contractor is entitled to contractual relief under the Changes clause or similar provision of the contract. In the case of a cost-plus-fixed-fee contract, the DEAR Acquisition Guide provides for contract risk range of 0 to .5%. This reflects the fact that the effect of any risk/contingency that is realized during contract performance will be borne by the Government on a cost-reimbursable contract unless the cost is unallowable.

What is the Guidance contained in this AL?

Contracting officers shall not use either management reserve or contingency (as defined in the DOE 413 series of directives or similar project management concepts) in the pricing of contract actions, even if they have been validated as part of the project management process.

Contracting officers shall not, except as narrowly allowed by FAR 31.205-7(c)(1), price estimated costs for contingencies into DOE contract actions and shall not pay any fee to compensate for excluding such contingencies from the contract price.

Contracting officers shall not include in the contract price any amount (for management reserve, contingency, etc.) to cover prospective requests for equitable adjustments, changes, or risks that might or might not occur during performance.

Contracting officers shall not relieve the contractor of its responsibility to demonstrate that its proposed costs are reasonable and its estimating techniques are sound.

Contracting officers shall ensure that the contractor demonstrates that any proposed cost and estimating technique/system used to develop such proposed costs are reasonable, e.g., the proposed cost and estimating technique/system used are fully explained, reasonable, and appropriate to the circumstances of the acquisition.