OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

ACQUISITION,
TECHNOLOGY
AND LOGISTICS

OCT 20 2004

DPAP/P

MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY
(ACQUISITION, LOGISTICS AND TECHNOLOGY)
ASSISTANT SECRETARY OF THE NAVY
(RESEARCH, DEVELOPMENT AND ACQUISITION)
ASSISTANT SECRETARY OF THE AIR FORCE
(ACQUISITION)
DIRECTORS OF DEFENSE AGENCIES

SUBJECT: Utilities Privatization – Contract Pricing

The purpose of this memorandum is to provide instructions for contracting officers to apply in pricing contracts for privatization of utilities in accordance with the provisions at 10 U.S.C. § 2688, "Utility Systems, Conveyance Authority".

In an October 9, 2002, memorandum, the DEPSECDEF stated that utilities privatization is the preferred method for improving utility systems and services. Enclosure 1 to this memorandum provides instructions to Government personnel for pricing contracts under the utilities privatization program. Contracting Officers shall follow these instructions in pricing and negotiating utilities privatization contracts.

Some of the major sectors of the utilities industry have expressed concerns regarding the application of the Cost Accounting Standards and the provisions at FAR Part 31. On September 2, 2004, the Department was granted a waiver from the Cost Accounting Standards provided certain conditions are met. In addition, on October 14, 2004, my office granted a deviation from FAR Part 31 provided certain conditions are met. The FAR deviation and the CAS waiver are included as Attachments A and B to Enclosure 2, respectively.

The Head of the Contracting Agency shall report to this office, on a quarterly basis (beginning with the quarter ended December 31, 2004) any use of the FAR deviations and/or CAS waivers in accordance with the authority provided for in Attachments A and B of Enclosure 2. The report shall be submitted electronically to Mr. David Capitano at david.capitano@osd.mil. within 30 days of the end of the quarter and shall include, at a minimum, the following information:

1. Contract Number
2. Contractor Name
3. Date of Contract Award
4. Amount of the Contract Award

If you have any questions regarding this memorandum, please contact Mr. Capitano, Senior Procurement Analyst, at 703-847-7486.

Deidre A. Lee
Director, Defense Procurement
and Acquisition Policy

Enclosures:
As stated

Enclosure 1

Instructions for Pricing Utilities Privatization Contracts

A. Considerations in Selecting the Type of Contract:

The type of contract should be carefully selected in each contracting situation. The following describes several pricing methods provided for under FAR Part 16. It also discusses the applicability of the Cost Accounting Standards (CAS) and FAR Part 31 for each of these pricing methods. Note that other pricing methods than those listed herein are also available. When using these other methods, the Contracting Officer should review FAR Part 16 to determine whether the method is appropriate, and also review pertinent requirements to determine the applicability of CAS and FAR Part 31.

1. Firm Fixed Price (FFP):

Use:. FFP contracts are the preferred contracting method when the conditions described at FAR 16.202-2 exist. The term of this contract will generally be much shorter than the maximum allowable term of 50 years provided for utilities privatization contracts under 10 U.S.C. 2688(c)(3).

CAS Application: CAS normally applies to FFP contracts, unless one of the exemptions listed at 48 CFR 9903.201-1(b) exist. These exemptions include the one at 48 CFR 9903.201-1(b)(15), which exempts CAS for any FFP contract awarded on the basis of adequate price competition and without the submission of cost or pricing data. In addition, the CAS Board has granted a waiver for FFP contracts awarded under the utilities privatization program when certain conditions exist (see Attachment B of Enclosure 2).

FAR Part 31 Application: The provisions of FAR Part 31 do not apply to FFP contracts that are priced using price analysis. The provisions of FAR Part 31 normally do apply to FFP contracts that are priced on the basis of cost analysis. However, the Director, Defense Procurement and Acquisition Policy (DPAP) has granted a class deviation from many of the provisions of FAR Part 31 for FFP contracts awarded under the utilities privatization program, provided certain conditions are met (see Attachment A of Enclosure 2).

2. Fixed price with economic price adjustment (where the price adjustment is based on an index or established prices, not based on actual costs incurred) (FPEPA):

Use:. This contract type may be used when (i) the conditions in FAR 16.203-2 exist; (ii) the limitations in FAR 16.203-3 are met; and (iii) there is an established index or indices that can serve as a basis for adjusting the contract price.

CAS Application: CAS normally applies to FPEPA contracts, unless one of the exemptions listed at 48 CFR 9903.201-(b)(1) exists. However, the CAS Board has granted a waiver from CAS for FPEPA contracts awarded under the utilities privatization program, provided certain conditions exist (see Attachment B of Enclosure 2).

FAR Part 31 Application: The provisions of FAR Part 31 do not apply to FPEPA contracts when they are awarded on the basis of price analysis, rather than cost analysis. The provisions of FAR Part 31 normally do apply to FPEPA contracts when they are awarded on the basis of cost analysis. However, DPAP has granted a class deviation from many of the provisions of FAR Part 31 for FPEPA contracts awarded under the utilities privatization program, provided certain conditions are met (see Attachment A of Enclosure 2).

3. Fixed price with prospective price redetermination (where the price adjustment is based on actual costs incurred) (FPPPR):

Use:. This contract type may be used when the conditions described in FAR 16.205-2 exist and the limitations in FAR 16.205-3 are met.

CAS Application: CAS normally applies to FPPPR contracts, unless one of the exemptions listed at 48 CFR 9903.201-(b)(1) exists. However, the CAS Board has granted a waiver from CAS for FPPPR contracts awarded under the utilities privatization program, provided certain conditions exist (see Attachment B of Enclosure 2).

FAR Part 31 Application: The initial pricing of these contracts are not subject to FAR Part 31, provided that the contract price is determined on the basis of price analysis. The initial pricing of these contracts is subject to FAR Part 31 when the contract price is determined on the basis of cost analysis. The price redetermination is also subject to FAR Part 31, since it is determined on the basis of actual costs incurred (this is cost analysis). However, DPAP has granted a class deviation from many of the provisions of FAR Part 31 for FPEPA contracts awarded under the utilities privatization program, provided certain conditions are met (see Attachment A of Enclosure 2).

4. Cost reimbursable:

Use: This contract type may be used in those situations when the conditions descrbied in FAR 16.301-2 exist and the limitations in FAR 16.301-3 are met.

CAS Application: CAS applies to cost reimbursable contracts, unless one of the exemptions listed at 48 CFR 9903.201-(b)(1) exists. A waiver from CAS ***has not*** been granted for these types of contracts.

FAR Part 31 Application: FAR Part 31 applies to all cost reimbursable contracts. A deviation from FAR Part 31 ***has not*** been granted for these types of contracts.

B. Profit:

When negotiating utilities privatization contracts for which the price is determined based on cost analysis, FAR 15.404 requires that the Contracting Officer use a structured approach in determining profit. This structured approach shall utilize the weighted guidelines method, as required by DFARS 215.404-71 (this requires consideration of performance risk, contract type risk, facilities capital employed, and cost efficiency) in determining an appropriate profit amount.

C. Contract Management:

By their complex, long term nature, utilities privatization contracts require specialized expertise to effectively manage the contracts, control cost growth and ensure quality of contract performance. Procuring Contracting Officers (PCOs) must ensure that a plan for developing and maintaining the required contracting and technical expertise throughout the life of the acquisition is established and adequately supported. When the PCO utilizes another DoD component or government agency to provide that expertise, a Memorandum of Understanding should be developed to ensure the component or agency provides professional support over the long term.

Contracting Activities should provide written policies to guide members of the acquisition team to ensure issues can be effectively and consistently resolved. Training and briefings to the team should be provided to ensure knowledge transfer of the best business practices and consistent procedures within the DoD component. DoD components should also use the Utilities Privatization Working Group to encourage knowledge sharing among contracting activities involved in utilities privatization.

Contracting officers shall meet the following guidelines in procuring DoD utilities privatization contracts.

1. Issue an RFP package that is clear and complete.

2. Produce a technical data package that accurately reflects the system and provides data on the condition and past performance of the system.

3. Assure that the service performance standards expected for utility service are clear. The difference between local utility standards and the contract standard should also be identified.

4. Develop a quality assurance plan prior to contract award.

5. Develop an acquisition plan that includes post award contract administration and cost growth control.

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(RESEARCH, DEVELOPMENT AND ACQUISITION)
ASSISTANT SECRETARY OF THE AIR FORCE
(ACQUISITION)
DIRECTORS OF DEFENSE AGENCIES

SUBJECT: Utilities Privatization - Class Deviation from FAR Part 31

I hereby authorize a class deviation from FAR Part 31 for certain contracts awarded in conjunction with the conveyance of a utility system under 10 U.S.C. § 2688, "Utility Systems, Conveyance Authority". To qualify for the deviation, the contracts must meet the conditions detailed in Attachment A.

This class deviation applies to all qualifying contracts awarded from the date of this deviation through April 30, 2007. This class deviation supercedes the class deviation for interest costs issued on April 15, 2002.

The Head of the Contracting Agency shall report to this office, on a quarterly basis (beginning with the quarter ended December 31, 2004), any contracts awarded that use this deviation in accordance with this memorandum. The report shall be submitted within 30 days of the end of the quarter and shall include, at a minimum, the following information:

1.Contract Number
2.Contractor Name
3.Date of Contract Award
4.Amount of the Contract Award

If you have any questions regarding this memorandum, please contact Mr. David J. Capitano, Senior Procurement Analyst, at 703-847-7486.

Deidre A. Lee
Director, Defense Procurement
and Acquisition Policy

Attachments:
A. Deviation to FAR Part 31 - Contract Price Principles and Procedures
B. CAS Waiver
C. 10 U.S.C. § 2324 (e): Specific Costs Not Allowable.

Attachment A

Deviation from FAR Part 31 - Contract Cost Principles and Procedures

Section 1. ***General Deviation from FAR Part 31*****.** This deviation applies to Government contracts awarded in conjunction with the conveyance of a utility system under 10 U.S. C. 2688 provided all of the conditions listed in this section are met. This deviation permits, but does not require, the Head of the Contracting Agency to waive the requirements of FAR Part 31.

The Head of the Contracting Agency may exclude from the contract some or all of the requirements of FAR Part 31 provided all of the following conditions are met:

a. The contract is fixed price with prospective price redetermination;

b. The contract either:

(i) Is exempt from the application of the Cost Accounting Standards (CAS); or

(ii) Meets the criteria for a waiver from the Cost Accounting Standards (CAS) as provided for at Attachment B of this memorandum, and CAS has been waived for the contract;

c. If the contract is exempt or waived from CAS, the contract requires that the accounting practices used to prepare the proposal for the initial contract and/or the price redetermination (i) comply with pronouncements of the Federal Energy Regulatory Commission (FERC), the National Association of Regulatory Utility Commissioners (NARUC), the Rural Utility Service (RUS), or the American Water Works Association (AWWA) and (ii) are consistent with the contractor's written and established practices for measuring, assigning, and allocating costs;

d. The business segment performing the contract is not, at the time of contract award, currently performing on any other contract that is subject to the provisions of FAR Part 31;

e. The contract requires that the actual costs used for purposes of establishing the initial fixed price and/or the price redetermination:

(i) Meet the limitations specified in Section 2 for any deviation granted from FAR 31.205-20, Interest and other financial costs;
(ii) Meet the limitations specified in Section 3 for any deviation granted from FAR 31.205-41, Taxes;
(iii) Exclude the types of costs listed at 10 U.S.C. § 2324(e) (and any revisions to this statute as of the date of contract award), which is included as Attachment C to this memorandum. Any reasonable method of estimating such costs is sufficient to meet this requirement; and
(iv) Exclude the types of costs that are not normally considered as reimbursable by the applicable regulatory body that oversees the utility rate determinations of the business segment performing the contract.

f. The contract provides the Government with access to all records related to the accounting practices used to determine the costs and the supporting data for any estimates of unallowable costs.

Section 2. ***FAR 31.205-20 -- Interest and Other Financial Costs.*** This deviation from the requirements at FAR 31.205-20 applies to all Government contracts awarded in conjunction with a conveyance of a utility system under 10 U.S.C. § 2688, provided that all of the conditions listed in this section are met. This deviation permits (but does not require) the Contracting Officer to allow external interest and/or directly related financial costs in lieu of cost of money. The deviation does not apply to any imputed interest on the contractor's own funds.

This deviation applies only when all of the following conditions are met:

a. The contracting officer determines, in writing, that:

i. Allowing the costs will significantly reduce the costs of the United States for the utility services provided under the subject contract;

ii. The interest costs and directly related financial costs incurred to obtain loans or borrow capital from third-party financial institutions are reasonable based on the particular facts and circumstances involved.; and

iii. The interest and directly related financial costs are associated with capital expenditures to acquire, renovate, upgrade, and/or expand utility systems under the subject utilities privatization contract.

b. The contract states that cost of money is an unallowable contract cost under FAR 31.205-10, Cost of money, either during or after the period of the loan for all assets to which the loan relates; and

c. Interest rates used to calculate allowable costs are limited to 600 basis points above the Contract Disputes Act interest rate (41 U.S.C. § 611) in effect at the time the contractor makes the capital expenditure.

Section 3. ***<u>FAR 31.205-41 -- Taxes</u>*****:** This deviation from the requirements of FAR 31.205-41 applies to Government contracts awarded in conjunction with a conveyance of a utility system under 10 U.S.C. § 2688 provided that all of the conditions listed in this section are met. The deviation permits (but does not require) the Head of the Contracting Agency (HCA) to allow the Federal income tax directly related to a Contribution in Aid of Construction (CIAC tax).

To the maximum extent practical, contracts should be structured in a manner that will not result in a CIAC tax. However, there may be cases where incurrence of the CIAC tax is necessary to achieve the most beneficial business case for the Government. In those cases, the HCA may determine that the CIAC tax is an allowable cost provided all of the following conditions are met.

a. Based on the particular facts and circumstances involved, the HCA determines that allowing the CIAC tax will result in significant benefits to the Government that outweigh the cost of allowing the tax.

b. The HCA has adequately documented, in writing:
    i. The basis for the DoD determination of fair market value using a generally accepted valuation methodology.
    ii. The basis for the determination that the benefits to the Government outweigh the estimated cost of the tax (this requires an estimate of the expected corporate tax rate of the contractor, the marginal tax liability caused by the CIAC, and the anticipated difference in fair market value between the DoD and IRS valuations).

c. The contract limits the allowable cost to the portion of the actual CIAC tax attributable to the difference between:
    i. The fair market value determinations of DoD using a generally accepted valuation methodology; and
    ii. The fair market value determination of the Internal Revenue Service in assessing the tax.

Attachment B

Ms. Deidre A. Lee
Director, Defense Procurement and
Acquisition Policy
Department of Defense
Washington, DC 20301

Dear Ms. Lee:

This responds to your December 19, 2003 letter, and the additional information you provided on April 5, 2004, to the Cost Accounting Standards (CAS) Board, requesting a CAS waiver for contracts entered into under the authority of 10 U.S.C. 2686, "Utility Systems, Conveyance Authority."

On September 2, 2004, the CAS Board approved the requested waiver subject to the conditions set forth in the attached "Enclosure."

In granting this waiver, the CAS Board recognizes that the utilities industry has a set of established accounting practices that are used by regulatory authorities to set rates for utility customers (e.g., FERC, NARUC, RUS, or AWWA). The Board believes that the enclosed waiver conditions, which include requirements for contractors to consistently follow these established industry accounting practices, and to disclose in writing the accounting practices used for allocation of indirect costs, provides adequate protection for the Government. If any contractor selected for a contract under the above described authority does not agree to the conditions in this waiver, the contractor will be subject to CAS requirements, provided it otherwise satisfies the appropriate CAS applicability criteria.

Please inform this Office, within ninety days after the close of each fiscal year, of the extent and use of this waiver.

Sincerely,

James P. Bedingfield Member	Anthony M. DiPasquale Member	William F. Reed Member	Eugene L. Waszily Member

Enclosure

The Cost Accounting Standards are hereby waived for contracts entered into under the authority of 10 U.S.C. 2686, "Utility Systems, Conveyance Authority" that meet all of the following conditions:

1. The contract is one of the following types:

   a. Firm fixed price contracts (FFP);

   b. Fixed price contracts with economic price adjustment (where the price adjustment is based on an index or established prices, not based on actual costs incurred) (FPEPA); or

   c. Fixed price contracts with prospective price redetermination (where the price adjustment is based on actual costs incurred) (FPPPR).

2. The business segment performing the contract is not, at the time of contract award, currently performing on any other contract that is subject to the Cost Accounting Standards.

3. The contract is awarded without the submission of cost or pricing data.

4. For contracts that are awarded without adequate price competition (regardless of contract type) and for all FPPPR contracts, the contract must include a clause that:

   a. Requires the contractor to prepare the proposal for the initial contract or for the price redetermination using accounting practices that (i) comply with pronouncements of the Federal Energy Regulatory Commission (FERC), the National Association of Regulatory Utility Commissioners (NARUC), the Rural Utility Service (RUS), or the American Water Works Association (AWWA) and (ii) are consistent with the contractor's written and established practices for measuring, assigning, and allocating costs;

   b. Requires the contractor to disclose, in writing, its established accounting practices for allocating indirect costs to contracts for which CAS has been waived, and to consistently use those disclosed practices to prepare proposal(s); and

   c. Provides for an adjustment to the contract price if it is later found that the price was increased because the contractor used accounting practices that were in noncompliance with FERC, NARUC, RUS, or AWWA, or were inconsistent with the contractor's written and established practices. The amount of the adjustment shall be the difference between the contract price that was negotiated and the price that would have been negotiated had the business unit used compliant accounting practices that were in accordance with FERC, NARUC, RUS, or AWWA, and were consistent with the contractor's written and established practices. The Government shall be entitled to a credit or cash recovery (at the Government's option) for the amount of the increased price plus interest. The interest shall be computed from the date the payment by the

Government until the date of repayment by the contractor. The interest rate shall be the rate specified at 26 U.S.C. 6621(a)(2).

5. For FPPPR contracts, the contract includes the clause at FAR 52.215-2, Audit and Records-Negotiation.

6. For FPPPR contracts, the contract includes the following clause

> The actual costs used for purposes of establishing any price predetermination under the contract must exclude all statutory and contractually unallowable costs. The actual costs must also exclude the types of costs that are not normally reimbursed by the applicable regulatory body that oversees the utility rate determinations of the business segment performing the contract. Any reasonable method of estimating such costs, including a statistical sample of contractor costs projected to the total cost universe, is sufficient to meet this requirement. Should any unallowable costs be included in the negotiated price predetermination, the Government shall be entitled to recover the amount of those unallowable costs plus interest from the date of the predetermination until the date of repayment, in accordance with 26 U.S. C. 6621(a)(2).

7. For FFP and FPEPA contracts (where the price adjustment is not based on actual costs incurred), the contract includes a clause that provides the Contracting Officer and his authorized representative access to all relevant contractor records, including but not limited to the accounting practices and cost records in use at the time of the contract award and at the time of the price redetermination.

Attachment C

10 U.S.C 2324 (e): Specific Costs Not Allowable. -

(1) The following costs are not allowable under a covered contract:

(A) Costs of entertainment, including amusement, diversion, and social activities and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities).

(B) Costs incurred to influence (directly or indirectly) legislative action on any matter pending before Congress, a State legislature, or a legislative body of a political subdivision of a State.

(C) Costs incurred in defense of any civil or criminal fraud proceeding or similar proceeding (including filing of any false certification) brought by the United States where the contractor is found liable or has pleaded nolo contendere to a charge of fraud or similar proceeding (including filing of a false certification).

(D) Payments of fines and penalties resulting from violations of, or failure to comply with, Federal, State, local, or foreign laws and regulations, except when incurred as a result of compliance with specific terms and conditions of the contract or specific written instructions from the contracting officer authorizing in advance such payments in accordance with applicable provisions of the Federal Acquisition Regulation.

(E) Costs of membership in any social, dining, or country club or organization.

(F) Costs of alcoholic beverages.

(G) Contributions or donations, regardless of the recipient.

(H) Costs of advertising designed to promote the contractor or its products.

(I) Costs of promotional items and memorabilia, including models, gifts, and souvenirs.

(J) Costs for travel by commercial aircraft which exceed the amount of the standard commercial fare.

(K) Costs incurred in making any payment (commonly known as a "golden parachute payment") which is -

(i) in an amount in excess of the normal severance pay paid by the contractor to an employee upon termination of employment; and

(ii) is paid to the employee contingent upon, and following, a change in management control over, or ownership of, the contractor or a substantial portion of the contractor's assets.

(L) Costs of commercial insurance that protects against the costs of the contractor for correction of the contractor's own defects in materials or workmanship.

(M) Costs of severance pay paid by the contractor to foreign nationals employed by the contractor under a service contract performed outside the United States, to the extent that the amount of severance pay paid in any case exceeds the amount paid in the industry involved under the customary or prevailing practice for firms in that industry providing similar services in the United States, as determined under the Federal Acquisition Regulation.

(N) Costs of severance pay paid by the contractor to a foreign national employed by the contractor under a service contract performed in a foreign country if the termination of the employment of the foreign national is the result of the closing of, or the curtailment of activities at, a United States military facility in that country at the request of the government of that country.

(O) Costs incurred by a contractor in connection with any criminal, civil, or administrative proceeding commenced by the United States or a State, to the extent provided in subsection (k).

(P) Costs of compensation of senior executives of contractors for a fiscal year, regardless of the contract funding source, to the extent that such compensation exceeds the benchmark compensation amount determined applicable for the fiscal year by the Administrator for Federal Procurement Policy under section 39 of the Office of Federal Procurement Policy Act (41 U.S.C. § 435).