



**DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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FORT BELVOIR, VA 22060-6219**

IN REPLY REFER TO

PAC 730.31/2002-12

June 4, 2002
02-PAC-046(R)

**MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA**

SUBJECT: Audit Guidance on CAS and FAR Part 31 Cost Principles Applicability to Utility Privatization Contracts

BACKGROUND/SUMMARY

In response to 10 USC 2688 and Defense Reform Initiative Directive (DRID) #9, DoD began efforts to privatize its utility systems. Under utility privatization contracts, the Department of Defense transfers the utility distribution system ownership and operating responsibility to a nongovernmental entity. Utility privatization contracts do not include the purchase of the utility itself (e.g., electricity, water, gas).

Headquarters has provided advice to the Army Corps of Engineers, Army Audit Agency (AAA) and DLA regarding CAS and FAR Part 31 cost principles applicability to utility privatization contracts. The same advice has been provided to the Financial Advisors (FAs) and Procurement Liaison Auditors (PLAs) involved in assisting contracting officers throughout the procurement process.

We are providing audit guidance on this subject because we became aware that increasing numbers of FAOs are being asked to perform accounting system and financial capability reviews, as well as provide advice on FAR Part 31 cost principles and CAS applicability. A table summarizing CAS and FAR Part 31 cost principles applicability of various components of the utility privatization contract is provided at Enclosure 1.

GUIDANCE

Generally, planned utility privatization contracts contain three components:

- The sale of the distribution system to transfer its ownership to a nongovernmental entity,
- Operating and maintaining the system, and
- Capital improvements to bring the distribution system up to proper standards.

The period of performance may be up to 50 years.

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CAS and FAR Part 31 applicability is determined based on the procurement methodology to be used for each component. We discuss the three components of utility privatization contracts separately.

a. Transfer of ownership

CAS and FAR Part 31 do not apply to this component of the contract. The sale of the distribution system itself (e.g., pipes, poles) is based on the fair market value, as required by 10 USC 2688. CAS and FAR Part 31 apply to the contractor's costs of performing a contract, not to the government's disposition of its assets. Since the price of the utility distribution system is not based on a contractor's performance costs, CAS and FAR Part 31 do not apply.

b. Operations and maintenance (O&M)

(1) FAR Part 31

The O&M component of the contract will generally be awarded using fixed price redeterminable (prospective) pricing. The initial contract award will generally be made based on adequate price competition without submission of cost or pricing data. After a specified time (DLA is using 2 years), the price for the next period (for DLA, years 3 and 4) is based on actual costs incurred during the preceding period (for DLA, years 1 and 2). The price continues to be redetermined using this methodology on a pre-established interval (for DLA, every 2 years).

Under this planned pricing methodology, it is our understanding that the solicitation and contracts will include the clause at FAR 52.216-5, Price Redetermination – Prospective.

(a) Initial pricing

If the initial pricing of the O&M effort is based on adequate price competition, FAR Part 31 does not apply. However, if the initial pricing is based on cost analysis, then FAR Part 31 applies. FAR 31.102 states:

The applicable subparts of Part 31 shall be used in the pricing of fixed-price contracts, subcontracts, and modifications to contracts and subcontracts whenever (a) cost analysis is performed, or (b) a fixed-price contract clause requires the determination or negotiation of costs.

(b) Price redetermination

In all cases, the redetermination of the contract price after the contract is awarded will be subject to FAR Part 31. The contract clause for this contract type, FAR 52.216-5, requires submission of cost data in support of the redetermination. The clause defines "costs" as:

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Allowable costs in accordance with Part 31 of the Federal Acquisition Regulation (FAR) in effect on the date of this contract.

(2) CAS

CAS applies to the O&M component of the contemplated contract if the CAS applicability thresholds are met and the contract does not meet one of the other CAS exemptions at 9903.201-1(b), such as an award to a small business. The CAS applicability threshold is \$7.5 million if a prospective privatization contractor is not currently performing a CAS-covered contract of \$7.5 million or greater. Otherwise, the threshold is \$500,000. The CAS exemption at 9903.201-1(b)(15) for contracts awarded on the basis of adequate price competition without submission of cost or pricing data applies only to firm-fixed-price contracts, not to the fixed price redeterminable contracts typically used for O&M.

(3) Contracts awarded to a state-regulated utility

If the prospective contractor is a state-regulated utility, the price charged for the O&M effort **may** also be regulated by the state. If the price is set by regulation, CAS and FAR Part 31 will not apply. FAR Part 31 will not apply because the price will be based on other than cost analysis and the clause at FAR 52.216-5 should not be in the contract. CAS will not apply because the exemption at 9903.201-1(b)(5) exempts contracts and subcontracts in which the price is set by law or regulation. However, contracting officials and auditors should be careful. Just because the prospective contractor is regulated by the state does not necessarily mean that the price charged to the government for O&M itself is regulated by the state. Because the O&M effort is a unique effort to the prospective privatization contractor, i.e., such effort is not provided to the contractor's other customers, we believe that the prices charged to the government for O&M will not likely be regulated by the state.

c. Capital improvements

(1) FAR Part 31

Generally, the price for capital improvements is FFP. As discussed in paragraph b.(1) above, FAR Part 31 applicability to fixed-price contracts depends on whether cost analysis is performed. Therefore, if cost analysis is not performed in determining the price for capital improvements, FAR Part 31 does not apply. If cost analysis is performed, FAR Part 31 applies.

(2) CAS

If the capital improvements component of the contract is treated as a separate contract, the capital improvements component would be exempt from CAS under 9903.201-1(b)(15) if it is FFP and competitively awarded without submission of cost or pricing data. Otherwise, it is subject to CAS. See further comments in paragraph d. below.

d. CAS applicability threshold

When determining the contract value for CAS applicability purposes, the applicability should consider only the elements that are subject to CAS. These elements include:

- O&M
- Capital improvements

Normally, CAS applies to the capital improvements component because it is an integral part of the privatization contract which includes the CAS-covered O&M effort. Costs of a contract are normally accounted for as a single final cost objective. However, the contracting officer could choose to price and account for each component within a contract as a separate final cost objective. If accounted for as a separate final cost objective, CAS would not apply to the capital improvements component if it was priced as FFP and competitively awarded without submission of cost or pricing data.

Cost objectives are not restricted to contracts. CAS 402-30(a)(2) and CAS 410-30(a)(4) define a cost objective as:

A function, organizational subdivision, contract or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects, etc.

CAS defines a final cost objective at CAS 402-30(a)(4) and CAS 410-30(a)(5) as:

A cost objective which has allocated to it both direct and indirect costs, and, in the contractor's accumulation systems, is one of the final accumulation points.

In summary, while the O&M effort is subject to CAS, the contemplated contract could be structured to identify the O&M component and the capital improvements component as two separate final cost objectives within the contract. The capital improvements component would then be exempt from CAS if it meets the requirements of the exemption at 9903.201-1(b)(15); i.e., FFP, competitively awarded, and no cost or pricing data submitted.

In order to effectuate the separate CAS applicability to the capital improvements component of the contemplated contract, the contract would need to contain language requiring that each component be treated as a final cost objective with a provision made to estimate, accumulate, record, and report the cost by component, including both direct and indirect costs, as a final accumulation point. If the contract does not contain such language, the capital improvements component should be considered CAS-covered together with the O&M component when determining the CAS applicability threshold.

e. Applicability to commercial and noncommercial entities

(1) FAR Part 31

Utility privatization contracts may be awarded to publicly-owned companies, user-owned cooperatives, municipalities, and holding companies. Within FAR Part 31, Subpart 31.2 applies to commercial companies, including publicly-owned companies and holding companies, among others. Subpart 31.6 and OMB Circular A-87 apply to state and local governments, including municipalities. Subpart 31.7 and OMB Circular A-122 apply to nonprofit entities. Most user-owned cooperatives are nonprofit entities. Auditors should ensure that the correct requirements in FAR Part 31 are applied to the subject contract.

(2) CAS

CAS applies to utility privatization contracts awarded to non-commercial entities unless one of the exemptions at 48 CFR 9903.201-1(b) applies. While OMB Circular Nos. A-87 (Cost Principles for State, Local, and Indian Tribal Governments) and A-122 (Cost Principles for Non-Profit Organizations) do not specifically address CAS applicability, the circulars include references to CAS-covered contracts and CAS-covered contractors, making it abundantly clear that contracts with these organizations are not exempt from CAS unless one of the exemptions applies.

f. Class Deviation – Interest Costs

On April 15, 2002, the Director, Defense Procurement authorized a class deviation from the cost principle at Federal Acquisition Regulation (FAR) 31.205-20, Interest and other financial costs, for utilities privatization contracts, see Enclosure 2. The deviation allows the utilities privatization contractor to recover interest costs associated only with capital expenditures to acquire, renovate, replace, upgrade, and/or expand utility systems. The contractor will not be permitted to also receive facilities capital cost of money as a contract cost under FAR 31.205-10, Cost of money. The class deviation is effective for utilities privatization contracts awarded from May 1, 2002 through April 30, 2007.

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CONCLUDING REMARKS

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact Pat West, Program Manager, Accounting and Cost Principles Division, at (703) 767-3250.

/signed/ Robert DiMucci
(for)

Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Enclosures – 2

1. Summary Table of FAR and CAS Applicability to Utility Privatization Contracts
2. DDP Class Deviation – Interest Costs

DISTRIBUTION: C

Summary of FAR and CAS Applicability to Utility Privatization Contracts

	FAR Part 31 Applicability	CAS Applicability *
Sale of distribution system	Not applicable	Not applicable
Operations & maintenance (O&M):		
Initial award priced using adequate price competition without cost analysis	No	Yes
Initial award priced using cost analysis	Yes	Yes
Redetermination pricing	Yes	Yes
Initial award and redetermination pricing using state-regulated rates	No	No
Capital improvements:		
Contract identifies capital improvements component as a separate final cost objective within the contract, and priced as FFP based on adequate competition without cost analysis	No	No
Contract does not identify capital improvements component as a separate final cost objective within the contract, and no cost analysis performed	No	Yes
Contract does not identify capital improvements component as a separate final cost objective within the contract, and a cost analysis is performed	Yes	Yes

* This table applies only when the contracting officer decides to segment the contract to include the three components of utility privatization contracts covered by this audit guidance.

* The information in this table assumes no other exemptions at 9903.201-1(b) apply.



ACQUISITION,
TECHNOLOGY
AND LOGISTICS

DP(DAR)

OFFICE OF THE UNDER SECRETARY OF DEFENSE

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WASHINGTON, DC 20301-3000

April 15, 2002

In reply refer to
DAR Tracking No.: 2002-O0002

MEMORANDUM FOR DIRECTORS OF DEFENSE AGENCIES
DEPUTY FOR ACQUISITION AND BUSINESS
MANAGEMENT, ASN(RD&A)/ABM
DEPUTY ASSISTANT SECRETARY OF THE AIR FORCE
(CONTRACTING), SAF/AQC
DEPUTY ASSISTANT SECRETARY OF THE ARMY
(PROCUREMENT), ASA (ALT)
EXECUTIVE DIRECTOR, LOGISTICS POLICY AND
ACQUISITION MANAGEMENT (DLA)

SUBJECT: Class Deviation - Interest Costs

I authorize a class deviation from the cost principle at Federal Acquisition Regulation (FAR) 31.205-20, Interest and other financial costs, for utilities privatization contracts under which previously Government-owned utility systems are conveyed by a Military Department or Defense Agency to a contractor. Pursuant to this deviation, the utilities privatization contractor will be permitted to recover its interest costs associated only with capital expenditures to acquire, renovate, replace, upgrade, and/or expand utility systems, and the contractor will not be permitted to receive facilities capital cost of money as a contract cost under FAR 31.205-10, Cost of money. Interest rates used to calculate allowable interest costs pursuant to this class deviation must be 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. This class deviation is effective for utilities privatization contracts awarded from May 1, 2002 through April 30, 2007. Questions about this deviation may be addressed to Mr. Christopher Werner at (703)695-9764, or christopher.werner@osd.mil.

Deidre A. Lee
Director, Defense Procurement

cc:
DUSD(I&E)
DSMC, Ft. Belvoir

OPTIONAL FORM 99 (7-90)

FAX TRANSMITTAL

