Capability Guidance

Budgeting for Cost Risk

Purposes

1. Provision and manage project contingencies, reducing the risk of cost overrun or margin erosion.
2. Define and maintain boundaries of responsibility for cost that are aligned with project governance.

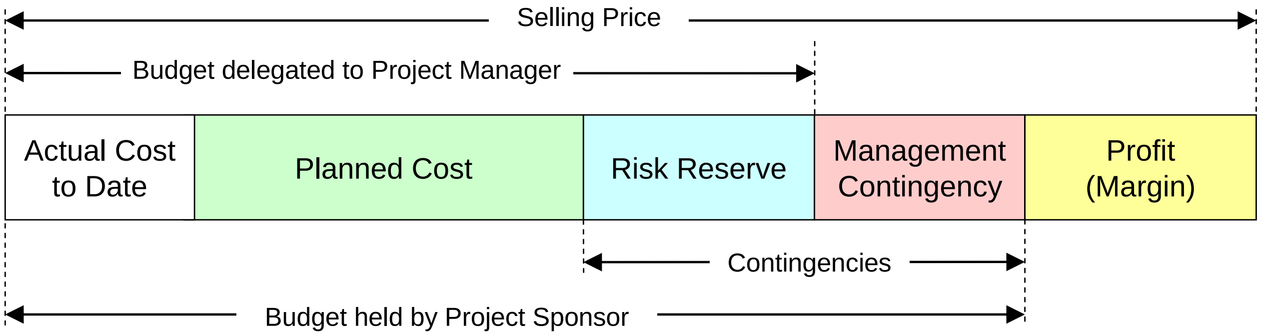
Typical approach

The figure below illustrates a typical approach to budgeting for project risk. Note that:

•Different organisations use different terminologies e.g. Risk budget instead of Risk Reserve.

•The Profit element is only relevant if the project is being sold to a customer on a commercial basis.

•Delegation of budgets may vary from that shown e.g. Management may retain some of the Risk Reserve.



Planned Cost

The planned cost is future cost, usually calculated deterministically from the project's project plan and cost breakdown. Although, the Project Manager may delegate responsibility for elements of the planned cost to members of the project team, they retain overall accountability for actual costs relative to planned costs.

Risk Reserve

The Risk Reserve may be used or delegated by the project manager to fund new risk responses and absorb the effects of residual risk. Its value risk should be derived from risk analysis (see the Cost Risk Analysis Capability Guidance sheet). It should be based on the implications of risks identified and being managed by the project team and should reflect the tolerance of risk by the organisation.

Some organisations derive values for risk reserve that are based on "post-mitigation" estimates. See the Pre and Post-mitigation Capability Guidance sheet for more information on the issues involved.

Management Contingency

Management Contingency is a source of funding that can be released to the project by senior management (typically the Project Sponsor) if and when necessary. The following factors may influence its value:

•Exposure of the project to unidentified risk, taking into account factors such as project size, duration, complexity, novelty and the influence of other stakeholder organisations.

•The significance of very low-probability / very high impact risk events of the type that would not usually be funded from the project budget.

•Organisational policy regarding the pooling of contingencies at the programme or project portfolio level.

Note that the above factors are not usually covered in the project team's risk register or analysis of risk. It is therefore irrational to extrapolate an estimate for Management Contingency from a project cost risk model.

Sponsorship and Governance

The Association for Project Management (APM) recommends that every project has a project sponsor, who is accountable for the project business case and flows down management decisions to the project manager.

A sound approach to estimating Risk Reserve and Management Contingency provides valuable assurance to project governance decisions including those made at key project approval points. Following project approval, differentiation between Risk Reserve and Management Contingency provides clarity about roles and responsibilities, while monitoring them provides information about the project's continued health.

Warning

It is tempting to use simple rules of thumb to derive or adjust estimates for Risk Reserve and Management Contingency e.g. Risk Reserve equals 10% of cost. However this can cause serious mistakes:

1. Some projects are risky and require much higher contingency levels than common rules of thumb.
2. Some projects are low risk – applying a rule of thumb might cause unnecessary loss of the project.
3. A "multiply by percentage" approach may in gross error if the base cost estimate is flawed or biased.