



OFFICE OF THE UNDER SECRETARY OF DEFENSE

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ACQUISITION
AND SUSTAINMENT

MEMORANDUM FOR COMMANDER, UNITED STATES CYBER
COMMAND (ATTN: ACQUISITION EXECUTIVE)
COMMANDER, UNITED STATES SPECIAL OPERATIONS
COMMAND (ATTN: ACQUISITION EXECUTIVE)
COMMANDER, UNITED STATES TRANSPORTATION
COMMAND (ATTN: ACQUISITION EXECUTIVE)
DEPUTY ASSISTANT SECRETARY OF THE ARMY
(PROCUREMENT)
DEPUTY ASSISTANT SECRETARY OF THE NAVY
(PROCUREMENT)
DEPUTY ASSISTANT SECRETARY OF THE AIR FORCE
(CONTRACTING)
DEFENSE AGENCY AND DOD FIELD ACTIVITY DIRECTORS

SUBJECT: Guidance on Inflation and Economic Price Adjustments

The current economic environment requires we understand the impacts of inflation to existing contracts and consider various approaches to manage risk of inflation to prospective Department of Defense (DoD) contracts. We acquire a wide range of goods and services to fulfill the Department's mission requirements; inflation is impacting several segments of our economy in varying degrees. Against this backdrop, DoD contractors and contracting officers (COs) alike have expressed renewed interest in using economic price adjustment (EPA) clauses. This memorandum provides guidance to assist COs to understand whether it is appropriate to recognize cost increases due to inflation under existing contracts as well as offer considerations for the proper use of EPA when entering into new contracts.

For purposes of existing DoD contracts, the treatment of cost increases as a result of economic conditions is dependent on contract type. Under cost reimbursement type contracts, the Government bears the risk of increased costs, including those due to inflation. Contractors are responsible for promptly notifying the CO that the costs incurred are approaching the limits specified in the applicable clause, as applicable under Federal Acquisition Regulation (FAR) clause 52.232-20, Limitation of Cost, or FAR clause 52.232-22, Limitation of Funds. Upon receipt of notice, the Government may increase the contract funding to allow for continued contract performance; the contractor is not obligated to continue performance beyond what can be accomplished within the contract's funded amount. Under fixed-price incentive (firm target) (FPIF) contracts, the contractor's actual (allowable and allocable) costs are recognized up to the contract ceiling. To the extent the actual cost differs from the target cost, the target profit will be adjusted by application of the contract share ratio to the costs over or under the target cost. Under fixed-price contracts with economic price adjustment (FPEPA), the EPA clause normally establishes a mechanism to mitigate specifically covered cost risks to both parties as a result of industry-wide contingencies beyond any individual contractor's control; the Government will bear the cost risk up to the limit specified in the clause (if any).

Unlike contractors performing under cost-reimbursement, FPIF, or FPEPA contracts, contractors performing under firm-fixed-price (FFP) contracts generally must bear the risk of cost increases, including those due to inflation. In the absence of an applicable contract clause, such as an EPA clause authorizing a contract price adjustment as a result of inflation, there is no authority for providing contractual relief for unanticipated inflation under an FFP contract. We are fielding questions about the possibility of using requests for equitable adjustment (REAs) under FFP contracts to address unanticipated inflation. REAs entail a contractor's proposal to the CO seeking an equitable adjustment to the contract terms based on a contracting officer-directed change within the scope of the contract, in the areas defined by the applicable Changes clause, or by another contract clause that authorizes an equitable adjustment based on specific actions taken. Since cost impacts due to unanticipated inflation are not a result of a contracting officer-directed change, COs should not agree to contractor REAs submitted in response to changed economic conditions.

For contracts being developed or negotiated during this period of unusually high inflation, an EPA clause may be an appropriate tool to equitably balance the risk of inflation between the Government and contractor. Including an EPA clause may enable a contractor to accept a fixed-price contract without having to develop pricing based on worst case projections to cover the cost risk attributable to unstable market conditions because of the EPA clause's built-in mechanism to mitigate such risk. COs should consider contract length as one of the primary considerations when deciding whether to use an EPA clause. Defense FAR Supplement (DFARS) 216.203-4(1)(ii) indicates EPA clauses based on established prices or on the actual cost of labor and material should only be used when delivery or performance will not be completed within six months after contract award. FAR 16.203-4(d)(1)(i) limits use of EPA clauses based on cost indices of labor and material to contracts with an extended period of performance, with significant costs to be incurred beyond one year after performance begins.

In crafting an EPA clause, COs must be mindful that the impacts of inflation vary widely, depending on the nature of costs. Therefore, when selecting indices to be used to measure inflation for purposes of an EPA clause, the CO should take care to use an index that is closely related to the cost components judged to be most unstable. Further, the CO should limit the scope of the EPA clause to those costs most likely to be impacted by economic fluctuations and should exclude costs that are not likely to be impacted by inflation from adjustment under the clause, such as FFP negotiated subcontracts with no EPA provisions, depreciation, or labor costs for which a definitive union agreement exists. In accordance with DFARS Procedures, Guidance, and Information (PGI) 216.203-4, economic price adjustments do not normally apply to the profit portion of the contract.

It is important to use independent, recognized sources as the basis for measurement of inflation in EPA clauses. The index (or indices) selected to measure inflation should not be so large and diverse that the inflation measurement is significantly affected by fluctuations not relevant to contract performance, but the selected index (or indices) must also be broad enough such that the measured inflation rate is not significantly affected by a single company. For example, DFARS PGI 216.203-4 cites the Bureau of Labor Statistics (BLS) Producer Price Index series; the Employment Cost Index for wages and salaries, benefits, and compensation

costs for aerospace industries; and the North American Industry Classification System (NAICS) Product Codes.

Appropriate EPA clauses will not be one-sided, but will be fair to both parties. For example, an equitable EPA clause will: 1) allow for both upward and downward revision of the stated contract price upon the occurrence of specified contingencies; 2) use the same index to establish the negotiated price and to adjust the negotiated price under the terms of the clause; and 3) incorporate a ceiling and a floor on adjustments that are of the same magnitude (if a ceiling and floor are included). COs should ensure that EPA clauses allow for contract price adjustments based on pre-established formulas rather than simply reopening price negotiations.

It is critical that COs ensure that the contingency allowances covered by the EPA clause are excluded from the base contract price. Additionally, each EPA clause must clearly present and explain the mechanics of calculating the price adjustments authorized under the clause, as well as specifically identifying the timeframes or events that will trigger a price adjustment.

COs must be cognizant that any clause addressing potential contract cost or price changes due to economic conditions, e.g. inflation, is effectively an EPA clause, whether or not the term EPA appears in the clause. The guidance contained in this memo is applicable to any clause that results in cost or price changes due to changed economic conditions.

As a best practice, COs should request assistance from their local pricing and policy offices, the Defense Contract Management Agency, or the Defense Contract Audit Agency when contemplating using of an EPA clause. COs should also review the guidance contained in DFARS PGI 216.203-4. Of course, as is prudent in most cases, COs should consult their legal counsel before deciding to use an EPA clause.

Finally, COs and financial managers should take into account that contingent liabilities arise when EPA clauses are used in contracts. Such liabilities should be administratively reserved as commitments pending determination of actual obligations. Chapter 8 of the DoD Financial Management Regulation, section 0802, addresses estimation of amounts that should be carried as commitments, and provides for conservative estimation sufficient to cover the obligations that probably will materialize.

The challenges presented in this period of economic uncertainty require us to employ appropriate solutions to both protect Government interests and ensure the continued health of the defense industrial base to support our mission. To the extent those solutions include use of the FPEPA contract type or inclusion of an EPA clause, COs must work with contractors to ensure EPA clauses provide appropriate risk mitigation while being fair to all parties to the contract.

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