

DoD Issues Guidance on Inflation and Economic Price Adjustments: Top 6 Things You Need to Know

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On May 22, 2022, the Department of Defense (DoD), in response to industry-wide concerns with rising inflation and the use of price adjustments, issued its [Guidance on Inflation and Economic Price Adjustments](#) which appears to signal recognition by the DoD that current economic conditions, particularly inflation, are affecting construction costs.

Even while acknowledging the “impacts of inflation to existing contracts,” the DoD made it clear that contractors currently performing firm fixed price contracts would not be entitled to equitable adjustments for unanticipated inflation. The impact of inflation, the DoD reasoned, is a risk that contractors must shoulder under firm fixed price contracts.

DOD GUIDANCE FOR CONTRACTING OFFICERS

The DoD does, however, offer guidance in the May 22 memo to its contracting officers on how and when to utilize Economic Price Adjustment (EPA) clauses when entering into new contracts. EPA clauses provide a mechanism to [manage specific cost risks](#) beyond a contractor’s control, shifting a defined aspect of the cost risk to the Government. EPA clauses can serve to balance the risk of inflation between the Government and the contractor.

FAR 52.216-4, Economic Price Adjustment – Labor and Material, sets forth the process for implementing adjustments, but some limitations must be adhered to:

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- No adjustment if the production costs are not affected by the changes
 - No adjustment for rates or unit prices that are not in the contract schedule
 - No adjustment in quantities from those shown in the schedule
 - No upward adjustment for labor or material which does not result in a net change of at least 3% of the total contract price
 - The aggregate of the increases in any unit price cannot exceed 10% of the original unit price, but there is no limitation on the number of decreases
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Below, we break down what is important to note from the May 22 guidance and the considerations that the DoD expects its contracting officers to consider when deciding whether to insert an EPA clause in a contract:

- **Contract length** – contracts with longer construction durations, including phased projects, may benefit from an EPA clause.
- **Index selection** – to measure inflation, select an index for the specific cost components anticipated to be the most unstable. Numerous index values are tracked throughout the industry and can be selected for specific materials, labor, locations, or combinations thereof.
- **Scope subject to EPA calculation** – select only those cost components most likely to be impacted by significant economic fluctuations.
- **Reliable sources** – the sources used to measure inflation should be, as the DoD notes, “independent” and “recognized.” These sources should be readily available for the bidding contractors’ access prior to bidding for analysis.
- **Fairness** – to both parties. For example, adjustments can be made both upward and downward.
- **Clarity** – the bidding documents must clearly explain the mechanics by which the adjustment will be calculated and identify the timeframes or events that would trigger an adjustment. Clarity also includes base index values and base bid costs defined for the EPA calculation in the contract award documentation.

Material price adjustments (MPA) have been around for a long time, and various agencies (e.g. Departments of Transportation) utilize these for economic price adjustments of selected materials that are most likely to undergo significant inflation on projects with long durations and/or phases. The Producer Price Indexes (PPI) published by the U.S. Bureau of Labor Statistics ([bls.gov](https://www.bls.gov)) and the BLS’ [Producer Price Index \(PPI\) Guide for Price Adjustment](#) are very useful in assisting owners with the development of EPA clauses.

DoD may be one of the first federal agencies to issue formal guidance to its contracting officers on EPA clauses, but given the current climate, it is likely other federal agencies will follow.

WHAT LESSONS CAN CONTRACTORS TAKE FROM THIS LATEST DOD GUIDANCE?

First and foremost, contractors should request that EPA clauses be incorporated into contracts during the solicitation phase to provide some protection from market risks. Otherwise, the successful contractor will be without any means to secure an adjustment due to inflation.

Secondly, contractors should partner with owner agencies in this process to achieve an equitable EPA clause. EPA clauses will likely be project specific, geared toward the duration, scope, delivery method, and geographic location of each project. Federal agencies will benefit from industry engagement to identify specific economic risks that could be addressed with an EPA clause, select an appropriate index to measure inflation growth and develop a suitable methodology for calculating economic adjustments.

Finally, these EPA clauses do not represent unlimited protection against inflation. EPA clauses may be narrowly drafted by contracting officers based on the considerations noted above. This could leave contractors with potentially limited access to adjustments for select materials or labor categories based on the specific risks posed by inflation for those particular cost components.

It is certainly welcome news from the DoD that it recognizes the risk that inflationary pressures have on the cost of construction and the ability of contractors to accurately project the cost of construction, but contractors should read EPA clauses carefully when preparing their proposals and bids to understand the extent to which these clauses will offer protection from market volatility.

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