DOD ISSUES *QUESTIONABLE* GUIDANCE ON INFLATION

Economic Price Adjustment Clause in New, Existing, and Option Contracts

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INTRODUCTION

In the midst of decades-high inflation, the Department of Defense (DOD) recently advised its industry partners on who *they believe* will be **SHOULDERING THE BURDEN OF INCREASED COSTS IN EXISTING AND NEW CONTRACTS.**

On May 25, 2022, the DOD finally issued its much-needed **Guidance on Inflation and Economic Price Adjustment** *(copy attached)* ("Guidance Memorandum"). The Memorandum comes as inflation is steadily rising, forcing contractors with fixed-price contracts to bear the risk and result of skyrocketing supply costs. Consequently, many contractors are finding their profit margins eroding and even falling into a loss position, without much sympathy or cooperation from Contracting Officers.

While the Memorandum reinforces bad news for contractors on existing fixed-price contracts, the Guidance Memorandum provides contractors with **valuable insight on how Contracting Officers *may* address sharing or shifting the risk of inflation** on new contracts. The Guidance Memorandum is currently silent on how Contracting Officers should treat contract options, although applicable FAR clauses offer a path forward on most contracts.

This blog post summarizes the impacts of the Guidance Memorandum for (1) **new contracts**, (2) **existing contracts**, and (3) the impact on **option contracts**.

NEW CONTRACTS

The Guidance Memorandum specifically encourages Contracting Officers **to include** economic price adjustment (EPA) clauses in new contracts now being solicited.

In this way, the Guidance Memorandum does offer some hope to contractors currently negotiating contracts. It highlights that "DOD contractors and contracting officers alike have expressed renewed interest in using Economic Price Adjustment (EPA) clauses." Additionally, it confirms that "an EPA clause may be an appropriate tool to equitably balance the risk of inflation between the Government and contractor."

HOWEVER, this direction does not provide Contracting Officers with new authority, as FAR 16.203-2 already allows adding an economic price adjustment clause when (i) there is serious doubt about the stability of market or labor conditions that will exist during an extended period of contract performance, and (ii) contingencies that would otherwise be included in the contract price can be identified and covered separately in the contract. Nonetheless, the newly issued Guidance Memorandum will likely make convincing Contracting Officers to use that authority a much easier proposition. The Guidance Memorandum also offers direction to Contracting Officers regarding how to **appropriately craft** an EPA clause, including direction to include an allowance for both upward and downward adjustments in price.

As such, contractors should evaluate new solicitations (for fixed-price contracts) to ensure they contain an EPA clause. If the solicitation does not, **contractors must account for the possibility of an increase in inflation** or other market forces driving supply prices higher and avoid contracts that would leave them overly exposed to such conditions.

Importantly, if a new solicitation contains an EPA clause, contractors should evaluate whether that clause is adequately flexible to account for **unforeseen price increases during the life of the project.** This should include, just as the DOD urged to its Contracting Officers, **(1)** considerations for selecting an index to measure inflation that is linked to cost **components that are most unstable**; **(2)** identifying limitations regarding the scope of the EPA clause to exclude costs that are unlikely to be affected by inflation; and **(3)** taking the time and internal effort to develop pre-established formulas for calculating the **new pricing**, instead of merely reopening price negotiations should the need arise.

EXISTING CONTRACTS

Conversely, the Guidance Memorandum encourages Contracting Officers to continue to effectively **stonewall** contractors with existing fixed-price contracts without an EPA clause. It reiterates the position used by many contracting officers that "[i]n 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." In Excell's experience, while this is technically accurate in a narrow sense, a detailed understanding and appropriate analysis of applicable Federal Acquisition Regulation (FAR) clauses often allows an access point to recovery of additional incurred costs in most scenarios.

Based on the present-day position being taken by the DoD, this newly issued Guidance Memorandum goes on to reiterate that, without an applicable contract clause or change, contracting officers may not (and arguably should not) agree to a contractor's requests for equitable adjustment to account for inflation.

Obviously, this published guidance now mandates that contractors look to **other contractual means** to recover their unpredictably high incurred costs.

Accordingly, it is Excell's position that, based upon years of experience in this arena, contractors should base any requests for adjustments in **(a)** an economic price adjustment clause, if available; **(b)** an alternative contract clause that authorizes price adjustments; or **(c)** by identifying established (written) government direction that can be utilized as a factual changed condition or a government-caused matter affecting time, money, or both.

IMPLICATIONS FOR CONTRACTS WITH OPTION YEARS

Notably, the current DOD guidance remains **silent** as to contracts containing **options** to extend the contract for additional periods of time ("option contracts"). Thus, under the precepts of the Guidance Memorandum the question is simple: **Should Contracting Officers treat options for additional contract periods as part of the existing contract or as a new contract?**

To be clear, while the answer ultimately depends on the language of each individual contract, contractors facing an exercise of option years with pricing based on a pre-inflation price analysis conducted in the evaluation of the original contract may find relief under **FAR 17.207 "Exercise of Options"**.

> *Specifically, that provision requires that, for the Government to validly exercise an option, "the option must have been evaluated as part of the initial competition and be exercisable at **the amount specified** in or **reasonably determinable** from the terms of the basic contract." FAR 17.207(f).*

In fact, based upon existing rulings, the Government's evaluation of pricing in the original solicitation becomes **no longer binding** at

the time the option is exercised, the Government may not rely upon the initial reasonableness determination to show the option is legally exercised. See *Magnum Opus Techs., Inc. v. United States*, 94 Fed. Cl. 512, 538 (2010). In *Magnum*, base rates and pricing in the awarded contract included escalation rates for each of 10 potential option years. However, after award, the base rates and pricing were changed by modification, which made the **originally awarded pricing and escalation rates** non-binding upon the option years.

Historically, FAR 17.207 has also been interpreted to mean that, once the government acknowledges that the **market has changed** since the initial price evaluation of the solicitation occurred, the government cannot rely upon its evaluation at the time of the initial award to establish the reasonableness of pricing in exercising its options. See *Magnum Opus Techs., Inc. v. United States*, 94 Fed. Cl. 512, 538 (2010). Accordingly, **relying upon the price evaluation at the time of award despite changed market conditions violates FAR 17.207(d).** See *Magnum Opus* at 539 (internal citations omitted). In essence, given the current market conditions, it is now evident that the DoD has acknowledged via its Memorandum that **the market has materially changed**.

Finally, if the Government's exercise of an option on a multiyear contract is improper in any way, contractors may have a remedy for additional costs by treating the exercise as a Constructive Change under the Changes clause.

Thus, whether the rates established for option years have been rendered inapplicable by Changes or modifications to the contract, by changed market conditions, or the defective exercise of an option, contractors should carefully scrutinize every available recourse to **ensure option pricing is modified to adequately protect the contractor's profitability**, as well as the profitability of its shareholders, while simultaneously treating the Government to the level of fairness it contracted for.

If you have any questions about this recent development, or would like to discuss your specific situation, Excell Consulting is ready and able to assist. And remember, initial consultation calls to **Excell** are always ***FREE! Call (719) 599-8336 today!***

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Author's note: The information contained in this article is for general informational purposes only. This information does not constitute legal advice, is not intended to constitute legal advice, nor should it be relied upon as legal advice for your specific factual pattern or situation. – John G. Balch, CEO, MA, CPCM

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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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