Topic 9 –
Economic Price Adjustment & Extraordinary Contractual Requests

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Agenda

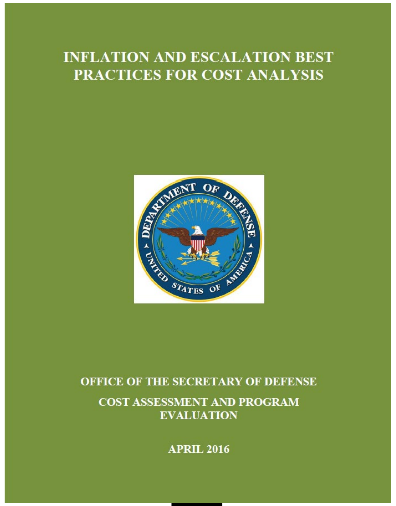
- How does the Government measure inflation and how is it used for programming and budgeting?
- When is it appropriate to use an Economic Price Adjustment clause?
- What is an Economic Price Adjustment clause, and how does it work?
- What is an Extraordinary Contractual Request? How is it utilized?
- Additional Resources
- Q&A

Measuring and utilizing inflation for programming and budgeting

U.S. ARMY

OSD CAPE

2016: Introduced escalation, real price change

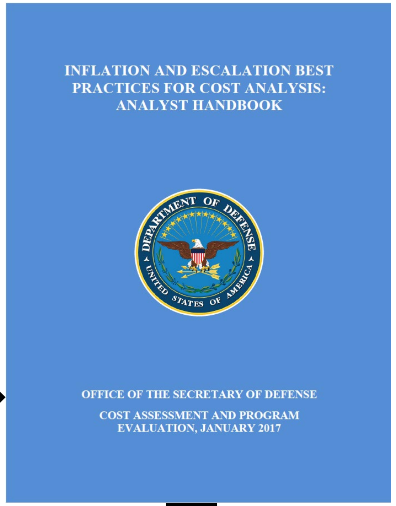

INFLATION AND ESCALATION BEST PRACTICES FOR COST ANALYSIS

OFFICE OF THE SECRETARY OF DEFENSE

COST ASSESSMENT AND PROGRAM EVALUATION

APRIL 2016

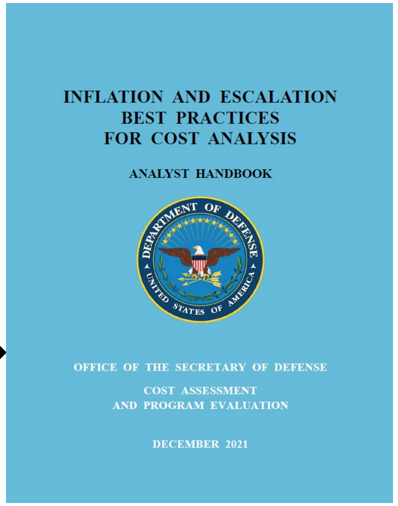
2017: Expanded on escalation theory, some applications


INFLATION AND ESCALATION BEST PRACTICES FOR COST ANALYSIS: ANALYST HANDBOOK

OFFICE OF THE SECRETARY OF DEFENSE

COST ASSESSMENT AND PROGRAM EVALUATION, JANUARY 2017

2021: Added step-by-step instructions, clarified definitions for ease of implementation


INFLATION AND ESCALATION BEST PRACTICES FOR COST ANALYSIS

ANALYST HANDBOOK

OFFICE OF THE SECRETARY OF DEFENSE

COST ASSESSMENT AND PROGRAM EVALUATION

DECEMBER 2021

U.S. ARMY

Measuring and utilizing inflation for programming and budgeting, cont.

OSD CAPE

TY$ = Then-Year Dollars
CY$ = Constant-Year Dollars
CP$ = Constant Price

- Indices may measure inflation or escalation
  - **Inflation** = economy-wide (DoD uses the GDP price index for inflation)
  - **Escalation** = commodity-specific
- Obligations are for budget outputs, expenditures are a common input type
  - **Outlay profile** = appropriation-specific spending pattern
  - Obligations include an outlay profile, expenditures do not
- TY$ have real-world significance, CY$ and CP$ are normalized for analytical purposes
  - TY$ may represent obligations or expenditures (TY$ obs or TY$ exp)
  - Removing inflation from TY$ obs → CY$ obs; removing inflation from TY$ exp → CY$ exp
  - There are FIVE dollar types: TY$ obs, TY$ exp, CY$ obs, CY$ exp, CP$
- Indices may be raw or weighted
  - **Weighted indices** include an outlay profile, **raw indices** do not
  - Use weighted indices with obligations, raw indices with expenditures
- Latest handbook cancels “base-year dollars (BY$)” as a term in inflation/escalation best practices, but “base years” still exist
  - The old term “BY$” is ambiguous, may refer to either CY$ or CP$
  - **Base year** = analyst-selected reference year for CY$ or CP$ (e.g., 2008 is the base year for CY08$)

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Measuring and utilizing inflation for programming and budgeting, cont.

OSD CAPE

When to use each dollar type

	Recommended for…	Not recommended for…
CP$	*Intermediate calculations:* • Average cost factors • Cost Estimating Relationships (CERs) • Cost Improvement Curves (CICs) • Visualizing programmatic trends	*Reporting final values:* • External reports beyond DoD cost community, unless well-documented and necessary to explain cost estimate methodology
TY$ obs and CY$ obs	*Reporting final values:* • Total costs • Reports for stakeholders beyond DoD cost community: – Budget (actual budget values in TY$ obs, with CY$ obs for comparison in some displays) – Acquisition Program Baseline (APB) – Selected Acquisition Report (SAR) – Analysis of Alternatives (AoA) – Business Case Analysis (BCA) – Affordability Analysis	*Intermediate calculations:* • Calculations other than addition and subtraction with other values of same type (and same base year if CY$ obs) • Average cost factors across multiple years • CERs • CICs
TY$ exp and CY$ exp	*Displaying data obtained from primary sources that capture expenditures*	*Intermediate calculations or reporting final values (see above)*

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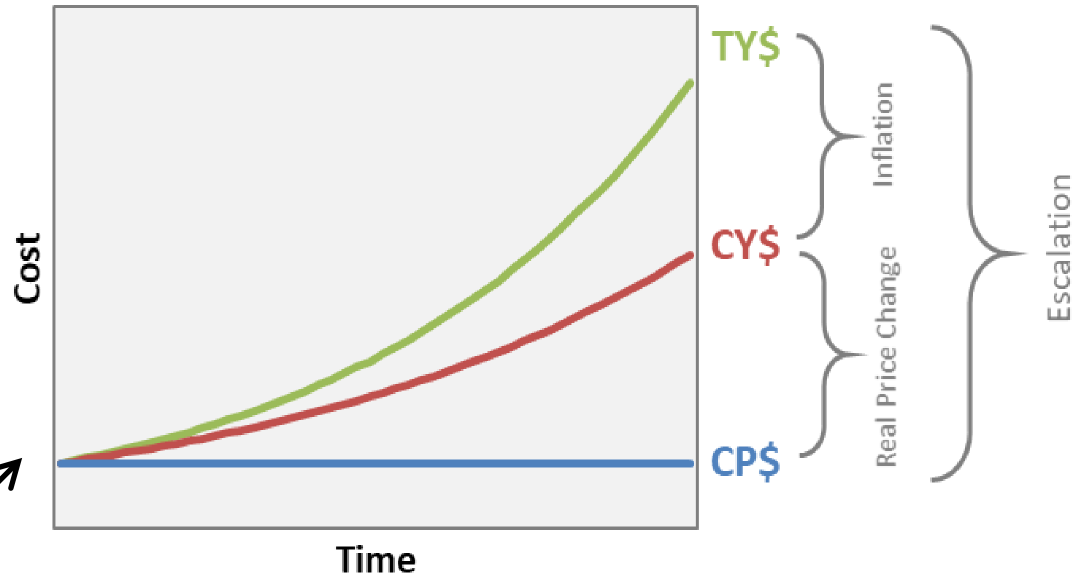
Measuring and utilizing inflation for programming and budgeting, cont.

OSD CAPE

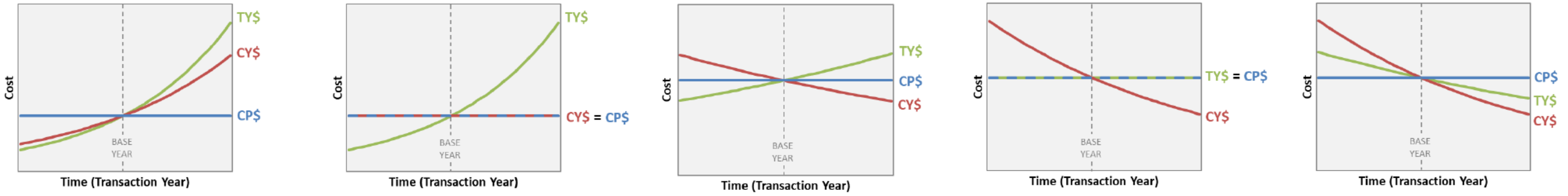
Terminology Relationships

TERMINOLOGY SCHEMATIC



Dollar type relationships depend on the magnitude and sign of real price change (RPC) relative to inflation

SCHEMATIC A (RPC > 1) | SCHEMATIC B (RPC = 1) | SCHEMATIC C (RPC < 1, |RPC|< Inflation) | SCHEMATIC D (RPC = 1/Inflation) | SCHEMATIC E (RPC < 1)



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Measuring and utilizing inflation for programming and budgeting, cont.

OSD CAPE

Example Calculation

Given:

FY17 cost = $100
FY18 cost = $105
FY17-18 inflation = 2%

Price Escalation = Inflation * RPC

Solve for rate of RPC:

Price escalation = ($105 - $100) / $100 = 0.05 → 5%
Real Price Change = Price Escalation / Inflation
= 1.05/1.02 = 1.0294 → **2.94%**

How can I visualize these rates as dollar values?

$105 = $100 * Price Escalation
= $100 * (Inflation) * (RPC)
= $100 * (1.02) * (1.0294)
= $100 * (1 + 0.02) * (1 + 0.0294)

"FOIL" Method:
First Outer Inner Last

= $100 * (1 + 0.02 + 0.0294 + [0.02 * 0.0294])

Original = **$100** Inflation = **$2** RPC = **$2.94** Inflation *on* RPC = **$0.06**

Rates are multiplicative, dollars are additive.

Appropriate use of an Economic Price Adjustment clause

- DFARS PGI provides wide latitude to the Contracting Officer in tailoring an EPA clause to the current market conditions.
- DFARS PGI 216.203-4
  - EPA provisions should be used only when general economic factors make the estimating of future costs too unpredictable within a fixed-price contract. **The primary factors that should be considered before using an EPA provision include volatility of labor and/or material costs and contract length.** In cases where cost volatility and/or contract length warrant using an EPA provision, the provision must be carefully crafted to ensure an equitable adjustment to the contract.
  - In other words, where a **volatile** cost element (e.g. direct material or labor costs) makes it difficult for either party to **reasonably** predict future values.
  - Considerations:
    - Frequency and amplitude of fluctuations – Significant? Over extended periods? Variance from historical norms?
    - Can be isolated to a single or few cost elements – Specific PPI? Specific labor index?

Appropriate use of an Economic Price Adjustment clause, cont.

- Benefits to Contractor:
  - Some protection against price increases
  - More certainty in planning
- Benefits to the Government:
  - Lower Initial Prices – The government should expect to see lower prices in terms of escalation and profit.
  - Price Reductions – Should the indices go down, the Government would receive reduced pricing.
- Benefits to both:
  - Protection – EPAs help to protect our business base, especially smaller businesses.
  - Longer Contracts – With an EPA, the contractor may be willing to agree to longer term contracts.

Appropriate use of an Economic Price Adjustment clause, cont.

- Considerations to NOT utilize an EPA clause:
  - Commercial and non-commercial market impacts
    - If there is a commercial market, how is that market managing the fluctuation?
    - Are there factors in a non-commercial market which may affect the fluctuation; legislation, mergers/acquisitions, new market entrants, etc.?
  - Long Term Agreements
    - Are LTAs for material the norm? Are they in place?
    - Is there a Collective Bargaining Agreement? If so, what period does it cover?
  - Contract Type
    - Should be limited to FFP
    - Not recommended to be combined with other contract types that allow for adjustments; e.g. FPIF, CPIF, CPFF
  - Funding Profile
    - Can the funding profile account for unit price increases?
    - How would unit price decreases affect the Requiring Activity?

Appropriate use of an Economic Price Adjustment clause, cont.

- Additional Considerations:
  - Composition – It requires additional resources and time to write and negotiate the EPA terms.
  - Future Resources – It requires resources from both the contractor and Government to process each EPA. If the EPA should rely on actuals, the resources can be significant.
  - Increases – Additional funds must be available for price increases or PM must be prepared to accept lower quantities.
  - Limited Relief – EPAs offer only limited relief and could still result in FAR 50 claims or refusal to perform should costs skyrocket.

EPA Clause Construction

- Step 1 – Conduct Market Research
  - Identify an index that closely matches the product or major cost driver
  - Limit construction to the area where market research identifies the volatility
    - Adjustment can be the percentage of the unit price represented by the commodity
  - “Goldilocks” rule for selecting an index: neither too broad nor to narrow
  - May use more than one index. However, simpler is better.
- Step 2 – Select the appropriate clause
  - 3 FAR clauses, with 52.216-2 Economic Price Adjustment – Standard as most common
  - May write a Section H special provision

EPA Clause Construction, cont.

- Step 3 – Identify Band and decide Trigger or Dead Band
  - The width of the band should reflect the volatility identified by market research
    - Generally, +/-3%
  - Trigger Band – receives full adjustment when index outside the band
    - Given PPI has a value of 100 and band of +/- 3%
    - Actual PPI for calculation is 104
    - Adjustment is 4% increase to unit price
  - Dead Band – receives adjustment for the delta when index outside the band
    - Given PPI has a value of 100 and a band of +/-3%
    - Actual PPI for calculation is 104
    - Adjustment is 1% increase to unit price

EPA Clause Construction, cont.

- Step 4 – Determine Minimum and Maximum Adjustment
  - Should reflect the volatility identified by market research
  - Maximum over 10% requires Chief of the Contracting Office approval.
  - Minimum does not have to mirror the maximum.
  - Minimum not required (usually only works for competitive actions).
- Step 5 – Determine Applicability
  - EPA Clause does not have to begin at award for LTC
    - E.g. begins in year 4 of a 5 year contract
  - Prospective or Retroactive
    - Most EPA Clause are prospective in that they adjust unit prices for the instant or future action.
    - Though allowed, retroactive EPA clauses are discouraged

EPA Clause Construction, cont.

- Step 6 – Determine Timing of Adjustment
  - Generally, a reasonable time period before the next ordering period
    - Too soon and may not capture timely data
    - Tool late and may not give enough time to execute administrative modification
    - Commonly 30-90 days
  - May also occur on different time periods
    - Quarterly, or semi-annually
    - Order specific – a defined time period prior to each order issued
- Step 7 – Build an Attachment (Recommended)
  - Design a spreadsheet for the contractor to fill out that automatically executes the calculation once they update the correct index

Extraordinary Contractual Request

- P.L. 85-804 as implemented by FAR Part 50
  - Provides a way to amend contracts **without consider**ation when such action will **facilitate national defense** and **other legal authorities are inadequate**.
  - Must be requested by the contractor
  - Sent to board for review/approval (DASA(P) Chairs for Army)
- Before pursuing, investigate other legal authorities:
  - Equitable adjustment to satisfy a Change Order (FAR 43.103(a))
  - Contract Financing (FAR 32)
  - Schedule Relief
    - Excusable Delay (FAR 52.249-14)
    - Other changes in delivery schedule (Changes Clause(s))
  - Providing GFM (Changes Clause(s))
  - Termination for Convenience – Cancellation (FAR Part 49)
  - Request for Variance (Changes Clause(s))

Extraordinary Contractual Request, cont.

FAR 50.103-2(a) (1)

When an:

(1) actual or threatened loss under a defense contract, however caused,

(2) will impair the productive ability of a contractor

(3) whose continued performance on any defense contract or whose continued operation as a source of supply

(4) is found to be essential to the national defense, the contract may be amended without consideration, but

(5) only to the extent necessary to avoid such impairment to the contractor’s productive ability.

Extraordinary Contractual Request, cont.

No contract, amendment, or modification shall be made under Pub. L. 85-804's authority-

(1) Unless the approving authority finds that the action will facilitate the national defense;

(2) Unless other legal authority within the agency concerned is deemed to be lacking or inadequate;

(3) Except within the limits of the amounts appropriated and the statutory contract authorization; and

(4) For any amount over $34 million, unless the Senate and House Committees are notified in writing of the proposed obligation and 60 days of continuous session of Congress have passed

Extraordinary Contractual Request, cont.

- Advocate for Broad Discretion from Approving Authority/Secretary or CAB to KO to execute
  - Any deviation from Decision must go back to approving authority/CAB
- Include Global Release of ALL claims
- Coordinate with Agency/ CAB to determine Coms Plan
  - Have Documents redacted and ready for Release when Decision is Announced
- Attorneys play a key role in process
- Relationship with the Contractor is important

Additional Resources

- CON 7470, Inflation and Economic Price Adjustments
- CON 7480, Extraordinary Contractual Actions
- EPA clauses: https://www.dau.edu/event/Striking-the-Balance-Constructing-EPA-Clauses
- Inflation: https://www.dau.edu/event/Accounting-for-Inflation-Producer-Price-Index
- Inflation (Part 2): https://www.dau.edu/event/Accounting-for-Inflation-Using-the-Producer-Price-Index-Part-2-12-Oct-2022
- ECR: https://www.dau.edu/event/Extraordinary-Contractual-Actions-26-October-2022

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