

New DoD Guidance on Inflation and Economic Price Adjustments

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In response to industry questions about economic price adjustments for inflation, the Department of Defense (DoD) recently issued [Guidance on Inflation and Economic Price Adjustments](#). Key takeaways from DoD's guidance — which aims to help contracting officers (COs) “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” — are discussed below.

Background

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 a contract clause authorizing a contract price adjustment as a result of inflation, DoD takes the position that “there is no authority for providing contractual relief for unanticipated inflation under an FFP contract.”

DoD reports that it is “fielding questions about the possibility of using requests for equitable adjustment (REAs) under FFP contracts to address unanticipated inflation.” However, DoD takes the position that, because “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.”

Nonetheless, DoD acknowledges that, for contracts being developed or negotiated during this period of unusually high inflation, an economic price adjustment (EPA) clause “may be an appropriate tool to equitably balance the risk of inflation between the Government and the contractor.” As DoD notes, 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.”

DoD Guidance

Highlights from DoD's guidance to COs:

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- In crafting an EPA clause, COs “must be mindful that the impacts of inflation vary widely, depending on the nature of costs.” Thus, 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.
 - 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.”
 - Appropriate EPA clauses “will not be one-sided, but will be fair to both parties.” For instance, “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.”
 - COs should “ensure that the contingency allowances covered by the EPA clause are excluded from the base contract price.”
 - 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 “should take into account that contingent liabilities arise when EPA clauses are used in contracts.”

Conclusion

DoD’s guidance does little to address the hardships that federal contractors with existing fixed-price contracts are facing because of inflation. However, DoD’s guidance is a step in the right direction in that it signals to contractors that DoD is listening and that, going forward, DoD hopefully will be increasingly receptive to including reasonable EPA clauses in its fixed-price contracts. Accordingly, contractors should be proactive in requesting the inclusion of EPA clauses in solicitations, providing pre-award input on the specific terms of those clauses, and seeking clarification on the mechanics of

those clauses.

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National Law Review, Volume XII, Number 161

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