According to the Department of Defense **publication** "Inflation and Escalation Best Practices for Cost Analysis," estimates for future project costs must address (1) inflation, (2) real price change (RPC), and (3) escalation. Each of those terms has an official DoD definition, which we provide below:

Inflation means "a rise in the general price level over time, which is an economy-wide average over all goods and services transacted. Inflation represents a decrease in the value of money (i.e., the dollar), due to an increase in the supply of money and credit relative to available goods, resulting in a rise in the general price level." The definition of "inflation" continues, as follows:

Key to the definition of inflation is that it measures the economy-wide change in price as opposed to the change in price of any specific good or service. The inflation index used in Federal budgeting is the Gross Domestic Product Chain-Type Price Index, known more commonly as the GDP Price Index …. The Bureau of Economic Analysis (BEA) of the Department of Commerce develops the index based on value-added prices of all final goods and services (sometimes referred to as a 'market basket') produced on US soil. It includes investment goods, consumption goods, services, and products exported overseas.

(Footnotes omitted)

Real price change (RPC) refers to the price movement of specific goods and services rather than to economy-wide changes. "While inflation affects all prices in the same proportion, prices for specific goods and services may change at different rates due to real price change …. Positive real price change indicates that the item has become more expensive relative to an economy-wide basket of goods and services …. The label 'real' in real price change refers to the fact that it is measured in inflation-adjusted dollars, also known as 'real dollars.'

The DoD publication lists several factors that may drive RPC, including: market shifts; changes in the supplies of specific materials; changes to cost of doing business (e.g., overhead rates), for either contractors or the government; economies or diseconomies of scale; changes in the mix of the workforce, such as labor categories or skill levels; changes to inputs to production; rate effects and learning effects; technological change, such as increased automation of a production process.

Escalation is “the combined effect of inflation and real price change, as defined in the previous two sections.” According to the DoD: “Escalation may be positive, negative, or zero; since inflation is usually positive in a growing economy, the direction of escalation depends primarily on the magnitude and sign of real price change …. Escalation may also be equal to inflation in two cases: the market basket may be so broad that it approximates the entire economy (which, by definition, experiences inflation only), or the market basket experiences no real price change relative to the economy as a whole.”

Having defined our terms, let us offer the opinion that, when DCAA auditors and DCMA contracting officers negotiate *escalation* factors in a contractor’s proposal, they tend to focus on *inflation* and ignore RPC. Contractors are very aware of RPC. For example, contractors understand that the cost of labor has skyrocketed in recent months—especially in certain areas, such as software developers. Costs of certain goods and materials have similarly skyrocketed. However, when government auditors and analysts look at a contractor’s escalation rates, they tend to compare the proposed escalation only to inflation indices (*e.g.,* Global Insight). Thus, there is tension because the cost of every good or service is increasing at the average, overall rate.

Everybody knows that inflation is on the rise. Even the Department of Defense acknowledges it. In May, 2022, the Principal Director, Defense Pricing and Estimating, issued a **memo** addressing the impacts of inflation on existing contract prices as well as on new contracts. The memo was, uh, unfortunate. Yes. That’s the term. Unfortunate.

First, the memo utterly ignored RPC, but maybe that’s because it was written by people who didn’t understand cost analysis. So, let’s call that a “nit.”

Second—and far more importantly—the memo utterly missed the point. It stuck to legalese and missed the true impact of cost escalation risks on the Department’s supply chain—and therefore the risks to the Department’s mission.

What do we mean?

The memo outlined Department policy with respect to firm, fixed-price contracts, using language that might as well have been lifted straight out of the FAR. The memo said—

… 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.

Sure, go there. That's a nice legal position, but when your mid-tier and lower-tier suppliers—and your small business suppliers—begin to go bankrupt because the costs of performing the contracts exceed their available cash flow, and your "reprocurement costs" associated with Terminations for Default are meaningless because the suppliers are bankrupt and can't pay—and in many cases there will be no other suppliers to perform in any case—and when your programs start to fall behind schedule and now you have to report Nunn-McCurdy breaches to Congress … well. At that point you will realize—*far too late*—that your lawyers' advice wasn't so smart after all, because you didn't deliver your weapon systems and your contractor services to your warfighters, even though you adhered to contractual policies and procedures.

Not incidentally, delivering goods, services and weapon systems to the warfighters is, fundamentally, the *entire job* of the Department of Defense's back office.

The memo seemingly ignores history, when inflationary pressures (among other factors) led to the United States Government *bailing-out Lockheed via an Act of Congress.* Don't believe us? Google it. One salient fact was the imminent insolvency of Rolls-Royce, maker of aircraft engines. One report summarized the situation thusly: "If the engine supplier for the L-1011 was bankrupt, the contract for the RB.211-22 engine would be nullified." Now, perhaps the crisis was driven by technical challenges in fixed-price development contracts, but the salient fact is that the contracts were fixed-price, and the contractors couldn't absorb the associated losses. If the supply chain collapsed, the prime contractor (i.e., Lockheed) was toast.

There’s more in that May, 2022, memo about how to craft and negotiate Economic Price Adjustment (EPA) clauses in new contract awards, but every word of that guidance tells savvy readers that the authors never read the DoD’s publication on the topic—the publication we linked to in the first sentence of this article. If they’d read, and absorbed, the guidance in the publication, they wouldn’t be talking solely about inflation, they’d be talking about RPC, as well.

We guess the agency lawyers missed that one.

Anyway, perhaps having received feedback similar to ours, or perhaps after waking up in the morning, realizing what a bad idea the first memo was, a **second memo** was issued, which revised the first memo. While not admitting any missteps were previously made, the second memo walked-back some of the policy positions that had been taken, “[b]ased on feedback from the Department’s acquisition executives about how inflation is presently affecting the Defense Industrial Base and contractors’ ability to perform under existing firm-fixed-price contracts.”

The revised memo provides contracting officers with some flexibility—

… there may be circumstances where an accommodation can be reached by mutual agreement of the contracting parties, perhaps to address acute impacts on small business and other suppliers. For example, provided adequate consideration is obtained for the Government, such an accommodation may take the form of schedule relief or otherwise amending contractual requirements.

The revised memo also notes that—

For extraordinary circumstances where contractors have sought or may seek an upward adjustment to the price of an existing firm-fixed- price contract to account for current economic conditions, each of the Secretaries of Defense, Army, Navy and Air Force has authority under Public Law 85-804, as implemented by Part 50 of the Federal Acquisition Regulation (FAR) and the Defense FAR Supplement (DFARS), to afford Extraordinary Contractual Relief. While the law and regulation have established stringent criteria, the Department will consider contractor requests to employ this authority, subject, of course, to available funding.

Which is nice, but if you read closely, you'll see that any extraordinary relief is limited by the amount of "available funding." Meaning that it will essentially take an Act of Congress to grant it.

Mark Twain famously said, "History doesn't repeat itself, but it often rhymes." Here we are, fifty years after the Lockheed bailout and loan guarantees, and we have seemingly learned nothing. The mission is in jeopardy and, rather than addressing the real problem—which is that DoD is lacks the flexibility to quickly adapt to changing economic conditions—we have seemingly put the attorneys in charge.

In my view, we need to put the attorneys and policy-wonks on the back-burner right now, and get the practical business-people in positions to make tough decisions. But, you know, that's just one opinion.