Fixed Price Economic Price Adjustment Model

Idea In Short

Fixed Price Economic Price Adjustment Contract is a variation of the Fixed Price Contract [FP] provides for upward and downward revision of the stated contract price upon the occurrence of specified contingencies.

A fixed price contract with economic price adjustment, under certain circumstances, allows for changes in the price. Price adjustments are based on price divergence i.e. upward or downward price movement of specific items or deliverables. These price movements can either be positive or negative.

Upward price adjustment

Under such contracts, you can make price adjustments when the market conditions fluctuate. However, these conditions should be beyond the service provider's control. Inflation, trade sanction, pandemic and natural disasters are examples of such conditions. However, these contracts stipulate the price ceiling beyond which you cannot increase price. Moreover, the price increases must be reasonable and agreed to by both, the client and the service provider. You should document the price ceiling and the conditions of adjustment in the contract before you begin the work.

Downward price adjustment

Just a price increases, you should also set the provisions for price reductions when rates fall below certain thresholds. The contract should also explicitly mention the price floor below which you cannot decrease price. Generally, these contracts provide two types of price adjustments based on :

1. An actual increase or decrease in costs associated with specific labor or materials

2. Standard costs or indices that are specifically laid out in the service contract

Adjustments based on actual costs of labor or material

Price adjustments are based on divergence i.e. upward or downward movement of labor or material costs that arise during project execution

Adjustments based on cost indexes of labor or material

Price adjustments are based on divergence i.e. upward or downward movements in labor or material cost indices identified in the contract

Usage

FP EPA contracts are usually only appropriate when there is reasonable doubt regarding the stability of certain conditions over the extended period of a project, such as:

- Market stability
- Labor conditions
- Established prices
- Actual labor or material costs
- Labor or material cost indices

Additionally, contracts of this nature should only be used when the contingencies that would normally be included in a fixed price contract can't be easily identified and covered separately in that contract. Because FP-EPA contracts can be difficult to administer, they are not a typical choice under normal circumstances.

Differences

At the core, fixed price economic price adjustment contracts are similar to regular fixed price contracts. The main difference is that these contracts allow for price adjustments under certain circumstances (contingencies).

Caveats

To avoid confusion and dispute about price adjustments and when they are allowed, both the client and the service provider should agree on the terms when concluding the contract. You should explicitly address the uncertainty that is common in certain markets. The economic conditions of the market will change over time. Typically, clients and service providers use FP-EPA contracts when engagements last extended time periods. Usually, these periods last several years. Therefore, both clients and service providers should document the contingencies to transparently accommodate for the changing market conditions during the contract term.

Summary

A fixed-price contract with economic price adjustment is used when there is serious doubt concerning the stability of market or labor conditions that will exist during an extended period of contract performance. Contingencies that would otherwise be included in the contract price should be explicitly identified and covered in the contract. Price adjustments based on established prices should normally be restricted to industry-wide contingencies. Price adjustments based on labor and material costs should be limited to contingencies beyond the service provider's control.