PPI Program Spotlight

U.S. Department of Labor
Bureau of Labor Statistics

How to Use the Producer Price Index for Contract Escalation

NO. 98-1
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Spotlight

Producer price indexes, calculated by the Bureau of Labor Statistics (BLS), measure the average change in prices received by domestic producers for commodities in all stages of processing, for detailed commodities, and for the net output of selected industries. The data are useful in price adjustment clauses because they measure price changes objectively and are free from possible manipulation by either of the contracting parties.

The role of the BLS is to provide requested data and to explain their underlying methodology and limitations. BLS does not encourage or discourage the use of price adjustment measures in purchase or sales agreements. Nor does the Bureau directly assist in writing contracts or provide advice on disputes arising from contract interpretation. However, the Bureau will provide technical and statistical assistance to users who are developing indexing procedures.

The following are general guidelines to consider when developing an escalation agreement. Clauses should be written with great care to avoid serious problems when contract adjustments are implemented.

- ***Establish the base selling price subject to escalation.*** Specify the item subject to escalation as precisely as possible. Include per-unit quantity or a certain volume of units that will be escalated. Provide the effective month and year of this base selling price (this time period is often called the base period). In addition, indicate the length of time the contract will remain in effect.

- ***Select an appropriate index or indexes.*** The index or indexes selected will affect the price change and should be chosen carefully. Data users can select from stage-of-processing, or commodity- or industry-based indexes.

  Aggregated stage-of-processing (SOP) indexes contain detailed commodity data that are grouped according to their level of fabrication and end-use. SOP indexes, such as the PPI for finished goods, may best indicate the general trend of inflation. The index for finished goods excluding foods may be more appropriate for the user wishing to exclude the effects of volatile movements in food prices.

  Commodity indexes are organized by similarity of end-use or material composition, without regard to the industry in which they were produced. Indexes are calculated for specific commodities and for aggregated groupings. Indexes for detailed commodities or commodity groupings indicate specific price trends for individual products.

  Industry based indexes are organized by producing industry as defined in the Standard Industrial Classification system. Such indexes reflect the price trends of a constant set of goods and services for the net output of a specific industry and for aggregate groupings.

- ***Clearly identify the selected index and cite an appropriate source.*** The escalation clause of a contract should identify the selected index by its complete title and any identifying code. (Example: Producer Price Index for industrial electric power, commodity code 0541.) Contracting parties should not cite table numbers and/or table titles in their escalation contracts because they are subject to change.

- ***Specify that the selected index will not be seasonally adjusted.*** In general, seasonally adjusted indexes are not appropriate in escalation agreements. Because price adjustment clauses usually are intended to capture actual price changes, contracting parties normally would not want to remove seasonal price movements from their adjustment.

- ***State the frequency of price adjustment.*** The escalation clause should specify whether price adjustments are to be made at fixed intervals, such as quarterly, semi-annually, or annually, or only at the expiration of the contract. Avoid ambiguous wording such as "the index for aluminum mill shapes as of September 30," since several different and equally plausible interpretations are possible for such language.

- ***Indicate whether the index used in the adjustment calculation will be preliminary or final.*** An index remains preliminary for 4 months after its release. If additional price information is received by BLS during this period, it is incorporated and the index is adjusted. Because the preliminary index is subject to change, the final compilation is recommended for use in contract escalation.

- ***Provide for missing or discontinued data.*** Occasionally any given Producer Price Index may be unavailable for a particular time period. This usually happens because price information was not supplied by a sufficient number of survey respondents to meet BLS publication standards. Sometimes an index is permanently discontinued when a commodity declines in market importance. Escalation clauses should provide successor indexes for such instances. A provision for using the next higher-level series should be included in the contract.

- ***Avoid locking indexes used for escalation into any particular reference base period (e.g. 1982=100).*** Official PPI data for current time periods are not available on previous reference bases after a base change has been implemented by BLS. Relative movements of any series over time are not affected by a base revision.

- ***Define the mechanics of price adjustment.***
  Simple percentage method changes the base price by the same percentage as that calculated for the selected producer price index.
  Escalation of a portion of the base price changes the base price so that only part of it is escalated by a selected producer price index, while the balance remains fixed.
  Composite indexes are based on several PPI series. The advantage of a composite index is that it may more accurately identify the appropriate change for a base price since it will refer to several of the costs involved in producing the product or service in question.