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## **Avoiding the High Costs of Cost-of-Living Adjustments in Outsourcing Contracts: A Litmus Test of Sourcing Done Right**

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Most consumers understand how the rising cost of living can challenge their budgets, but buyers of outsourcing services negotiating contracts seldom fully grasp the long-term effect that the price-inflation clauses they negotiate can have on their outsourcing pocketbook. If buyers agree upon an inappropriate price-increase mechanism, they may find themselves paying millions of dollars in costs that escalate and compound during a typical 5-year to 7-year contract duration. TPI recognizes the problems associated with these price-inflation clauses (often known as “economic cost adjustments”) and can help buyers navigate the pitfalls in negotiating them.

Through our work with clients, we help negotiating parties determine the appropriate approach to economic cost adjustments by:

- Helping determine what proportion of costs will probably be impacted by inflation or deflation,
- Advising as to which of several cost-of-living or labor-cost indices should be used as the underpinnings for these formulas, and
- Providing guidance on appropriate formula calculations.

We help corporate buyers negotiate with service providers to obtain contracts that accurately reflect future labor and non-labor costs during a contract period. In this paper, we will examine the crucial future pricing factors affecting a purchaser of outsourced services and how an expert advisor can help the negotiating parties resolve these issues successfully.

## **Determine the appropriate portion of the market basket impacted**

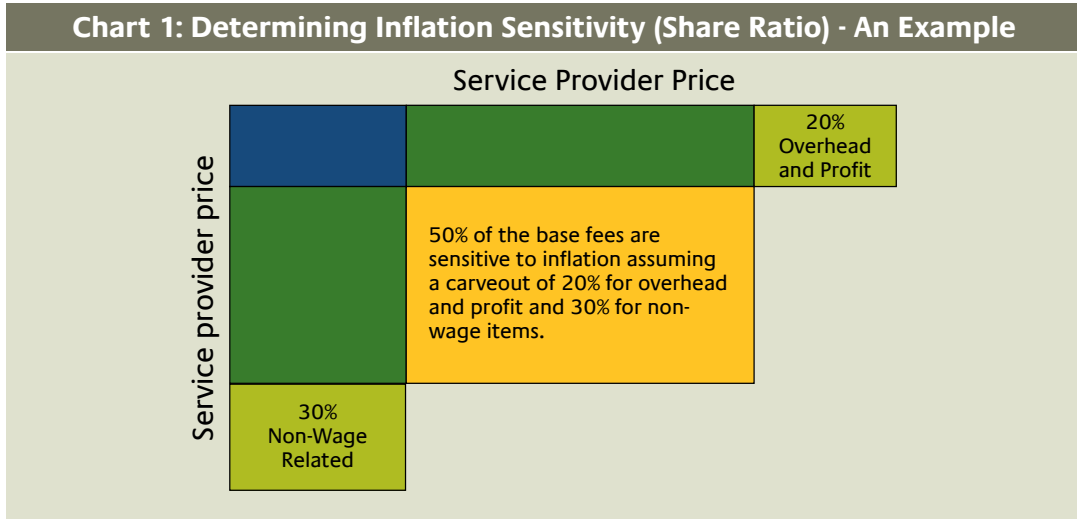
The first consideration is determining what portion of an outsourcing market basket might be subject to inflation or deflation. In a typical Information Technology

Outsourcing (ITO) contract, the cost of IT hardware, such as servers, is likely to actually decline during a contract’s term, in accordance with Moore’s Law.<sup>1</sup> Although the cost of maintaining facilities is likely to increase, the facility costs themselves may remain constant. Clients are usually reluctant to inflate the service provider’s overhead and profit. Average labor costs typically rise; however, many outsourcing providers experience employee turnover that is high enough to significantly reduce labor cost increases, as newly hired workers replace longer-tenured (more highly compensated) workers. Business Process Outsourcing (BPO) transactions tend to be much more labor-based than ITO contracts. Hardware/software components are included only if the hosting of the system is also provided, such as an HR system along with the HR functions.

Given the diverse elements in an outsourcing service provider’s cost structure, an important issue in many outsourcing negotiations is the relative role of labor costs versus various nonlabor costs in economic cost-adjustment formulas. Service providers may understandably bargain for annual price increases based solely on a major cost-of-living and/or employment cost index in the client’s country. A more appropriate price inflator, however, is one that reflects not only realistic inflation rates for labor but also those for hardware, facilities and other factors. This discounting factor to allow for non-labor price changes — the “sensitivity ratio” or “share ratio” — typically decreases economic cost adjustments in contracts to approximately 60 percent to 70 percent (or higher in BPO transactions) of what those costs would be if they were based on labor costs alone. Chart 1, which follows, shows an example of how the “share ratio” might account for inflation sensitivity in a contract.



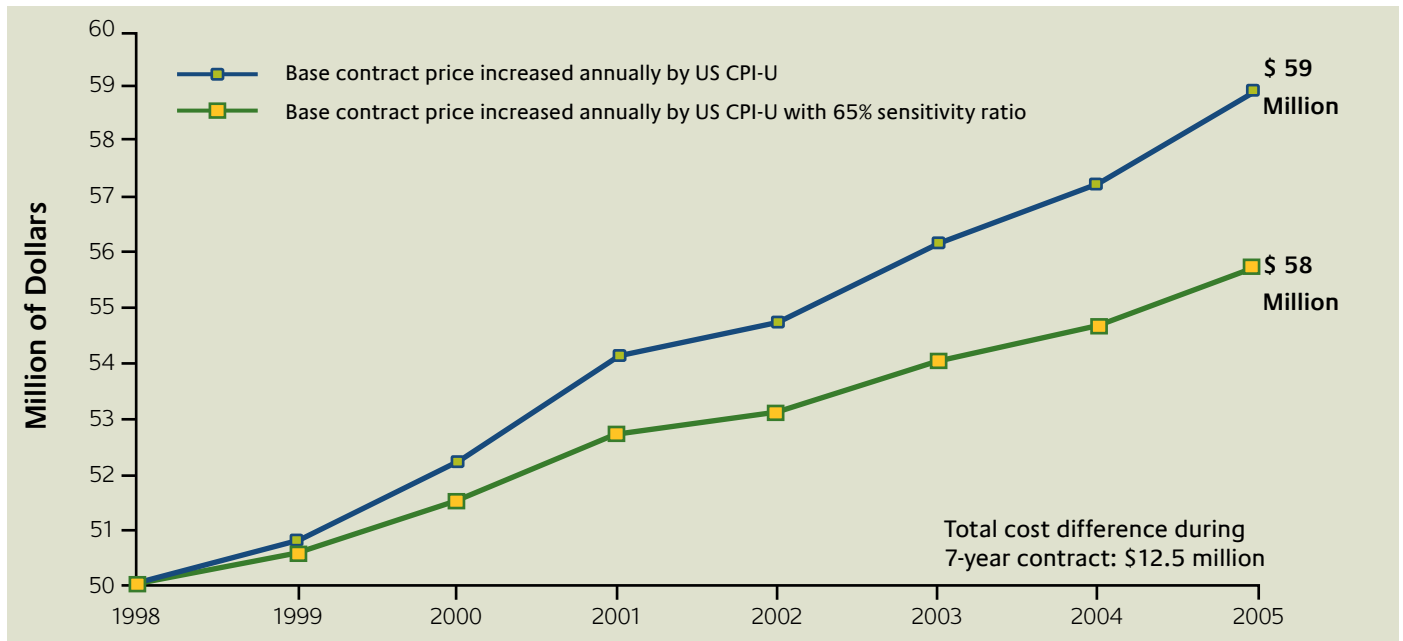
**Chart 1: Determining Inflation Sensitivity (Share Ratio) - An Example**



(Source: TPI, Inc.)

Chart 2, which follows, shows the impact of a typical negotiated “sensitivity ratio” of 65 percent compounded during a 7-year contract (1998-2005), compared to the impact of 100 percent of the annual U.S. CPI-U.

**Chart 2: Effect of Sensitivity Ratio (Share Ratio) on Annual Contract Cost (Starting Value = \$50 Million)**



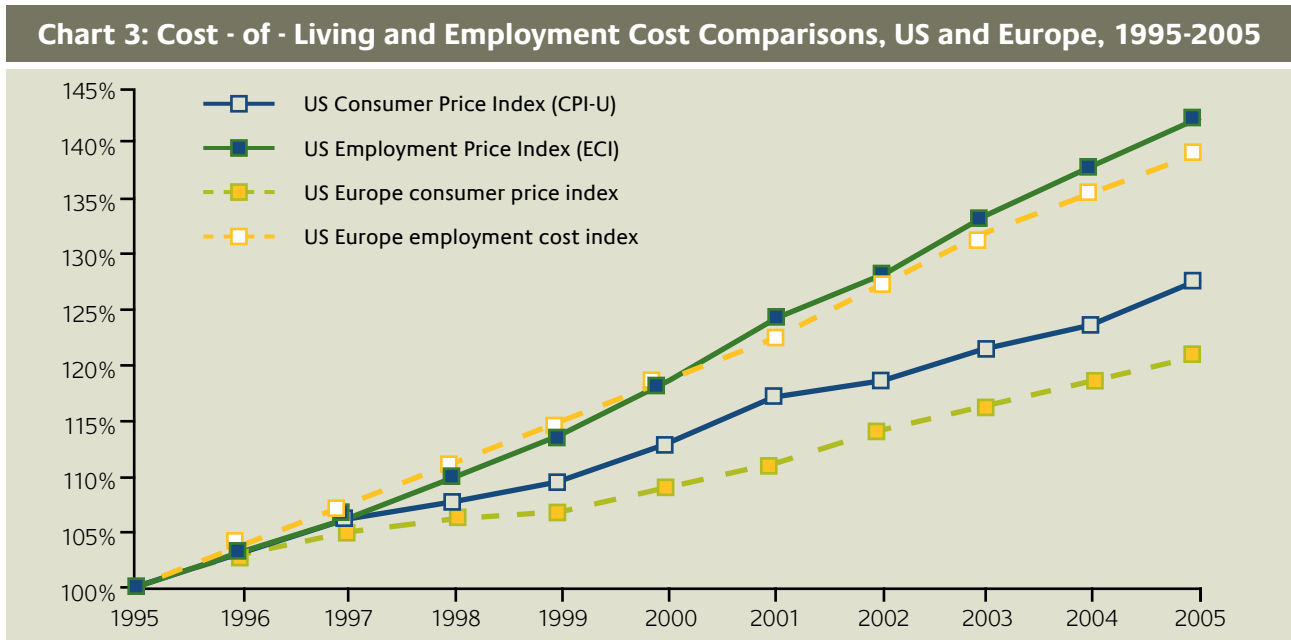
(Source: TPI, Inc)



In this case, using a sensitivity ratio of 65 percent for a US\$50 million (annual) contract would have made a total cost difference of US\$12.5 million during the 7-year contract period. When compared to contracts without this provision, we are typically able to assist clients in negotiating a favorable sensitivity ratio that can save 0.3 percent to 1 percent per year (compounded).

### Select the appropriate index

A second critical consideration that impacts negotiated economic cost adjustments is selection of the appropriate cost-of-living indices on which to base price-inflation and/or price-deflation formulas. Clients should pay the expected cost increase/decrease in the country where services are to be delivered, not the country from which they are provided. Governments in the countries of major purchasers of outsourcing services (United States, United Kingdom, Japan, etc.) compile and publish highly sophisticated indices of cost-of-living and employment costs. Additional statistical measures are available from research firms and employer organizations. These measures can sometimes be more volatile, however, and reliance on the wrong index can cost a purchaser of outsourcing services millions of dollars during a contract's lifespan.



(Source: United States data and European employment cost index: Bureau of Labor Statistics, U.S. Department of Labor (except 2005 European employment costs, from Federation of European Employers); European consumer price index Harmonized Index of Consumer Prices, European Central Bank)

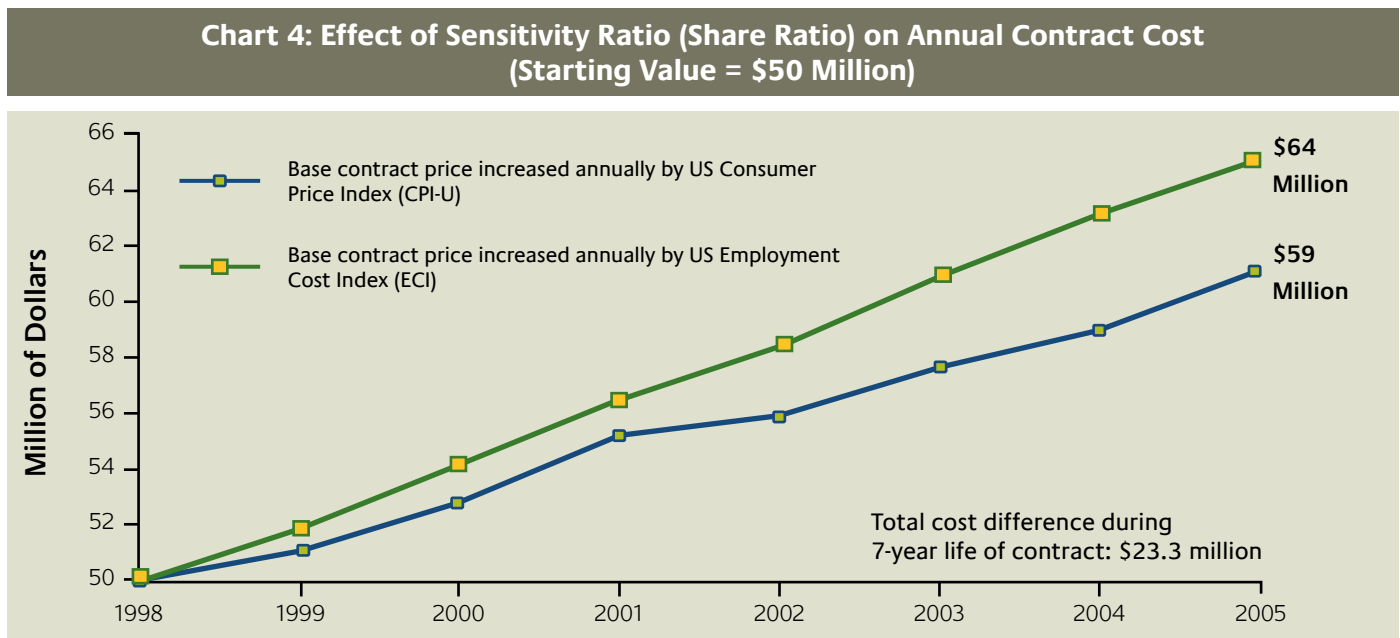
Chart 3 compares major cost-of-living and employment cost indices for the United States and Europe. It suggests that the index used can have a notable impact on contract costs.



For U.S.-headquartered companies, TPI usually recommends the Consumer Price Index for urban Americans, unadjusted for seasonal variations (CPI-U), as compiled by the U.S. Department of Labor’s Bureau of Labor Statistics (BLS). This index reflects costs for a broadbased market basket of goods purchased by most of the U.S. population; thus it is a good gauge of the living cost of the U.S. workforce.

Another measure, the Employment Cost Index (ECI) — also compiled by the BLS — assesses labor costs experienced by employers in all sectors, including information technology (IT) and professional workers. Focusing on changes in wages and benefits, it is generally a more volatile index than the CPI. It might be logical to use this index if exactly the same employees were providing exactly the same services every year. However, workforce turnover and retirements tend to offset the impact of steadily rising salaries and benefits in the work force, and these diminishing factors are not well represented in the ECI.

Chart 4, which follows, indicates the dramatic difference using one of these price-increase measures instead of the other can have on annual costs during a 7-year contract. In this example, the total cost difference during the 7-year life of a US\$50 million (annual) contract using the ECI versus the U.S. CPI-U is US\$23.3 million.



(Source: TPI, Inc.)



For European Union (EU) countries, economists are combining cost-of-living and employment statistics compiled by individual country governments into increasingly sophisticated composite data for the expanding group of European nations although, of course, huge regional differences remain.

TPI recommends using a government index from the country in which the outsourcing client receives the services. In negotiations on behalf of U.S.-based clients, we are frequently successful in achieving agreement on using the United States' CPI-U as the standard. Similar indices exist in major European and Asian countries, which are suitable for these clients. We suggest using government-provided indices since they are typically more reliably available than private-company-compiled indices, for which future availability and consistency may be less certain.

Selecting the right index is especially important in offshore transactions. TPI's advice is that whereas the service provider assumes the costs and the benefits of choosing a source — such as India — that has had higher inflation than the United States or Europe (recently, approximately two or three times higher), the client should bear costs and realize benefits of the location where it receives the services. For this reason, the provider might deliver services from multiple sources to reduce the overall impact of inflation on its labor costs. In India, the inflationary wage pressures are partially offset by the “turnover effect,” where younger, less expensive workers tend to replace those who leave. Turnover provides some downward pressure on the typical wage increases even after allowing for the cost of training the newer, probably younger, workers.

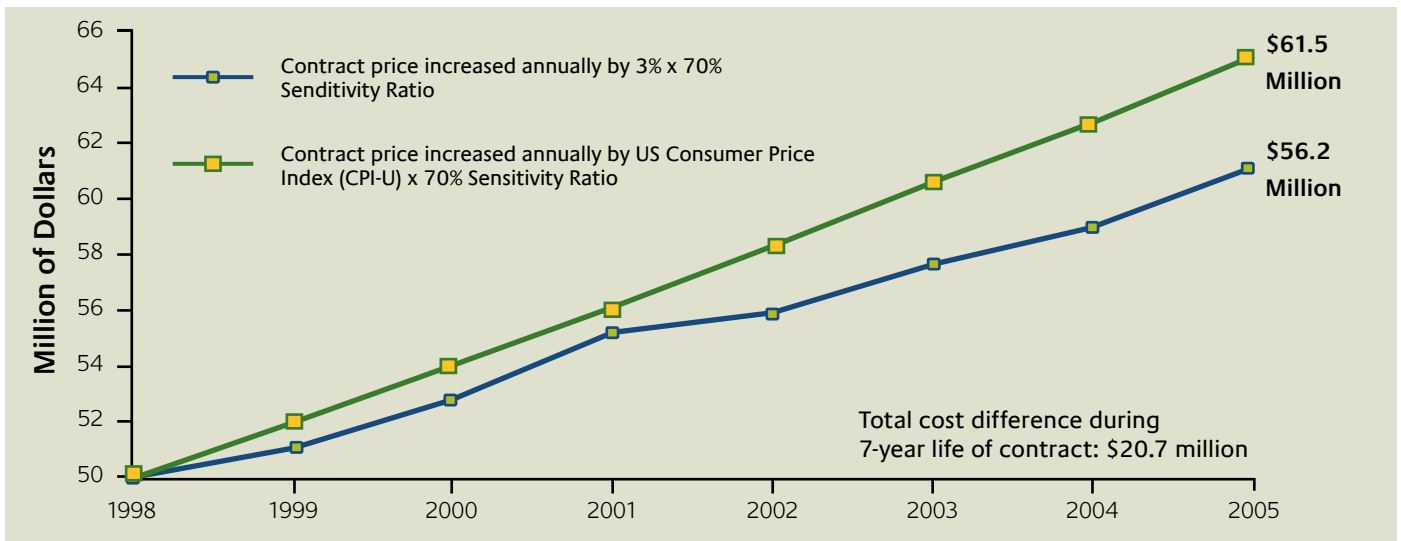
## **Build a conservative but flexible approach into the contract**

If we assume that inflation or deflation can and must be accounted for in a reasonable way based on both the right sensitivity ratios and the right index, what process should an outsourcing contract include to comfortably allow for economic cost adjustments? Instead of basing any service provider's cost increases on an estimated average rate of inflation during each contract year, we often recommend that the service provider determine what its costs will be without inflation and then negotiate a retrospective adjustment formula based on actual inflation or deflation. We often use the Base Case — the client's existing and projected costs for the “in-scope” functions — as the basis for determining what costs will be affected by inflation/deflation. The Base Case determines the amount of employee-related costs — such as compensation and training — as well as other inflation-sensitive costs and non-inflation-sensitive costs. This tends to provide a reasonably consistent measure that both the service provider and the client can accept.

Chart 5, which follows, shows the differences between a presumed annual inflation rate of 3% and actual inflation rate (as measured by the U.S. CPI-U) in a 7-year, US\$50 million (annual) contract. In this example, the total cost difference during the 7-year life would have been US\$20.7 million.



**Chart 5: Contract Cost Inflated by a Fixed Rate Versus by CPI-U With 70% Sensitivity Ratio**





## Conclusion

Clearly, to avoid paying more than is reasonable because of economic change adjustments in outsourcing contracts, corporate buyers of services must negotiate with the following factors in mind:

- Future changes in the “market basket” of all costs, not just labor
- The appropriate index to use in calculating inflation
- The need for negotiated and agreed-upon formulas that will reflect the corporation’s actual future cost increases or decreases

Although only representing buyers of outsourcing services, TPI helps both clients and service providers to arrive at an effective and long-term joint resolution of these issues, so that their negotiated contracts exhibit the “staying power” to stand the test of time.

<sup>1</sup> Moore’s law is the empirical observation that the complexity of integrated circuits, with respect to minimum component cost, doubles every 24 months. It is attributed to Gordon E. Moore, a co-founder of Intel. (Wikipedia, 2006)

**ABOUT TPI:** TPI is the founder and innovator for the sourcing advisory industry, and the largest sourcing advisory firm in the world. We are expert at a broad range of business support functions and related research methodologies. Utilizing deep functional domain expertise of accomplished industry experts who possess extensive practical experience, TPI collaboratively works with organizations to help them optimize their business operations through the best combination of insourcing, offshoring, shared services and outsourcing. For additional information, visit [www.tpi.net](http://www.tpi.net).

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