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Dynamics of Price Adjustments in a Globalized Sourcing World

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INTRODUCTION

Today, we often hear that leading service providers (supply side) establish new delivery centers in different parts of the world or acquire companies in other countries to establish their presence or scale up operations. At the same time, Fortune 500 companies and others (demand side) are aggressively expanding into emerging high-growth markets — where countries are witnessing an annual GDP growth rate higher than 5-6 percent — so they can grow their share of global revenue. The expansion of global sourcing of services is a direct outcome of this trend.

On the demand side, for example, India accounted for over 30 percent of the total Asia Pacific outsourcing market between January 2007 and June 2007, and China has increased its share to 20 percent. This trend clearly indicates that these economies are not only large suppliers of services but also constitute growing markets for similar services. Consequently, service demand as well as service delivery are now global.

The onshore-offshore phenomenon is slowly giving way to a global services delivery model. Global contractual arrangements make it more complicated to finalize fair and equitable arrangements. Contract negotiators must especially consider carefully the provisions for price adjustment factors and how they can produce an enduring contract that avoids renegotiation, at least on this count, through its term.

This paper analyzes the implications of the global sourcing trend for three select price adjustment factors — *inflation*, *foreign exchange (forex) fluctuations* and *taxes*; these factors potentially can lead to price adjustments over the term of the contract.

Without being prescriptive, we want to identify how to provide such adjustments and to discuss the underlying principles that typically drive such contract negotiations.

It is important to note that the provisions are eventually structured into a contract that results from client and service provider negotiations that reflect a specific market situation. Among others, the following factors shape such negotiations:

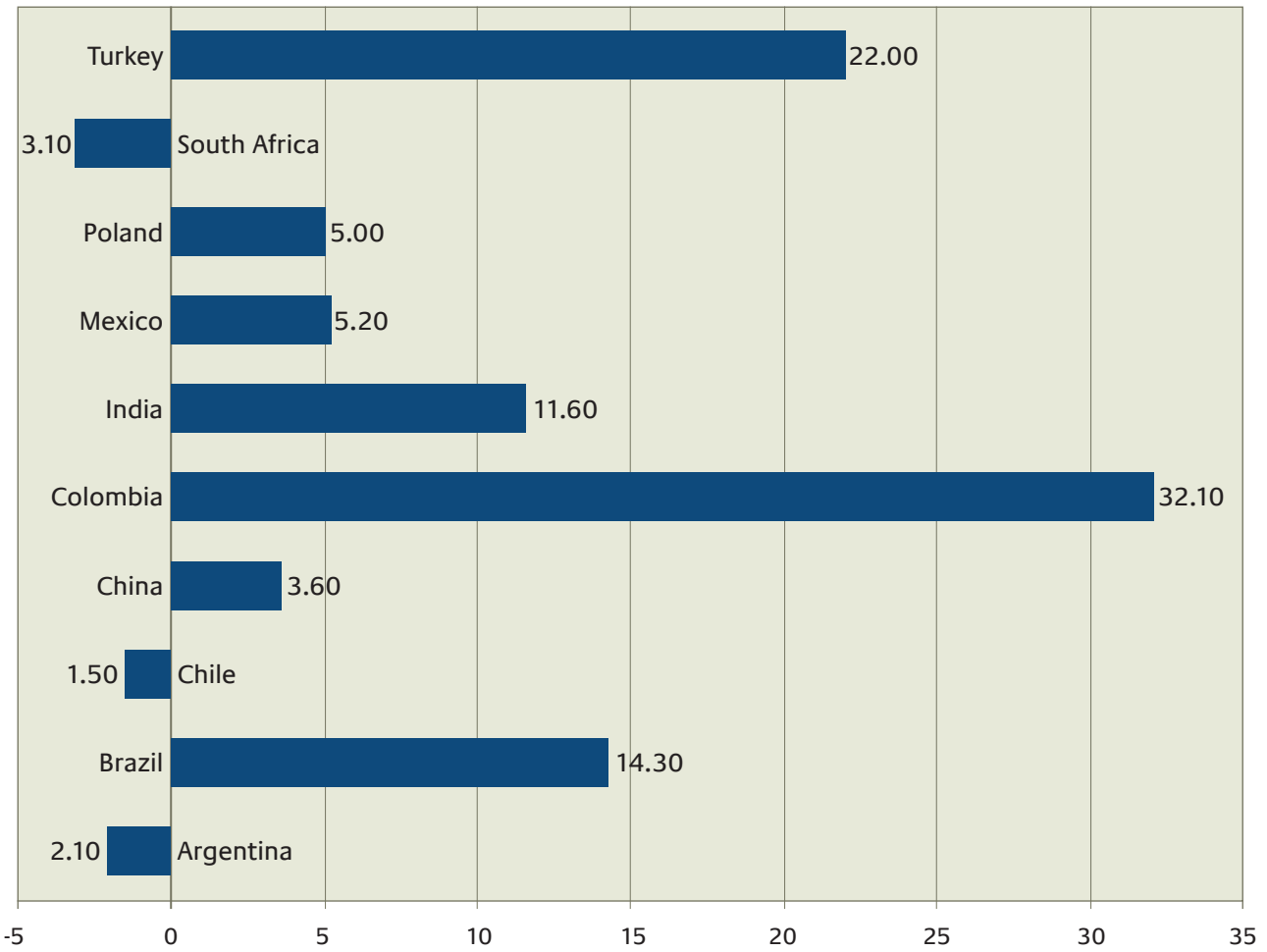
- Relevant market influences
- Respective negotiating leverage, which can be affected by:
 - Significance of the transaction to the service provider — its total contract value, nature of services, geographical scope and so forth.
 - Unique service provider capabilities vis-à-vis client requirements
- Relative negotiation skills of client and service provider teams.

COMPLEXITY AND SIGNIFICANCE

We can obviously see the great complexity of these factors in global contracts, but we can also inspect some statistics to gauge this complexity. The following chart illustrates the real (inflation-adjusted) exchange rate fluctuation between June 2006 and May 2007 for most emerging markets in relation to the U.S. dollar. The data show that currency movement among countries varies widely in magnitude and direction. The South African rand, Chilean peso and Argentine peso depreciated against the U.S. dollar, counter to the general trend of appreciation by other developing market currencies.



Currency Fluctuation in Real Terms (expressed as a percent) of Select Developing Markets vis-a-vis U.S. Dollar over One Year

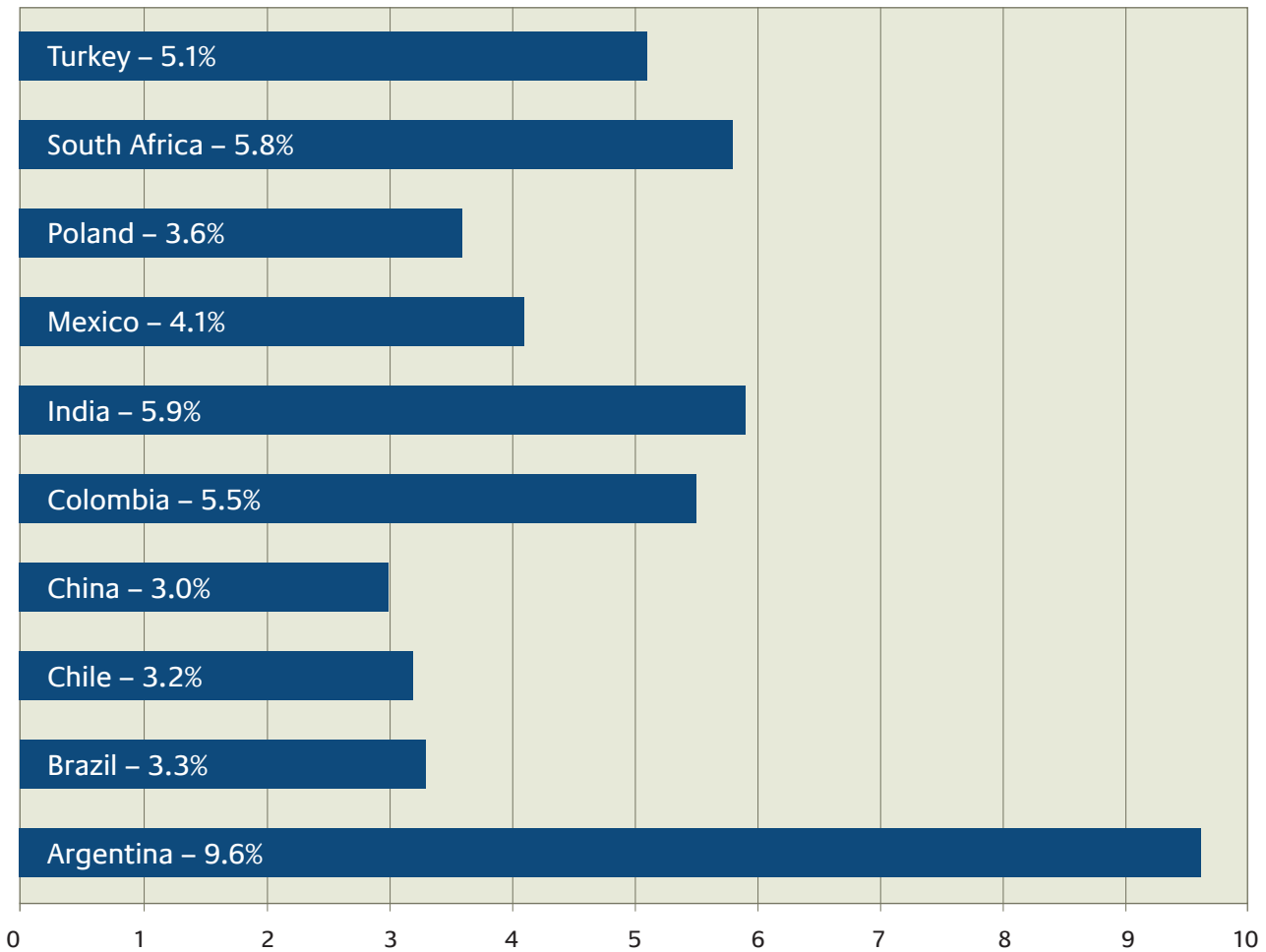


Source: Credit Suisse
Period: June 2006 - May 2007



The next chart depicts the considerable variation in inflation across nations.

2007 Consumer Price Inflation in Select Developing Markets (expressed as a percent)



Source: The Economist, Wikipedia (July 2007)

Furthermore, the dollar impact of these fluctuations could have a significant impact on the overall contract value.



KEY OPTIONS AND ADJUSTMENT PRINCIPLES FOR CONTRACT NEGOTIATORS

Contract negotiators must be aware of the role of inflation in several key options and adjustment principles and how it affects contract structure.

Inflation

While most service providers with delivery locations in developing markets are experiencing high business growth levels on the one hand, they are facing significant challenges on the other — high inflation rates (essentially wage inflation) driven by employees who expect increased salaries, in markets in which the supply of experienced talent is in short supply, and other associated factors.

A service provider generally experiences two kinds of inflation:

1. Wage inflation: attributable to salary and wage increases in terms of total cost to company. This represents an average wage hike for employees across different ranks and performance levels. We must note that companies can take several measures to minimize the impact of an overall increase in a service provider's wage bill — especially as this is observed in the Indian market context:

- Increase the proportion of junior employees within the employee population — they are relatively less experienced and cost less.
- Increase hiring in Tier-2 cities, which have lower cost of living and wage levels relative to Tier-1 cities.
- Reduce the “buffer” employee pool, which increases overall employee billing utilization.

The average annual wage hike in the Indian IT services industry during the past two to three

years has been in the 10 to 15 percent range. Because of the large annual pool of available fresh graduates and engineers, however, most Indian service providers hire a significant number from this population to meet their high growth requirements, and this has helped them contain their overall employee cost as well.

2. General inflation: attributable to the cost increase of inflation-sensitive cost items such as facilities, travel and transportation, food and beverages and others. Additionally, other cost elements, such as telecom and technology costs, are not inflation-sensitive — they are usually deflationary because of technological advances and intense market competition.

The principal options for providing inflation adjustments in sourcing contracts include:

- 1. No adjustment for inflation:** This option rejects adjustment for inflation over the term of the contract, regardless of the countries that deliver the services (supply side) or the countries that receive them (demand side). In effect, the client choosing this option expects the service provider to consider non-adjustment of inflation in the negotiated prices upfront prior to execution of the contract. The extent to which the provider will absorb the inflation risk depends on how intense and aggressive a position it takes in each unique transaction. This option enables pricing to become predictable over the term of the contract for the client.
- 2. Adjustment based on inflation index:** To combat uncertainty, the price adjustment can be linked to an inflation index. Extremely important in such a case is the choice of an appropriate index, which can be based on either the demand or the supply country. The adjustment must not be based on an employment cost index alone, however, because that does not represent the overall cost base of the provider. Other cost



items, in addition to wages, include office infrastructure and telecom costs, some of which are not necessarily inflation sensitive.

- 3. Adjustment based on open book:** In this option, the client agrees to adjustments based on the actual cost impact of inflation on the service provider delivery cost. Agreement means that the service provider is willing to share with the client the detailed cost information (unit cost structure) from its book of accounts and to convince the client of the actual inflationary impact on the delivery cost structure. This option makes significant administrative demands on both parties; they must go through the details before they agree on the adjustment. Besides, the sharing of financial details at a unit cost level is normally deemed “confidential” by service providers. Because this is a cost plus option, it also exposes the client to the risk of a service provider inefficiently managing its own cost structure.

The selection of an inflation adjustment option results from negotiation and depends on the circumstances in every situation. Clients and service providers can consider the following *guiding principles*, however, to negotiate a balanced position:

Guiding Principles for Negotiation

1. The service provider is being fair-minded when it asks for an inflation adjustment, especially in a longer-lasting contract. However, the client must understand what service providers do to manage the inflationary impact on their cost elements in order to maintain their margins or, in other words, to manage the inflationary impact on their cost structure:
 - The average experience of the account delivery team – more-experienced employees are typically replaced (through attrition or otherwise) by relatively less-experienced

employees or recent graduates. This practice helps service providers contain their average cost structure.

Anecdotal evidence from our experience suggests that, in certain situations, service providers have a highly skewed employee mix, with as much as 50-60 percent of the account delivery teams made up of employees with less than two years of work experience.

- Country mix for service delivery – the mix of countries in the service delivery effort has an impact on the cost structure because low-cost sourcing destinations like India usually have experienced higher inflation than the demand countries in North America and Western Europe.
 - Inflation impact on labor costs – high inflation mostly impacts labor costs and these do not constitute 100 percent of the cost of revenue to the provider. The typical range is 35-90 percent of the total cost, though it varies from Business Process Outsourcing (BPO) to Information Technology Outsourcing (ITO) or for Application Development and Maintenance (ADM) service.
 - Distribution of the average wage hike – It is important to understand that everyone on the team does not get the same hike; some people receive a lower-than-average hike or no hike at all.
2. Inflation adjustment can be provided, with the above factors in mind, by using an appropriate inflation index — unless the contract was structured up front with the understanding that prices are expected to be escalation free. We do not recommend using any privately-sponsored indices, regardless of their popularity or vintage. We strongly recommend the use of government-published indices, preferring the general cost-of-living inflation index.



3. Specific situations may require the following variants to the options described above:

- Use of caps – a percentage limit, beyond which the inflation adjustment will be subject to negotiation and not merely formula based;
- Use of floors – a limit below which no price adjustment is triggered, because the service provider is expected to absorb a certain level of inflation.

4. In global delivery, one can also use a representative set of inflation indices to develop a weighted average for the demand or supply of services; the weighted average represents many countries rather than one. You can determine the weights according to the proportion of services (in monetary terms) delivered by the various involved countries on the demand and supply sides. This approach may be less demanding than the effort involved in using individual country indices.

Summary

Contract negotiators can consider using an appropriate index to adjust prices for inflation in global sourcing contracts, whose pricing is not explicitly defined as inflation free (so that the service provider can factor it into the overall price as they deem appropriate). The index can be the Consumer Price Index (CPI) or an appropriate substitute if CPI is not published.

Further, contract negotiators can make a convenient adjustment for both the client and the service provider in a multi-country demand and supply scenario; they can use an average or weighted-average index from several representative countries (such as the Harmonized Index of Consumer Prices (HICP),

which covers the consumer price fluctuation across the euro area).

Finally, we strongly discourage using private indices because these are typically not broad based and may be less reliable than government-published indices.

FOREIGN EXCHANGE FLUCTUATIONS

Foreign exchange (forex) fluctuations can be significant; they can also either appreciate or depreciate, as the prior chart in the paper shows.

- If the supply-country currency appreciates against the billing currency of the demand country, service provider revenues, and hence margins, decrease — as reported in terms of supply-country currency.
- A case in point is the most recent quarter (2Q07) financial results that India-based service providers announced. Most of these providers have reported less encouraging results mainly attributable to the recent sharp rise of Indian rupee against the US dollar.
- If the supply-country currency depreciates against the billing currency of the demand country, service-provider revenues, and hence margins, increase — as reported in terms of supply-country currency.

Contract negotiators have several ways of dealing with pricing adjustments attributable to forex fluctuations:

1. **No adjustment allowed:** The client does not provide for any price adjustments attributable to the forex fluctuations. The rationale for such a stance could be that the service provider can hedge its currency exposure as it deems necessary. This practice is generally accepted: it is followed in manufacturing and other businesses



and is a commonly-adopted practice in sourcing contracts.

2. Adjustment allowed for fluctuations

- **Adjustment within a band:** Price adjustments can be allowed up to a certain percentage (say 5 percent), based on forex rate movement; a greater adjustment may be subject to negotiations. The adjustment could include or exclude a floor (say 2 percent). The service provider would be expected to absorb fluctuation up to the floor if there is a floor defined.
- **Adjustment beyond ceiling** This adjustment is allowed only for extreme fluctuations — for example, of more than 5 percent annually. The adjustment is required if the fluctuation occurring within a certain interval (typically one year) is greater than the ceiling (say 5 percent).

Negotiators can adjust the prices in the billing currency, taking the fluctuation into account and considering it an extraordinarily volatile situation. The rationale is that hedging typically works only for reasonable forecasts and a stable environment and not for dramatic changes. The adjustment could be either automatic (formula based) or based on negotiations.

In some cases, extreme fluctuations can create a financially uneconomical situation for the client, causing it to invoke a termination clause. As an example, the fluctuation between participating currencies (e.g., the Great Britain pound (GBP) and euro) is allowed within a certain band if we apply the Exchange Rate Mechanism that works in Europe (This is now Exchange Rate Mechanism II, introduced at the time the euro was launched). To avoid a highly volatile situation, central banks control the fluctuation if it

exceeds the pre-determined band. Under these circumstances, extreme fluctuations are unlikely to occur and hedging mechanisms can work effectively.

Negotiators can vary their approach for making such adjustments, by considering several developments:

- Direct movement of supply-country versus demand-country currencies.
- Movement of supply-country currency against representative currencies of countries that are the major recipients of the services.
- Basket of currencies representing the mix of supply countries and another basket representing the mix of demand countries.

Of course, the question of such an adjustment does not arise in cases where both the supply currency and the demand currency are the same, because in such cases the service provider is presumably not impacted. The adjustment can be annual or semi-annual; though for administrative ease, the standard practice is to do it once yearly.

The following guiding principles apply to forex fluctuations for outsourcing contracts:

- **Compensation:** Compensate the provider for the impact of forex fluctuation. No compensation is due if there is no impact.
- **Do not pay for what can be hedged:** The client should not pay for what can be hedged. It is standard business practice for the responsible service provider to hedge its forex-related risks.
- **Avoid double dipping:** Consider using (inflation adjusted) real exchange rates for forex fluctuations, where inflation adjustment is separately provisioned. Using nominal exchange rates results in double dipping, because nominal exchange rate movements are also a function of the



relative rates of inflation in the countries being considered.

- **Mutual consent for exceptions:** Discuss extraordinary situations where some extreme fluctuation has occurred and agree to a mutually acceptable solution.

Summary

Forex fluctuation-related price adjustments may not be necessary, and the service provider is often obligated to manage the currency fluctuations. However, the client and the service provider may need to discuss and resolve any extraordinary situations. In cases where a separate price adjustment is allowed because of inflation, the parties should make provision for the forex adjustment on an (inflation adjusted) real exchange rate basis to avoid double dipping.

TAXES

Tax-related price adjustments can potentially arise because of changes in the existing tax code, such as imposition of new taxes, abolition of existing taxes or removal of tax holidays. These scenarios are presented as follows:

1. **Direct taxes:** These are taxes whose impact and incidence fall on the person who is responsible for paying the tax. Examples include corporate income tax, wealth tax and gift tax.
 - **Imposition of new taxes:** Governments of the countries in which the service provider provides client services can impose new taxes during the term of the contract. This has direct impact on the “post-tax” margin of the service provider.
 - **Change in the existing tax regime:** An existing tax rate change, or the abolishment of an existing tax, is announced. This announcement directly bears on provider tax liability.

2. **Indirect taxes:** These are taxes whose impact is on the provider but incidence is on the recipient of service. Examples include service tax, Goods and Service Tax (GST), Value Added Tax (VAT) and so on.

- **Imposition of new taxes:** Indirect new taxes may be imposed during the term of a contract. Such taxes need to be charged on service provider services to comply with the tax laws.
- **Changes in the existing tax regime:** Rates of existing applicable taxes may be revised, or an existing tax may be abolished altogether. Such events will impact the tax liability on the delivered service.

These changes can be possibly handled as follows:

- **Risk of the service provider:** In this situation, the service provider agrees to bear all tax-related implications when the contract begins and throughout its term. The service provider does not make price adjustments, and the client’s cost does not change because of any changes in tax laws during the term of the contract.
- **Risk of the client:** In this situation, the client bears the risk and cost of taxes existing at the time of the contract as well as those that may be imposed during the term of the contract. This may also mean reduction in the client’s tax liability if the rates are reduced or if any taxes become inapplicable or abolished.
- **Risk shared by the client and the service provider:** In this situation, the client and the service provider agree to share the risk of future taxes in some proportion.

The nature of tax liability may, in principle, dictate the tax burden.

1. **Direct taxes:** The income, wealth or estate and other taxes are by nature the direct liability of the service provider. Firms typically bear such



taxes and do not pass them on to their customers. While determining the contract pricing, service providers should take into account existing and known future direct tax liability — for instance, a known event is the 2009 expiration of tax concessions to service providers in India under the Software Technology Parks of India (STPI) Scheme. Among other factors, market competitiveness determines the extent to which the service provider wishes to include future tax liability into the price.

- 2. Indirect taxes:** VAT, GST, service tax and other indirect taxes are usually invoiced to the customers. The service provider may, therefore, reasonably expect the client to share some of the burden in case of any unexpected or increased tax liability.

The service provider is responsible for conducting tax planning that minimizes the incidence of such taxes, however. The client should not be expected to pay for the service provider's negligence or inefficient tax planning.

In cases where a change in taxes significantly affects client sourcing economics, contract termination clauses should enable the client to exit favorably and conveniently.

Summary

To recap, the service provider should typically be solely responsible for direct taxes; and client and service provider can negotiate about indirect taxes when the tax laws change. This may also mean a reduced existing, indirect tax rate and hence the liability of the client. The client can resort to a more favorable termination clause if significant changes in the (indirect) tax rate adversely impact the overall economics of the client contract.

OVERARCHING NEGOTIATION PRINCIPLES

The following principles should govern the overall negotiations:

Obligation to optimize cost: The service provider is obligated to make the appropriate decisions that optimize costs. For instance, the service provider can help ensure that work is delivered from the optimal location mix to minimize the impact of location on delivery costs.

Fair cost to client: The service provider should approach such discussions keeping in mind that it cannot charge and recover every single dollar from the client. It has to manage its business, cost structure and derived efficiencies competitively. The provider cannot expect the client to pay for provider inefficiency or failure to be market competitive.

Fair margin for the service provider: The client should approach the negotiation keeping in mind that the service provider must earn a fair and reasonable margin on the business. Market competitiveness determines what constitutes fair and reasonable and can therefore vary from time to time and according to the nature of the services.

Market as a determinant: Market factors can determine such discussions because client and service provider must be willing to accept currently prevailing market practices.

We believe that these guiding principles can help in negotiating price adjustments — for these factors, when observed in a balanced manner, can result in fairness to both clients and service providers and thereby can help the cause of building a strong partnership over the long term.



CONCLUSION

The global sourcing trend has implications for three factors — inflation, forex fluctuations and taxes — that can play a role in potential price adjustments during the term of the contract between client and service provider. TPI's industry experts have analyzed this role to identify how contract negotiators can provision such adjustments. Specialists at TPI have also examined the underlying factors that typically drive such contract negotiations.

By understanding these different factors and the business contexts that shape them, negotiators can successfully finalize fair and equitable arrangements even though they are global in scope and have a much higher level of complexity.

LOOKING FOR A STRATEGIC PARTNER?

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