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Lawyer Insights

A Look At Economic Cost Adjustments Amid Global Inflation

By Randall S. Parks and Florian Uffer
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Global inflation remains hot and providers of goods and services are testing whether buyers are ready to negotiate economic cost adjustments, or ECAs, to their prices.

Buyers should not be too quick to reject them. An ECA that thoughtfully takes into account the various dimensions of inflation risks and the relative ability of the parties to manage those risks can actually reduce net costs over time.

Inflation and Contractual Economic Cost Adjustments

Prior to the Great Recession in 2008, cost-adjustment provisions attracted more attention than they have in recent years.

With inflation rates averaging more than 3% during the two decades preceding the Great Recession, parties to long-term sourcing agreements invested significant effort in negotiating complex ECA terms, which tried to quantify inflation risks and then allocate them based on assumptions about which party could best manage them.

But ECA negotiations often were handicapped by a lack of reliable, detailed inflation data outside the U.S. and some buyers' insistence on controlling the tools that providers might use to manage inflation risk.

Consequently, the results were approximate, but parties generally found that rough justice was acceptable.

Times and market conditions changed and, apart from a brief worry about U.S. deflation during the Great Recession, inflation has been a back-burner issue in recent years.

With U.S. inflation averaging 1% to 2% annually since the Great Recession, many long-term sourcing agreements have ignored inflation or treated it as a detail, sometimes including provisions allowing for cost-of-living adjustments, or COLA, but capping such adjustments at a few percentage points annually.

Indeed, regardless of whether their agreements include a COLA clause, providers have been able to counter lower inflation rates by changing their delivery methods, modifying their pricing strategies, and eliminating costs through automation. But current explosive inflation rates are refocusing parties on the issue.

Unlike their U.S. competitors, Indian providers have been dealing with a more elevated inflation rate, which averaged roughly 6% over the past 10 years and peaked at nearly 12% in 2010 and 11% in 2013.

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But Indian providers have been able to offset inflation by virtue of the Indian rupee's significant long-term depreciation against the U.S. dollar.

Figure 1: U.S. Dollar to Indian Rupee Exchange Rate

But with inflation surpassing 8% in the U.S., U.S. providers are experiencing renewed pressure when facing long-term sourcing engagements.

Many observers predict even higher rates, resulting from the combined effects of increasing demand from government stimulus, synchronized global recovery from the COVID-19 pandemic, and supply chain disruptions — including new and unpredictable disruptions stemming from the Russian invasion of Ukraine.

Figure 2: U.S. CPI-U, 2001-2022

In response, providers once again are including ECAs in their proposals, dusting off ECA provisions, and

revisiting the key negotiation points in light of new market conditions. Some things for buyers to contemplate are collected below.

Do I Need an ECA?

Risk aversion is often the main justification for an ECA provision, which can be especially compelling from a provider's perspective. While buyers often reflexively reject the risk-shifting implicit in an ECA, they can also benefit from cost-adjustment provisions.

Most immediately, conceding to a well-crafted ECA can help manage a provider who might otherwise take cost-reducing measures that negatively affect its performance and the buyer's operations. While the buyer theoretically has contract remedies for poor performance, the triple burden of subpar services, long-term damage to the relationship, and the cost and effort of pursuit of those remedies may far exceed the cost of an ECA.

Rejecting an ECA also may just drive an inflation risk premium into the provider's prices in places it cannot easily be seen or managed, unnecessarily increase the overall cost of services, and sentence the parties to an inevitable future round of costly renegotiations. A well-considered ECA permits the parties to jointly assess inflation risks, price them transparently, and allocate them to the party best able to deal with them over time.

Negotiating ECAs

A simple ECA provision typically allocates 100% of inflation to the buyer, providing that the provider's charges will be increased each year in proportion to the increase in a specified index. At first glance, that might seem fair. The buyer already bears the risk of inflation in its pre-outsourced environment and consumer price inflation isn't controlled by the provider. Why shouldn't the buyer continue to bear this risk?

The main argument in favor of allocating inflation to the provider is that the buyer is giving the provider control of some or all of the tools that the buyer previously used to manage inflation, including:

- Optimizing employee costs by managing seniority ladders, mixing in lower-cost contractors, or migrating to lower cost locales;
- Tactically deferring equipment upgrades;
- Implementing process improvements; and
- Adding new tools and automation.

For transactions involving non-U.S. delivery locations, currency exchange dynamics are also relevant. The best example is the benefit that Indian providers have captured from the long-term depreciation of the rupee against the U.S. dollar over the past two decades, which largely offset inflation losses in many years. Buyers thus argue that the risk ought to go to the party with the tools and opportunity to manage it.

Most negotiated solutions acknowledge that the tools for managing inflation are often shared, resulting in more complex sharing ratios. For example:

ECA = (Change in Index) * (Affected Charges) * (Inflation Sensitivity)

In this example, all three elements are negotiated. The provider might suggest that the affected charges should consist of all charges, but a buyer would always want to eliminate pass-through expenses, taxes and any other charges that aren't subject to inflation.

A buyer of information technology-heavy services will also often argue that, since hardware and software costs historically have declined, only labor charges should be subject to the ECA.

The buyer can argue even further that labor charges include overhead, which in turn includes hardware and software allocations, thus warranting elimination through the application of a discount or sensitivity factor to the gross amount of labor charges.

That sensitivity factor might range from 70% to 90% depending on the type of labor and related overhead expenses.

In addition, buyers argue for further sharing to achieve price certainty at lower rates of inflation and amplify the parties' incentives to manage inflation themselves and to cooperate to control it at higher rates. A common construct allocates the first 3% of inflation to the provider, with amounts above that shared equally.

The first threshold usually is set based on the parties' mutual expectation as to the inflation rate during the term, which the provider then factors into its overall cost model. If actual inflation exceeds that amount, the sharing feature encourages cooperation to implement management strategies.

Occasionally, the economics may lead the parties to allocate inflation above a second, higher rate to one of the parties. Finally, ECAs usually are one-way and only address inflation — though the Great Recession reminded all of us that deflation is a possibility and two-way adjustments are not unknown.

Of course, the buyer should be prepared for the provider to object to allocations that don't take into account the buyer's insistence on controlling the geographic distribution of labor, the details of service delivery methods, and other service inputs which the provider might otherwise adjust to offset inflation.

Currency exchange can further complicate the ECA negotiation, though providers who are paid in U.S. dollars have not generally pushed for exchange adjustments in recent years. In most service delivery locations relevant to U.S. buyers — especially India — exchange rates have tended to benefit those providers over the past decade.

Since many U.S. buyers don't have the capacity to manage or hedge exchange risk effectively, they are happy to leave this issue to providers. However, in negotiating the ECA, buyers should recall that the provider may be capturing an unspoken currency exchange benefit.

Inflation Indices

While the Consumer Price Index for all Urban Consumers is most commonly used to determine U.S.

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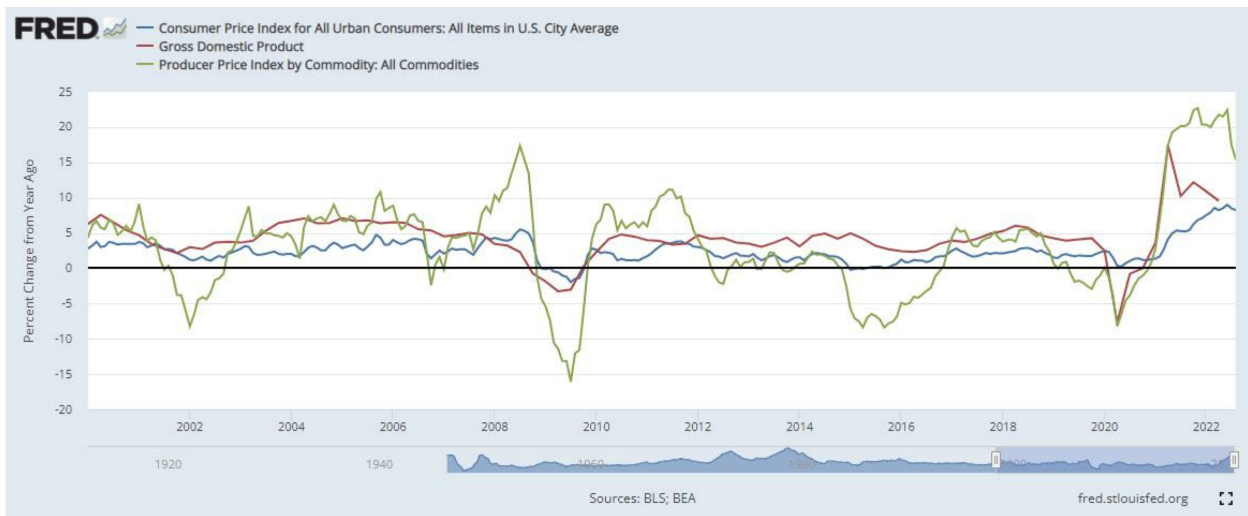
inflation in ECA provisions generally, other indices, such as the Gross Domestic Product Deflator and the Producer Price Index, are viable alternatives. As reflected in Figure 3 below, which compares these indices over the past 20 years, the choice of index for a cost-adjustment provision can significantly affect the calculation of adjustments.

Figure 3: Comparison of Different U.S. Inflation Indices



In addition, and assuming CPI as an ECA's underlying index, the parties must further consider which categories to include in the calculation of CPI. For example, common choices consist of including all items, or all items less food and energy.

Alternatively, parties in long-term services agreements could limit the data to just "services less energy services." These three categories are highlighted in Figure 4 below and, as the graph shows, the differences are significant.

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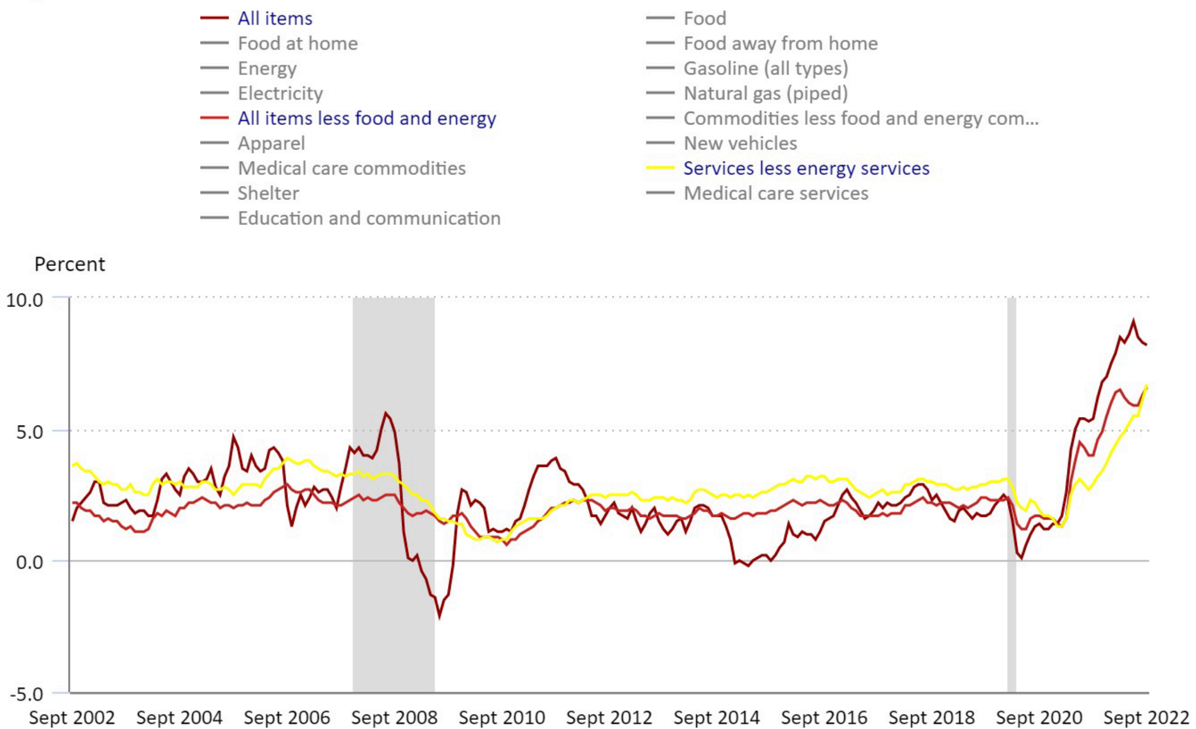
Figure 4: Comparison of Different CPI Categories



A thorough analysis of the economic differences between available indices is beyond the scope of this article. Instead, the takeaway here is that parties should be aware that there are a range of alternatives and that the choice of index will significantly affect resulting cost adjustments.

Conclusion

Spiking inflation rates have once again made cost-adjustment provisions a meaningful part of outsourcing negotiations.

The stakes clearly are high, as an inflation rate at 8%, compounded over a typical five-year contract term, would result in an 47% cost increase by year five.

While buyers should have some sympathy for providers seeking inflation adjustments under those conditions, simple index-based price escalators fail to create the right incentives and are likely to result in

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broken economic models.

Buyers should therefore not rush to accept, or reject, them. Instead, the parties should keep in mind that there are meaningful terms to be negotiated.

Indeed, durable and fruitful commercial arrangements are much more likely if the parties carefully analyze inflation risks and agree to share those risks according to their ability to manage them.

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