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**ROBERT H. CARPENTER, JR.**

ATTORNEY AT LAW  
5912 CASTLEBAR LANE  
PLANO, TEXAS 75093

—  
TELEPHONE 972.473.4834

—  
email: Bob.Carpenter@CarpenterLaw.net

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www.CarpenterLaw.net

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***THE PRICE ESCALATOR CLAUSE  
A Masked Bandit?***

Most, if not almost all, data processing and license agreements between community-based financial institutions and their vendors contain a clause providing for an increase in pricing under certain conditions. Some are tied to ECI, the Employment Cost Index, others to CPI, the Consumer Price Index. Sometimes vendors include percentage caps on the increases.<sup>1</sup> One vendor even proposed (and got) this escalator clause, a guaranteed price increase: "An acceleration rate of 6% shall be applied to the base per account [processing] fee and optional modules [charges] . . . at the beginning of each year after the effective date." At least this vendor's customer knew what the charges would be for the term of the agreement.

**"Who is that Masked Bandit?"**

- A. Zorro
- B. The Lone Ranger
- C. CPI
- D. A and C
- E. B and C

See page 4 for the correct answer.

Well, times are a changin'; so financial institutions should look much more carefully at proposals from data processors and software licensors that include price escalators. GonzoBanker™ reports that, of

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<sup>1</sup> A typical price escalator provision that incorporates ECI follows:

Provider may, with 60 days' prior written notice to Customer, increase the fees and charges listed in a schedule for recurring services once in each year of the initial or a renewal term after the first year of such term; but Provider may not in any year increase them more than the percentage increase in the Employment Cost Index for Total Compensation (not seasonally adjusted), Private Industry Workers, White Collar Occupations Excluding Sales, June 1989=100, published quarterly by the Bureau of Labor Statistics, U.S. Department of Labor, for the 12-month period preceding the increase. In calculating the percentage increase, Provider will use the most recently available quarterly ECI, as of a date that is no more than 95 and no less than 10 days prior to the date for the required written notice, and the quarterly ECI that preceded it by 12 months. If the ECI is no longer published or is replaced by another or an adjusted index, Provider may use a comparable index in calculating increases.

its last 2 years' clients, 70% changed core data processors.<sup>2</sup> Most of those who did not change vendors probably renegotiated their agreements and faced the price escalator issue.

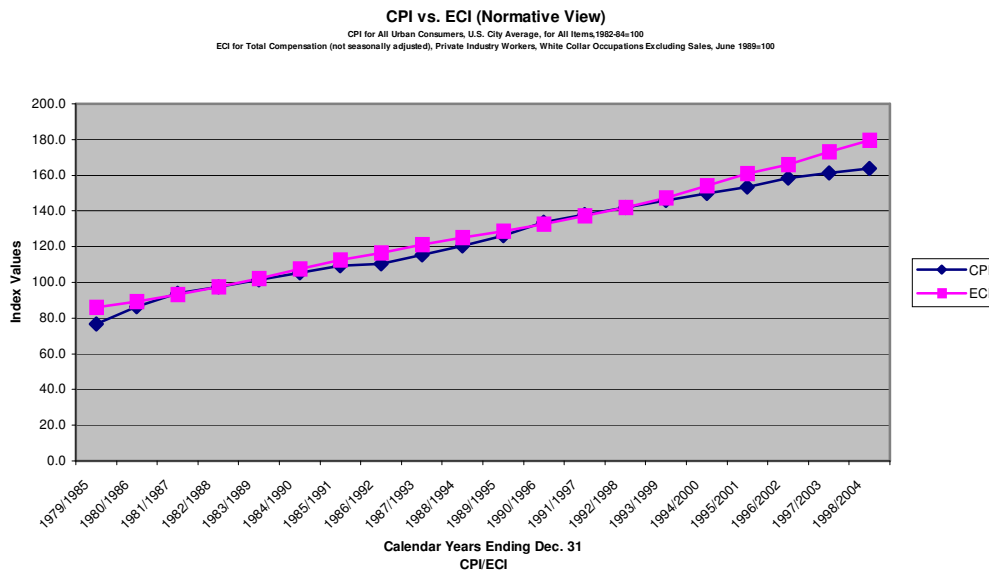
## ECI vs. CPI

The common response when a vendor offers a price escalator provision that incorporates ECI is to ask that CPI be substituted. The reason most often given is that most people think that they are more familiar with CPI than ECI. The vendor offers ECI because its costs are more closely related to labor costs that are reflected in ECI.

What is the ECI? Succinctly, ECI “is a quarterly measure of the change in the cost of labor, . . . [and] includes changes in wages and salaries and employer costs for employee benefits.”<sup>3</sup> CPI, on the other hand,

measures [from month to month] the average change in the prices paid for a market basket of goods and services. These items are purchased for consumption . . . Escalation agreements often use the CPI—the most widely used measure of price change—to adjust payments for changes in prices. The most frequently used escalation applications are in private sector collective bargaining agreements, rental contracts, insurance policies with automatic inflation protection, and alimony and child support payments.<sup>4</sup>

Notwithstanding the common reaction to ask for, or to concede, CPI in an escalation clause, one must know how these indexes perform in order to make a rational decision about them. Over the last 20 years, a proxy for the running of a complete economic cycle, CPI and ECI have both increased. The following chart illustrates this fact with each index adjusted to account for their different base years.



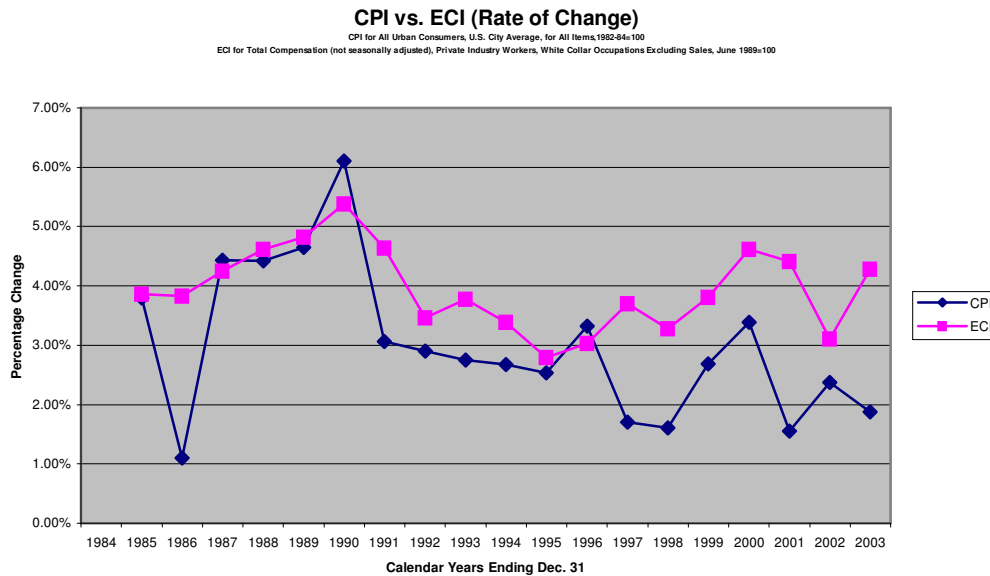
<sup>2</sup> Scott Hodgins, *Looks Like Dubya Beat the Odds*, GONZOBANKER, Jan. 14, 2005, <http://www.gonzobanker.com/article.aspx?Article=14>.

<sup>3</sup> Bureau of Labor Statistics, U.S. Dep't of Labor, *How to Use the Employment Cost Index for Escalation*, <http://www.bls.gov/ect/escalator.htm> (last modified Jul. 26, 2006).

<sup>4</sup> Bureau of Labor Statistics, U.S. Dep't of Labor, *How to Use the Consumer Price Index for Escalation*, <http://www.bls.gov/cpi/cpi1998d.htm> (last modified Oct. 16, 2001).

Only in more recent years has ECI's rate of change begun to increase at a rate significantly different from that of CPI. This might be because of the effect of offshoring. CPI is heavily "goods loaded," and those goods are increasingly produced overseas where production costs are lower than in the U.S. ECI focuses on U.S. labor costs, which have been steadily increasing.

Contract price increases are, however, measured by the change in a specific index over a determinable period rather than by the comparative approach demonstrated above, which should only guide the choice of the index used for escalator clauses. The following chart shows the rate of change for each index over consistent years.



While CPI seems to have been a more volatile measure (greater differences in rates of change over time) than ECI, over the last 20 years use of CPI would have resulted in lower costs to financial institution customers and lower revenues to their vendors. So, if a bank were offered ECI and negotiated for CPI, it has achieved a good result, right? Well, "yes" and "no."

### The "Masked Bandit"

As early as 1995, Federal Reserve Board Chairman Alan Greenspan suggested that CPI is a biased inflation measure. In fact, in a 1997 reprise of his 1995 Congressional testimony, updated based on new research data, Greenspan said: ". . . there is virtually *no* chance that the CPI as currently published *understates* the rate of growth of the [cost of living]. In other words, there is almost a 100 percent probability that we are overcompensating the average social security recipient for increases in the cost of living, and almost a 100 percent probability that we are causing the inflation-adjusted burden of the income tax system to decline more rapidly than I presume the Congress intends."<sup>5</sup>

<sup>5</sup> Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., The Consumer Price Index, Testimony Before the Comm. on Fin., U.S. Senate (Jan. 30, 1997) <http://www.federalreserve.gov/boarddocs/testimony/1997/19970130.htm>. See also Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Bias in the Consumer Price Index, Testimony Before the Comm. on the Budget, U.S. House of Representatives (Mar. 4, 1997) <http://www.federalreserve.gov/boarddocs/testimony/1997/19970304.htm>.

The International Monetary Fund has more recently taken up research on the bias implicit in a number of statistical measures. The IMF explains the CPI problem: “[T]he market basket of products and shops had been kept fixed for long periods and . . . improvements in the quality of products were not being adequately captured.”<sup>6</sup> Inflation is simply being overstated by CPI; and one can only imagine by most other indexes, including ECI. So, a financial institution with an indexed price escalator is probably paying too much.

### A Simple Answer

All of the analysis and hand-wringing since 1995 over index bias raises a rather straightforward question: “In a multi-year contract for services, why doesn’t the vendor quote a fixed price that gives the vendor a fair return and allows the customer to accurately predict its costs throughout the term of the agreement?” The answer, at least so far, has also been simple: “That’s just not the way the business is done.”

But such an answer is neither acceptable nor credible. Companies today must be able to accurately predict revenues and expenses for an annual budget and with some degree of precision for 3- or 5-year planning horizons. So, they *can* quote a long-term, fixed price for delivery of services that is fair and profitable.

Vendors have argued, and no doubt will continue to do so, that the price that they must quote for a multi-year contract without a price escalator would be higher than what they quote for one with such a provision. There simply is not any empirical

Correct Answer: D – If you answered B or E, then here’s some quick trivia. At the end of the initial 1949 Lone Ranger TV episode someone asks, “Who is that masked man?” to which another gives the response, “I don’t rightly know his real name, but I’ve heard him called . . . the Lone Ranger.” Zorro was the “Masked Bandit,” robbing the wealthy and giving to the poor in an attempt to restore justice in Old California.

or anecdotal evidence to support that position. Pricing in the data processing industry just has not been that disciplined. The incremental value of new business is so high that pricing discipline has not been a critical factor to vendor viability and profitability.

A financial institution considering a new or renegotiated data processing or license/maintenance agreement should think long and hard about whether an indexed pricing scheme is beneficial. And, if so, it should

carefully analyze to which index its pricing will be tied.

### Recent Client Newsletters

ePayments and how they challenge the new regulatory environment is the topic of the January 2005 newsletter “ePayments Put the Paper Check ‘Out to Pasture’.”

“Data Processors, Forced to Reevaluate Pricing Strategies?”—the December 2004 newsletter—examines the effect of changes in the length of IT agreements and in risk shifting provisions on the pricing strategies of data processors.

The November 2004 newsletter “Offshore Outsourcing—An Inevitability” discusses incorporating risk-optimizing actions, like carefully tailored performance standards, into IT agreements in order to control risks due to offshore activities.

Client newsletters are available at <http://www.carpenterlaw.net/newsletters/archivednewsletters.html>.

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<sup>6</sup> Int’l Monetary Fund, *Getting a Truer Measure of Producer Price Inflation*, 33 IMF SURVEY 338 (2004) available at <http://www.imf.org/external/pubs/ft/survey/2004/112904.pdf>.