Methodology

This study is based on analysis of the published accounts and financial statements of numerous companies operating in the United Kingdom. Companies that offshore do not separate their offshore costs in their financial statements. Instead they normally combine these under the general heading 'other operating costs'. A comparative analysis of profitability for companies that do and do not offshore work can, however, nonetheless reveal significant patterns.

Identification and Grouping

A number of companies that offshore and do not offshore IT work were randomly selected and are listed below. Their press offices were contacted to verify their offshoring policy.

Companies that offshore work

3
Abbey
Admiral
Amazon
AXA
BT
Barclays
BUPA
Centrica
DHL
Eagle Star (Zurich)
HSBC
Lloyds TSB
NTL
Norwich Union
Powergen
Prudential
Safeway
Sainsbury's
Sky
Standard Chartered
Tesco
Thames Water
Transco

Companies that do not offshore work

Alliance and Leicester
Carphone Warehouse
The Co Op
Direct Line
Halifax
Kwik Save
Legal & General
Nationwide
Natwest
Orange
Royal Bank of Scotland
Severn Trent Water
Somerfield
Standard Life
T-mobile
United Utilities
Welsh Water

The companies were then each allocated to one of the following six sectors or discounted from the study due to a lack of comparable data or useful comparators:

Banking
Supermarket/Retail
Insurance/Assurance
Water Utility
Gas/Electricity Utility
Telecommunications

The following rules were then applied to ensure that comparisons between the selected companies within each category would be meaningful:

- UK Listed PLC companies – therefore operate under the same tax / cost framework. For global companies employee cost ratios were derived purely from UK subsidiary.
- Financial Statements available for similar period (year end 2004)
- Operate within a similar market (ie comparable customer base)
- Offer the same or similar products
- Similar sized operations

The following is a list of the companies that were identified for each sector as being suitable for comparative purposes:

Banking

Offshore work	**Do not offshore work**
Barclays	Royal Bank of Scotland
HSBC	
Lloyds TSB	

Insurance/Assurance

Offshore work	**Do not offshore work**
AXA	CIS
Norwich Union	Legal & General
	Standard Life

Supermarket/Retail

Offshore work	**Do not offshore work**
Sainsburys	The Co Op
Tesco	Morrisons
	Somerfield/Kwik Save

Water Utility

Offshore work	**Do not offshore work**
Thames Water	South West Water
	Severn Trent Water
	Welsh Water

Gas/Electricity Utility

Offshore work	**Do not offshore work**
Centrica	Scottish Power
	United Utilities

Telecom

Offshore work	**Do not offshore work**
3	Orange
	T-Mobile

Source Data
The financial statements for each of these companies for year ending 2004 were studied and the following data extracted :

Total Income
Total gross costs
Gross Profit
Employee / Other operating costs

Any 'abnormal', one off costs were discounted, for example redundancy / restructuring / acquisition costs. Therefore operating costs used for the study were, as far as possible, normal year-on-year operating costs. Additionally, any one off abnormal income was also discounted.

The following ratios were then calculated:

Cost / Income
Profit / Income
Employee costs / Total cost
Employee costs / total net income

These ratios give a company's relative profitability, cost gearing and what proportion of its costs are employee-related. Offshoring costs are generally included in 'other operating costs' so this figure has to be included in the employee and other operating cost / total net income cost ratio. Since 'other operating costs' can include different items for different companies this ratio means comparisons are not statistically useful. Nevertheless, since common accounting practices lead many companies to put the same entities into the 'other operating cost' account line, the comparison can add some value and so has been included.

The second set of calculations undertaken for the study focuses on the statistically relevant and verifiable measurement of increases in profitability. The growth in profitability for a company over a period of time is easily measurable and can then be compared to other companies in the same sector. Profitability increases are presented as a percentage for each year in three sectors and, in two of these, changes over the whole timescale are compared, again as a percentage. Difficulty in obtaining genuinely comparable figures meant that these figures could not usefully be compiled for two further sectors: Assurance / Insurance and Telecoms.

Results By Sector

Key
Companies that offshore
Companies that do not offshore

Banking Comparison

Bank	Gross Income £x10^{9}	Cost £x10^{9}	Cost/ Income %	Profit £x10^{9}	Profit/ Income %	Emp. Cost/ Total cost %
Barclays	13.9	8.3	52	5.5	39	53
HSBC($)	50.5	27.7	54	22.8	45	48
Lloyds TSB	9.4	4.8	51	3.1	32	51
RBoS	22.7	9.6	40.8	13.1	57	44

Growth in Profitability (%)

Bank	2004
Barclays	39
HSBC	45
Lloyds TSB	32
RBoS	57

Explanatory Note

i. The years from 2000 to 2003 were a period of considerable change in the banking sector, with many banks making multiple acquisitions. This high number of complex one-off costs makes it impossible to compile profitability figures that can be meaningfully compared for these years.

Analysis

i. Royal Bank of Scotland, the only one of the banks studied not to offshore work, had the lowest cost-income ratio, highest profit-income ratio and lowest proportion of employee-related costs.
ii. RBoS also had the highest growth in profitability.

Life Assurance / Insurance Comparison

Company	Gross Income £x10^9	Cost £x10^9	Cost/ Income %	Profit £x10^9	Profit/ Income %	Employee costs/ Net total costs %
AXA (€)	70.7	68.1	96	2.6	3.6	48
CIS (Co-op) (2003)	0.67	0.61	91	0.06	9.0	42
Legal & General	16.8	15.4	91.6	1.4	8.3	43
Norwich Union	31.6	29.3	92	2.3	7.0	46
Standard life	20.1	17.6	87	2.5	8.7	41

Explanatory Notes

i. AXA is owned by a French-based parent company.

ii. Ratios are different from other sectors because these companies manage funds and pay out on claims.

iii. Net total costs exclude insurance/assurance claims and payouts.

Analysis

i. Non-offshoring companies had the lowest cost-income ratio (Standard Life), highest profit-income ratio (CIS) and lowest proportion of employee-related costs (Standard Life).

ii. All three non-offshoring companies out-performed the offshoring companies on all three measures.

Supermarket / Retail Comparison

Company	Gross Income £x10⁹	Cost £x10⁹	Cost/ Income %	Profit	Profit/ Income %	Employee costs/ Net total costs %
The Co-Op	5.4	4.4	82.2	0.96	17.7%	31%
Morrisons	4.9	3.7	75.0	1.2	24.4%	30%
Sainsbury's	18.2	16.8	92.3	1.4	7.7%	36%
Somerfield / Kwik Save	2.6	2.3	88.4	0.3	11.5%	38%
Tesco	24.7	23.2	94.0	1.5	6.1%	33%

Growth in Profitabilility (%)

Company	2001	2002	2003	2004	%Increase 2001-2004
Morrisons	21	22	23	24	14
Tesco	5.6	5.6	5.7	5.9	5

Explanatory Notes

i. Retail only comparison – other activities such as insurance and finance have been excluded.
ii. Net costs do not include purchases.
iii. Other than Tesco and Morrisons, the supermarkets are incomparable in terms of profitability increase over time because of takeovers and acquisitions.
iv. Morrisons does not offshore; its costs have risen in 2005 as a result of the takeover and efforts to incorporate Safeway's offshore activities, although these costs would be discounted as one-offs for the purposes of any future comparison between retailers during 2005.
v. Somerfield / Kwik Save are now owned by Sainsbury's, but do not offshore.
vi. Tesco embarked upon major outsourcing in 1998.

Analysis

i. A non-offshoring company had the lowest cost-income ratio (Morrisons) and highest profit-income ratio (Morrisons).
ii. All three non-offshoring companies out-performed the offshoring companies on both cost-income and profit-income measures.
iii. The proportion of employee-related costs exhibited no clear pattern: the highest figure belonged to a non-offshore company (Somerfield), but so too did the two lowest (The Co-Op and Morrisons).
iv. Morrisons' increase in profitability (14%) was considerably greater than Tesco's (5%)

Water Utility Comparison

Company	Gross Income £x10^{9}	Cost £x10^{9}	Cost/ Income %	Profit £x10^{9}	Profit/ Income %	Employee costs/ Net total costs %
Severn Trent Water	2.01	1.57	78	0.44	21	61
South West Water	0.292	0.173	59	0.119	41	73
Thames Water	1.17	0.778	66	0.39	33	71
Welsh Water	0.245	0.139	56	0.106	43	59

Growth in Profitability(%)

Company	2001	2002	2003	2004	%Increase 2001-2004
Severn Trent Water	22	22	21	21	-4.5
South West Water	36	38	40	41	13.8
Thames	31	32	32	33	6.4
Welsh Water	39	41	41	43	10.2

Explanatory Notes

i. This sector offers a statistically good comparison: same overheads, very similar business, same controls.
ii. Thames Water embarked upon major outsourcing in 1999.
iii. Severn Trent Water outsources work to STS but does not offshore.
iv. Welsh Water outsources to Logica but does not offshore.
v. Severn Trent Water has over the past three years invested more in infrastructure than any other water company and this is reflected in its cost-income ratio.

Analysis

i. Setting aside Severn Trent Water, both remaining non-offshoring companies had the lowest cost-income ratios and highest profit-income ratios.
ii. As with retail, the proportion of employee-related costs exhibited no clear pattern.

Gas / Electricity Utilities Comparison

Company	Gross Income £x10^9	Cost £x10^9	Cost/ Income %	Profit £x10^9	Profit/ Income %	Employee costs/ Net total costs %
Centrica	18.3	14.7	80%	3.59	19	51
Scottish Power	5.7	4.7	82%	1.0	17	49
United Utilities	2.1	1.52	72%	0.58	27	42

Growth in Profitability (%)

Company	2001	2002	2003	2004	%Increase 2001-2004
Centrica	19	18	19	19	0
Scottish Power	15	16	17	17	13
United Utilities	26	26	27	27	3.8

Explanatory Notes

i. Centrica includes British Gas, Onetel, and Dyno and uses offshoring extensively.

Analysis

i. No clear trends are visible in the cost-income and profit-income ratios.
ii. Centrica, the only offshoring company in this group, has the highest proportion of employee-related costs.
iii. Centrica's 0% profit increase compares badly with the profit increases of the non-offshoring companies, which average 8.4%.

Telecommunications Comparison

Company	Gross Income £x10^9	Cost £x10^9	Cost/ Income %	Profit £x10^9	Profit/ Income %	Employee costs/ Net total costs %
3	0.63 (dollars)	0.41	65	0.22	34	29
Orange	47.1	28.9	61	18.2	38.6	28
T-mobile	57.8 (euros)	31.4	54	26.4	45.6	23

Explanatory Notes

i. T-mobile is owned by Deutsche Telekom Group. Results here are for the UK subsidiary only.
ii. 3 is owned by 3com - results here are for 3com, the US based company.
iii. Orange is owned by French Telecom.

Analysis

i. Non-offshoring companies had the lowest cost-income ratio (T-mobile), highest profit-income ratio (Orange) and lowest proportion of employee-related costs (T-mobile).
ii. Both non-offshoring companies out-performed 3, the only offshoring company in this group, on all three measures.

Analysis of results overall

These results do not show any clear advantage to be had from offshoring. Moreover, they suggest that, more often than not, companies that do not offshore achieve more impressive results.

In all 6 categories, from a list of randomly chosen companies across several key business sectors, the companies that do not offshore had the lowest cost-income ratio.

In four out of six categories, companies that offshore had the highest cost-income ratio. Water Utilities and Gas / Electricity utilities were the exceptions.

The increase in average profitability of companies in the years 2001 to 2004 was higher for companies that did not offshore in every sector for which figures could be compiled.

Conclusions

The results of this study show that the case for offshoring has absolutely not been proved. It does not seem to enhance companies' profitability to an extent sufficient to offset the short-term losses to the UK's economy. Savings resulting from offshoring work, even if significant compared to the total cost of offshored work, are small in comparison to most companies' bottom line profit.

There is therefore a strong suggestion that offshoring does not significantly enhance companies' profitability. This study must be taken as indicative rather than definitive, however, as the sample of data taken, although random, is too small to be statistically significant. It seems likely from this work, however, that offshoring is not particularly useful. Perhaps most significantly, there are no trends whatsoever in the data which suggest that it is of any substantial benefit.

Currently, the majority of IT work permits are issued to foreign based companies whose UK subsidiaries specialise in moving work offshore. In the absence of evidence showing any economic benefit from offshoring IT work, there must be controls on the issue of these permits.

It is clear, on the basis of this study, that more work is needed to investigate this apparent failure of economic theory to deliver policy that works in practice. PCG urges the government to commission a thorough empirical study of the effects of offshoring as a matter of urgency.

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