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# Asset Ownership in Outsourcing Contracts

## *Exploring the Tradeoffs*


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Modern IT infrastructure requires a significant amount of capital. There are mainframes, servers, and desktops to purchase, software licenses to buy, and maintenance to pay. One of the key decisions to make when outsourcing information technology or renegotiating a contract is whether or not to construct a pure services-only deal or to include assets in scope and create a full managed services agreement.

There are benefits and costs to both approaches, and the decision is not simply a matter of financing – it has a significant impact on client capital budgeting, operational stability and currency, and flexibility for change in the future.

This paper identifies and considers the various tradeoffs of including or excluding hardware in outsourcing arrangements.

# Table of Contents



# 1. Considering the Tradeoffs

## 1.1 Capital Smoothing

Most environments have significant year-over-year fluctuations in their hardware and software spend. From a budgeting perspective, an ideal world would be one in which these costs were incurred evenly every year, but this is rarely the case. This can present a challenge for IT organizations, either because their firms do not have easy access to capital or because cultural or strategic reasons inside the firms create a reluctance to use this capital for IT.

For organizations that have difficulty acquiring or allocating capital, necessary refresh and modernization projects may fall further and further behind, causing a host of issues. Aging hardware fails, hardware and software go unsupported by their vendors or have increasingly expensive maintenance contracts, and it becomes more and more difficult to install modern tools on outdated platforms. In outsourcing arrangements, a supplier's commitment to provide capital investments and perform refresh of key assets can create tremendous value. However, this benefit comes at a cost.

Only the largest suppliers can or would want to play banker and provide this capital smoothing, effectively displacing smaller providers and reducing competition. Additionally, the supplier's financing rates are likely higher than the client's other sources of capital. This form of financing, because it exists for the deal, comes with special terms and conditions: higher terminations costs, longer terms, etc., which raise client switching costs. Finally, refresh obligations need to be built into these contracts and are amongst the hardest for suppliers to deliver.

**Key takeaway:** *IT service providers are high cost lenders and add restrictive terms and conditions to protect their investment.*

### 1.2 Supplier Competition

For the largest organizations, only a very short list of suppliers (perhaps 3-4) will be able to bring enough capital to perform a transition followed by a transformation in the first two years of a deal and spread that cost over five to eight years. The smaller the organization and the closer it is to its ideal state (i.e., requires less transformation), the longer the list of suppliers that will be able to bring the necessary capital to finance these activities. Some providers that specialize in a services area are unlikely to bring capital and will only provide services. Requiring the supplier to provide the capital denies the organization access to these specialized services.

**Key takeaway:** *Requiring capital as part of the service reduces the potential supplier pool.*

### 1.3 Switching Costs

With assets included in outsourcing contracts, the service provider will justifiably require certain protections. The length of term and size of termination fees agreed by the parties are largely a function of supplier investments made in the client environment. No supplier would be willing to provide $100 million of capital in year one of an agreement without commensurate terms and termination fees. As a result of having assets in scope, it becomes important to discuss what will happen when the relationship ends. For example, if a supplier provides infrastructure services and the servers and SANs were included in the scope, it would be extremely impractical to replace thousands of servers in many different locations spread across the country or world if the relationship were to end. Normally the parties agree to a termination assistance clause, which describes the terms under which the assets will be bought back by the client and at what price. The aforementioned raises switching costs. It is far easier to terminate a services agreement and start another one if assets are owned outright rather than, for example, conducting an inventory, hiring a third party assessor, negotiating that assessment, buying out the assets, and finally hiring a new service provider. These increased switching costs can force the client to accept a level of underperformance that they otherwise would not, simply because of the high cost to change.

**Key takeaway:** *Including assets increases switching costs.*

### 1.4 Refresh Obligations

For an IT organization, one advantage of embedding refresh in an outsourcing agreement can be that it removes the decision point. While we do not typically think of having less decisions as being a good thing, if a firm typically struggles with this particular decision, it may be better off in someone else's hands. The most common way for this decision to go wrong is by delaying refresh to save capital and causing a host of related IT operational issues.

Requiring a service provider to perform refresh in the contract should give the IT department a level of confidence that equipment will stay current. Conversely, excluding hardware from the agreement allows the client to delay refresh, and if they do, service providers will seek relief from service level commitments.

It is important to note, however, that including the assets in a service contract does not guarantee that refresh will actually take place; it only guarantees that the client will pay for it. If it was not getting done because the client organization lacked capital, then baking in the refresh is likely to solve the problem. If the problem was at least partly political (if, for example, business units are resisting the application or business process remediation necessary to make the refresh happen), then including refresh and putting a third party in charge of the activity is unlikely to produce a different outcome. Refresh is one of the hardest obligations for a supplier to deliver on in a services contract and one of the largest reasons it is difficult is due to political opposition from elsewhere in the organization.

It is also worth noting that in general the industry has done a pretty bad job of documenting refresh obligations in agreements. The typical approach of having a line in a contract financial responsibility matrix stating that servers should be refreshed every five years is woefully inadequate. Does a five year refresh cycle for servers mean that every server older than five years must be replaced? Or that every server must be replaced once over the course of five years? Or that 20% of the environment must be replaced every year? Or that an average server age of three years must be maintained in the environment? Depending on the current state of the environment and which of these interpretations we choose, there can be tens of millions of dollars of difference. It is very important to document explicitly the provider's ongoing responsibility regarding refresh, and, if they are to move the environment to an improved state, exactly what that plan entails.

**Common Question: *Do service providers enjoy bulk purchasing power?***

A common justification for including assets in scope is that because the outsourcer will be buying a larger total volume of units, they will enjoy a superior volume discount. However, it is important to note that the economics of a volume discount are largely a function of a vendor's desire to close large deals. Vendors tend to offer discounts to influence purchaser choice. If the outsourcer is buying the items the client has chosen, this puts them in no better a position when negotiating with the asset vendor than the clients themselves would be. Even in cases where the client can concede the equipment choices to the supplier, generally the supplier's other customers cannot, which makes the bulk purchasing leverage ephemeral. It is a very common experience that outsourcing service providers can achieve discounts that are equal to but not greater than a large client buying on its own behalf.

**Key takeaway:** *Incorporating refresh obligations in a contract can be an effective way to help maintain a current environment, but only under the right circumstances and must be structured and managed carefully.*

## 1.5 Utility Computing

Companies have been trying to establish a successful utility model since the dawn of the computer. In the early days there were visions of a city-operated mainframe and a green screen terminal in every home. More recently this idea has come to life in the form of software-as-a-service products (e.g., Salesforce.com, web-based email, etc.). In a successful utility computing model, the consumer need not worry about any of the underlying details. They do not care what type of server hosts the application, nor where the servers are hosted, nor in which language the application is written. They are simply presented with a standardized,

commoditized interface, which truly does behave like a utility. As time passes, more and more of the computing industry is likely to move in this direction.

An important consideration is whether a particular service lends itself well to a utility model. Consider an example of electricity versus pants. When considering electricity, consumers are unlikely to have strong feelings about the infrastructure by which volts and amps are delivered, because they will have very little impact on their experience in using appliances. Pants, on the other hand, are not exactly standardized. One person might be a tall, slim fellow and the other shorter and rounder around the middle, but both will have pretty strong feelings about the shape their pants take. You might also want them to match your jacket.

Many areas of computing are a lot more like pants than they are like electricity. It is crucial that architecture fits the application. Attempting to "get out of the business of technology" altogether by letting a third party design infrastructure can easily leave clients with a bad fit. Infrastructure components that can be highly common and are somewhat removed from the user or customer base likely lend themselves to a utility model; services that are unique to the firm or more closely touch the user experience probably do not.

**Key takeaway:** *Consider whether treating the outsourced infrastructure as a utility will be most efficient; maintain more control where the services are unique or highly visible.*

## 1.6 Standards

Most IT environments have grown organically over time and still struggle with standardization throughout the business units. A non-standardized environment brings with it a number of challenges. It requires a wide variety of skills to support, it will have a wider variety of more complex interactions, and it will have more unique problems crop up than a more standardized environment. Because of the increased cost and complexity, many organizations have a desire to simplify their environment: to consolidate from a large number of technologies down to a smaller number, leveraging enterprise infrastructure wherever feasible.

But change is hard.

Many of the most challenging problems in an IT organization are caused when an effort is made to change a component of the infrastructure. Significant labor and capital investment are required and there is always the risk of project overruns, unplanned downtime, or outright failure. However, the benefits of standardization are significant, and many companies are willing to pay these costs and bear such risks in the short term in order to enjoy benefits in the long term.

**Example: Backup Consolidation**

Imagine that a supplier is brought in to provide backup services and, as part of their bid, they propose to consolidate a wide variety of legacy tape backup systems onto a single disk-based system. They begin their consolidation and remove a significant volume from each of the legacy tape solutions and onto the new disk-based solution. As it turns out, many of the legacy tape backup solutions are connected to old servers hosting old homegrown applications, and the backup solution cannot be replaced until the server is refreshed, but the server cannot be refreshed until the application is remediated. The consolidation effort then grinds to a halt, and now running the environment involves supporting all of the old tape-based backup systems (at lower volumes) and the new disk-based solution as well. When reaching the end of the contract with this provider, the time arrives to rebid the solution. A new provider comes in and says, "Here's your problem! You have too many backup solutions. This makes your environment expensive and difficult to support. I propose we consolidate you to our premiere backup solution." This organization has incurred all the costs of a consolidation but will never reap any of the benefits. While this example seems a touch ridiculous, it is very easy to go down this path with the best of intentions and end up in this state.

Because of the political difficulties of fighting for standardization inside of an organization, many firms decide to outsource this particular responsibility. It is quite common for outsourced IT service providers to propose plans to consolidate infrastructure to a smaller number of servers, SAN platforms, and backup technologies.

One of the best ways to avoid this type of problem is to ensure that any business case that proposes a consolidation or standardization contains all of the costs related to the rewriting of applications, remediation of business processes, or any other work that needs to be completed as a precondition of standardization.

**Key takeaway:** *Embedding assets can help to maintain and enforce standards, but it won't happen automatically.*

## 2. Recommendations

When determining the ideal approach to handling capital assets in a sourcing transaction, clients are advised to consider financial, operational, and flexibility impacts. The following list addresses some of the primary considerations in these categories.

### Financial

- Embedding capital within the services contract can provide simplified and smoothed budgeting for the client.
- IT service providers seldom make efficient bankers; review embedded interest rates and consider the cost of procuring capital in this way.

### Operational

- If the IT department has had difficulty acquiring capital to maintain or upgrade systems, then it may be helpful to contract for such refresh on an ongoing basis; however, if the challenge has been primarily due to internal political factors (such as business unit or application developer pushback on upgrades), sourcing it to a supplier will not be an effective solution.
- Retaining capital allows the client to make decisions about whether to upgrade, perhaps deferring in budgetary lean years, but suppliers may require service level relief if hardware goes out-of-support.
- When negotiating a contract to include asset refresh, be absolutely clear about how frequently assets will be refreshed (e.g., percentage per year, at a specific age, relative to initial transformation, etc.); document exceptions or ability to recover cost if deferment decisions are made.
- Utility computing models can be an effective way to standardize infrastructure services and improve speed-to-delivery; however, they should primarily be considered for hardware that can be highly common.
- If standardization across the enterprise has been a struggle, then sourcing hardware under a managed services agreement may be an effective way to push out a common infrastructure platform.

| Flexibility |
| --- |
| • Embedding capital in a contract for operational or budgetary reasons usually comes with specific terms and conditions for repayment, requires longer contract terms to cover service provider investments, and increases switching costs.<br>• Only larger service providers may be willing or able to finance significant capital investments, reducing the potential supplier pool.<br>• Clients should retain the right to buy or transfer assets at contract termination or expiration. |

## 3. Summary

For organizations that struggle with the capital budgeting process, ongoing refresh of equipment, enforcement of standards across the IT organization, or a desire to get out of the technology business to focus on core competencies, baking in the assets can be a tool to accomplish key goals.

But, including assets comes at a cost. Reduced supplier competition, increased switching cost, and a requirement to manage supplier refresh obligations are three factors to consider when including assets in scope. Baking in the assets is not a panacea, and it is possible to have problems with refresh or the enforcement of standards, and despite including assets in the agreement, have the existing problems go unresolved or worsen. If, for example, an organization's slowness to perform refresh is caused by a capital shortage, then embedding the assets in scope can help. But if the absence of refresh is caused by the development group's lack of resources or will to remediate old applications, then putting assets in scope will likely do little to improve the situation. A recognition of the underlying causes of these problems will dictate the solution.

All of the facets of this decision interact with each other and create a complex network of drivers. It is important to carefully consider the organization's strengths and weaknesses, goals, political environment, and the details of the IT infrastructure. While there is no one right answer, thinking about the factors described above should help you frame the asset ownership position that makes the most sense for your organization.

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