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IT Procurement Best Practice: Leverage Services to Buy Products More Competitively

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Use credible alternatives wherever available to create competition from adjacent markets, especially where product competition is scarce. Cost comparisons can improve a product's competitiveness, but they must be used in a disciplined way to achieve positive results.

Key Findings

- IT departments are not the end customers for IT product vendors, which need to understand that sourcing decisions are often driven by business issues and technology-aware business stakeholders and budget holders.
- When an in-house service is preferred, this preference may not apply at any cost. IT departments and their product vendors are effectively in competition with external service providers (ESPs), even if few track their costs well enough to compete.
- "Apples-to-apples" comparisons are only possible between like-for-like equivalents. "Apples-to-apple-pie" comparisons are needed between products and services, which take into account all the costs of baking the apple pie and not just the cost of the apples.
- Successful IT procurement organizations engage product vendors as stakeholders in internal services, giving them the right financial incentives to compete with external services on value and effectiveness.

Recommendations

- Leverage indirect competition to make your product vendors more competitive. Focusing solely on cost because it is easier to measure is a "zero-sum game." It is easier to eliminate value from services than cost.
- Harness business users to drive competition between product vendors and service providers. Use their demand as a positive force to help you manage vendor relationships on a business basis.
- Leverage competition to pay less for basic, lowest-common-denominator technologies or services, but reward vendors that improve the value and competitiveness of your own service delivery.
- Instead of driving down the value and effectiveness of IT by demanding ever-increasing product discounts, use cost/benefit analysis to provide meaningful vendor incentives that maximize the value of your IT.

ANALYSIS

A new investment race has started in IT, but it is not a technology investment race. It is a race between consumers and vendors to optimize the delivery of effective business services. Major vendors clearly see IT asset management as a strategic issue: BMC Software leveraged Remedy to develop asset management, HP bought Peregrine and Mercury, IBM acquired MRO, Microsoft acquired AssetMetrix and Symantec assimilated Altiris. Some customers have even suspected vendors of acquiring asset management tools to neutralize them as potential threats to their revenue. There is a growing convergence of IT asset management and IT service management.

One lesson is clear: IT service delivery is an increasingly competitive business that goes beyond price competition. IT markets are changing and diversifying. Alternative ways of doing business are proliferating as fast as business requirements are evolving. Service providers often seem to have better vendor relationships, perhaps because IT is their core business so they better understand its value. Enterprise IT organizations need to invest more in sourcing, IT asset management and procurement to ensure fair cost comparison and to provide more business-like IT decision support. Otherwise, product vendors will understand enterprises' asset positions and sourcing decisions better than the enterprises do.

Ignoring the cost or value of IT is not a sound IT strategy. The business analysis and management of IT is becoming the most important innovation. IT is funded by business activity. Without financial support from the business, there would be no IT operations. When IT and its procurement staff focus solely on cost, they miss the most important side of the balance sheet — the added value of IT services that justify the funding to deliver them internally. Without any differentiating factors, the enterprise has little reason to fund the procurement and delivery of IT in-house.

Understand the Alternatives

IT procurement does not make important sourcing decisions. It executes these decisions in line with their business case, to which it may be asked to contribute market intelligence. To execute a sourcing decision, procurement must first understand the business case and all possible alternatives so it can leverage them as competition. The threat of competition is how IT procurement negotiates fair pricing and contract terms. If procurement fails to negotiate terms that satisfy the business case, then the original sourcing decision may need to be re-evaluated in light of changing market conditions.

Alternatives are becoming more diverse, as demonstrated by the 14 alternate IT delivery and acquisition models in "Alternative Delivery Models: The First Taxonomy." Most involve the delivery of technology as a service, the best known being software as a service (SaaS). Like-for-like, apples-to-apples comparisons cannot be made between unlike IT delivery and acquisition models or IT products.

Successful procurement organizations may still need to use these forms of indirect competition as leverage, especially in markets where direct competition is lacking. Adjacent IT services markets cannot offer competing products, but they can offer alternative solutions that meet some or most of the business requirements. This is not simply a matter of IT procurement tactics. Indirect forms of competition are increasingly real. A hosted server can now compete with an in-house server. SaaS can compete with licensed software on a hosted server. Shortsighted product vendors may still question the credibility of this competition.

Establish the Alternative Acquisition and Delivery Scenario

The most-credible and regular source of competitive pressure comes from business users. IT consumers are often well-informed about lower-cost alternatives. Business stakeholders may also have considerable experience in managing business assets and external subcontractors. IT procurement should use these resources to make vendors aware of competition from alternative delivery and acquisition models.

IT procurement does not make sourcing decisions and can use this fact to negotiate with limited authority. The business may have a pressing need to implement services fast and at low cost. This can be your starting point for managing the vendors that supply products on which your established and proven IT services are built. Vendors will inevitably question the viability and value of services they do not deliver themselves. Establish vendor competition as follows:

- Demonstrate the value for money and the rapid results offered by alternative sources.
- Challenge the vendor to help your IT organization compete on commercial and technical levels.
- Ask for a similar, lower-size alternative that keeps your services competitive.
- Make it clear that the enterprise will readjust its solutions architecture and will compromise established standards if necessary to meet immediate, pressing business objectives.

In response to business demands, enterprise architects are increasingly interested in commercials and procurement. You also need to discuss important architectural issues with your enterprise architects, such as the management of interfaces. Familiarize yourself with architectural options, as well as the types of interfaces supported and required. Your credibility may depend on an understanding of architectural and risk implications.

Compare the Options Fairly

The basis for fair comparison among products is often known as a like-for-like or apples-to-apples comparison. It is impossible to compare products to services directly in this way. However an apples-to-apple-pie comparison is still possible: If you know the recipe and the cost of the ingredients, then you can calculate how much it costs to bake an apple pie or run an IT service.

Take the simplistic example of a software application that costs 20% of the total cost of running a service during a five-year life cycle. If a SaaS offering costs $50,000 during the same period, then the software vendor would need to match a cost of $10,000 during that time to compete.

Software can become uncompetitive because other service delivery costs are too high. If it costs $50,000 just to run and manage the hardware, then you cannot sensibly expect the software free of charge. Enlist the vendor's help in improving the efficiency of your IT operations.

Understand Strategic Sourcing Decisions

Organizations acquire products or services for complex business reasons, including quality and control. It is a question of quality and effort whether you bake your own apple pie, buy it handmade by a chef or buy it mass-produced from a supermarket. Fast-food businesses are under pressure to pay competitive prices for food, whereas restaurants trade on their reputation for quality and variety. Every business places a different value on the quality and cost of what they buy. This is a practical example of cost/benefit analysis.

If quality apples become unavailable, or if prices rise dramatically, then even the most-expensive restaurant may have to re-evaluate its sourcing strategy or take apple pie off the menu. In increasingly dynamic and competitive markets, enterprises must regularly re-evaluate their sourcing decisions. If the IT organization fails to do this, then business users could make up for that oversight by going directly to external providers. All IT providers need to ensure that their services remain competitive in terms of cost and value.

Procurement and Vendor Management Take Teamwork

Many organizations fall into the trap of focusing on price because it is easier to measure. Product prices are just one of your many costs. Price discounts are rarely the most valuable thing your vendor can do for you. It is more difficult to describe or measure quality and business value. Work with your vendor at a strategic level to drive better value and align with business strategy through vendor management.

Cost containment can still be a business objective; however, instead of penalizing vendors through loss of revenue, reward vendors for reducing your service delivery costs. Look for win-win situations to maintain and improve your vendor relationships:

- Improved efficiency will help your business to grow and result in ordering more products from the vendor.
- More-advanced vendor offerings will win business against competitors.
- Your success as a reference can help your vendor win additional business.

The challenge is to give proven vendors a stake in your business outcome, in partnership with IT service managers or "product managers" as they are sometimes called. Negotiations should focus on cost/benefits analysis, trading benefits against costs to strike the right balance and make fair comparisons with ready-made service alternatives. Customers should also factor in the cost of managing ESPs. Managing an alternate delivery model to corporate standards can carry significant costs. Tasks such as compliance cannot be delegated without verification. All tasks delegated to the service provider, such as product procurement and asset management, require management oversight at some level.

Vendors continually conduct transactions in their own markets. This gives them greater knowledge of these markets, customers and competitors than any enterprise buyer hopes to achieve unaided. This advantage can be reduced by introducing indirect competition with externally provided services. Involving stakeholders and budget holders in negotiations helps to convince the vendor that these challenges to their business are real. Work with the vendor to reduce the total service delivery costs. Vendors no longer know where the tipping point is in their customers' business model — the price point where cost/benefit goes against them. This reintroduces price sensitivity and market volatility that has been missing from some IT markets. However, this newfound leverage must be used carefully.

With Great Power Comes Great Responsibility

More is at stake than reducing software and hardware costs. Product vendors and internal IT organizations are in indirect competition with alternative acquisition and delivery models. It is not in your interest to bankrupt your product vendor, nor is it in the vendor's interest to bankrupt you. It is in both your interests to work together and compete with alternatives. You need to build vendor relationships that reward those trusted vendors that help achieve your business objectives by sharing in your success. IT vendor relationships need to be more results-driven.

To leverage indirect competition, the vendor must remain convinced that it can compete at a profit. For example, it might be unrealistic to expect an enterprise storage vendor to compete with Amazon S3 storage service pricing. If a product vendor cannot meet the price point of a utility service, then that inability is only the starting point for negotiations.

If the vendor can help you deliver a more valuable service, then you should expect to pay more in return. The business value of IT depends on aligning IT with business objectives. In the public sector, where objectives are more long term, value-for-money frameworks can help to define value contributions to these objectives.

Realign Vendor Incentives With Business Objectives

The challenge is to provide vendors with financial incentives while still paying a fair price:

- Negotiate discounts down to the basics, and the vendor has no incentive to provide anything more valuable.
- Give a vendor back the difference if it meets your targets, and you will give it back its commercial incentive to perform.

Take the example of storage and software licenses for enterprise backup and recovery. Business requirements are often expressed as a recovery point and a recovery time. An external service that meets these objectives could be compared with the cost of delivering the same service in-house. Seek a discount down toward the cost of a basic service, and the vendor has no incentive to provide anything more valuable. However, enterprises need to improve backup and recovery success rates, and make more-efficient use of capacity. Vendors that deliver greater value deserve a greater reward.

Hold vendors accountable for cost differences above the competitive service baseline, which is often the lowest common denominator in a market. Procurement and stakeholders can help validate the cost/benefit analysis of benefits over and above that baseline, rewarding the vendor for delivering greater value and for meeting evolving business objectives. The reward for meeting business objectives could be the difference between the cost of a baseline service and the vendor's final offer price.

Improve Incentives

Procurement and vendor managers should leverage indirect competition to pay a fair rate for basic requirements. Theoretical savings can then be used as a financial reward for vendors that meet or exceed requirements. The reward for exceeding objectives could be meeting the vendor's initial asking price:

- Baseline service costs at market rates using qualitative and quantitative comparisons.
- Cater for possible demand shifts whenever negotiating costs in contracts.
- Base financial incentives on the cost/benefit of meeting business objectives.
- Measure vendor performance against these objectives.
- Reward vendor performance at an agreed-on cost/benefit level.

Alternative competition is credible and real, especially when competitive pressure comes from beyond the IT department. IT spending is increasingly aligned with business objectives, thanks to better IT asset and operational data. Use your realignment of spending with vendors to demonstrate that your internal services are market-competitive in terms of measurable value, not only price.

RECOMMENDED READING

"Don't Outsource Just to Save Money"

"How to Manage Risk in Alternative Delivery Models"

"Gartner Maturity Model for IT Procurement"

"The Pros and Cons of Conducting Market-Based Comparisons for Internal IT Organizations"

"Report Highlight for Market Trends: How Vendors Can Reduce the Cost of Infrastructure Support Services, 2008"

"Business and Sourcing: Collaborating for More-Effective and Successful Services"

"Build a Sourcing Governance Framework That Aligns With Your Organizational Style"

"Alternative Delivery Models: The First Taxonomy"

This research is part of a set of related research pieces. See "Spotlight: Optimize IT Asset Management and Procurement Costs" for an overview.

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