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Management Update: Use the Right Criteria to Evaluate Software License Metrics

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IT procurement personnel and software negotiators are increasingly struggling to anticipate costs associated with a confusing array of new licensing metrics that vendors are introducing. This research establishes key criteria against which to assess the appropriateness of any new licensing metric to your organization.

Key Findings

- Software vendors are increasingly licensing solutions based on newer, unfamiliar metrics.
- Customers need to assess these metrics against eight criteria: simplicity and ease of administration; clearly defined usage rights; predictability; control and external validation of increases to the metric; measurability; direct relationship between the metric and the value delivered; technology independence; and fair relationship of price to value.

Recommendations

- Software metrics should be evaluated against a structured set of criteria. If a software vendor proposes a new license metric that seems irrelevant to how you'll be using the software, and you have some leverage in the deal, then calibrate the impact of the new metric and compare it with your previous metric to determine the impact on pricing — that is, if this metric was used last month, what would the impact have been on the cost? If the costs are significantly higher, or the metrics present other challenges according to the criteria stated above, then require the vendor to propose an alternative model before agreeing to license the software.
- Be prepared to suggest alternatives, rather than merely relying on the proposals of the software vendor. If you're converting from an old license metric to a newer one, and your requirements aren't changing in terms of use or value, then ensure that you pay no additional fees as a function of the conversion, either in license or maintenance. Require full credits for license conversion, and ask that the discount on the new deal be the same or better than the original one. If license fees actually decrease, then maintenance should reflect the converted license price.

WHAT YOU NEED TO KNOW

Analyze any newly proposed metric against these eight criteria. If the metrics your software vendor proposes are new and don't meet many of these criteria, then be prepared to suggest alternatives, rather than merely relying on the creativity of the software vendor. If you have perpetual license rights, then be clear that conversions aren't mandatory, at least for the licenses you already have. Some vendors have effectively forced conversions of perpetual licenses to newer metrics by stating that no more licenses can be bought according to the older metric, and if you move to the newer metric, then you may be "double buying" — for example, if the old licenses were based on named users and the new ones are based on the total number of employees. To protect against this, we recommend negotiating a clause that states you can always purchase the existing technology license according to the defined license metrics in the contract. However, if *you* decide to convert from an old license metric to a newer one, and your requirements aren't changing in terms of use or value, then ensure that you pay no additional fees as a function of the conversion, either in license or maintenance. Require full credits for license conversions, and ask that the discount on the new deal be the same or better than the original one. If license fees actually decrease, then maintenance should reflect the converted license price.

ANALYSIS

Traditional licensing metrics — such as named user, concurrent user, and CPU/core and server — are being criticized or eliminated for several reasons (see Note 1). This has prompted software vendors to introduce an often-bewildering array of new metrics to replace them. Gartner has described and analyzed the strengths and challenges of some of the metrics that we see more commonly (see "The Advantages and Disadvantages of Different Software License Models" and "Toolkit: The Desktop Guide to Software Licensing").

However, new models or versions of these models are emerging daily. Many customers are confused by unfamiliar metrics as software vendors struggle to find a system that reflects the value delivered by their products.

There's no perfect license metric. The appropriateness of a metric in a particular situation will depend on factors ranging from the nature of the application and the way it's used to technical constraints and competitive offerings. Use the following eight criteria to gain a better understanding of vendors' metrics, and to determine how appropriate they are to your business.

1. Simplicity and Ease of Administration

Licensing metrics should be simple. It should be easy for your vendor to explain its metrics to the members of your organization who are negotiating the license agreement, and to those who are budgeting for and measuring the license usage. Metrics should be easy to understand and intuitive. A vendor or user should be able to explain the license metrics to a customer or colleague in less than three minutes, after which the metric should be understood accurately.

Vendors should define license metrics clearly in their contracts. In addition, they should document all the assumptions made when devising the metric, and provide examples. Most disputes between vendors and customers over usage rights arise after the contract has been signed. By this time, the contract's negotiators (the software vendor's and the customer's) have often left their respective organizations, and there's no additional documentation available to clarify what was meant by the stated metrics.

Finally, the vendor and its customer should be able to manage licenses from a financial, contractual and physical perspective without complex administrative processes.

Some software vendors use so many license metrics that they confuse customers that are trying to understand and monitor each metric. It's also difficult for customers to be confident that each metric is defined clearly in the contract. Gartner recommends a single licensing metric for a single product, and that there are no more than three metrics per solution. For example, a vendor should only use a fee per named user, CPU, and transactions processed to license an entire CRM solution, combining sales service and marketing functions. Metrics shouldn't be combined, such as "transactions processed per named user per CPU." Combining metrics in this way creates a multiplier effect that can increase costs exponentially as the software becomes more widely used, and as new transactions, users and CPUs are added.

Be aware of the significant numbers of subcategories in license metrics, such as named users. In some cases, the customer drives the software vendor to use too many categories to account for groups such as infrequent users. For example, if the primary license metric is named users, then it will be difficult to track the users if there are 10 different user categories. Organizations that are concerned about managing this complexity should focus on a reasonable cost for the average user (and the average use). When applying this method, some users will receive more value, while others will receive less, but the value for all users will be fair and reasonable. Organizations should establish new categories of users and define usage rights in advance to arrive at a sense of the average cost.

Finally, organizations should remember that, whatever the metric selected, some recognition of the value received can be managed via discounts. For example, when licensing a human resources software product that provides many employee self-service features, a financial institution, in which most employees will be able to use this functionality, may receive a smaller discount than a factory, in which fewer employees have access to computers. However, no discount will make a completely inappropriate metric more palatable.

2. Usage Rights Defined Clearly in the Contract

There are often many definitions of common license metrics — employee, transaction, connection and so on. Even when license metrics meet the simplicity criteria, the definitions and terminology used in the contract should reflect all such understandings. A metric should not only be defined clearly at the time of the negotiation, but also be just as clear when the contract is reread years later. If there's a chance that something could be interpreted in different ways (and this is often the case), then the contract should include examples of what the usage rights are, what is to be counted, how counting is to be done and what should be excluded from the metric count. Ask someone who's uninvolved in the negotiation, or uninvolved with software license agreements, to read the usage rights terminology and give his or her interpretation of how it will be measured to further ensure that the license is clear. It's easy for someone more familiar with these terms to say they're understood, only to find out that the vendor means something very different in a clarification document on its Web site.

3. Predictability

Most organizations need to budget in advance for software license fees and maintenance fees. Organizations won't be able to budget accurately if they can't predict the number of licenses they'll need, or the resultant maintenance and support fees. Vendors should propose metrics that enable user organizations to predict their annual costs at least a year in advance (ideally, those costs should be predictable for the length of the application life cycle). If there are questions about predictability, then organizations should include contract language that allows for some level of variation that only needs to be "trued up" at points in time — for example, something like an ability to license 10% or more without paying until the end of the year, rather than strict boundaries. Without such metrics, user organizations will struggle with yearly or multiyear cost projections, and they may have to repeatedly ask senior executives for additional funds. This will frustrate IT financial management initiatives. The requirement for predictability has caused problems with many "pay as you go" or usage-based models that we have seen proposed (see "Will Pay per Use Help to Cut Software License Costs?").

4. Control and External Validation of Increases to the Metric

You should be able to exercise some control over increases to the licensing metric. An example of license metrics that aren't controllable are those based on CPU speeds or CPU cores. User organizations can't control the speed of the processors or the number of cores in processors that are available on the market. It's already difficult to purchase single-core technologies, and, by 2012, eight core will be standard at the entry level — and potentially even 12 core. Organizations licensing by core and replacing servers will be forced into price increases for multicore processors, even if they didn't need, want or get the additional performance, because lower-core technologies will be unavailable (see "Optimize Your Software Licenses for Multicore x86 Systems").

In addition, metrics that are devised by software vendors without an external auditing facility can't be controlled — for example, IBM Processor Value Units (PVUs). The company assigns PVUs to products; however, because there's no formal or auditable external validation of the number of PVUs accorded (as there were historically with the MIPS metrics), it's impossible to predict pricing. User organizations should be able, at least in part, to control increases to the metric, and they should be able to validate increases externally.

5. Measurability

Your organization should be able to measure usage against the licensing metric that's employed according to the terms defined in the license agreement. If the license metric isn't measurable, then your organization can't prove compliance, and your software vendor will find it difficult to audit. If there's no inherent way to measure usage, then the vendor should provide measurement tools that users find acceptable, and that won't adversely affect performance. Ideally, these measurement tools should be provided by a third-party vendor that would have no interest in the billing result. If the vendor doesn't provide the tools, then remember that you're still responsible for compliance, so ensure that you have some defensible way of calculating your estimates of compliance. *If you need to invest in these tools at your own expense then, you'll also need to factor those costs into your software budget.*

6. Direct Relationship Between the Metric and the Value the Software Delivers

Many software vendors have begun pricing applications based on broad business metrics, such as the annual revenue of the company, the number of employees or freight costs. In some cases, these metrics are industry-specific. In our experience, most customers find it difficult to make direct correlations between these broad metrics and the value delivered from the software licensed.

Annual revenue and freight costs can increase or decrease for reasons unrelated to the software (for example, higher fuel costs have increased the cost of goods sold and the cost of freight under management metrics). Furthermore, in most cases in which a business metric is used, the vendor increases its fees when the metric increases, but doesn't reduce fees when the metric declines. Organizations that use business metrics should provide pricing based on metrics that can be influenced directly by the value the software brings to the business.

7. Technology Independence

The licensing metric should be independent of the technology platform (that is, the hardware, virtualization technologies, operating system and database) on which the software runs. The organization shouldn't be forced to pay additional costs if the software vendor changes its technology environment — for example, to support Linux or move to a service-oriented architecture. In many cases, software vendors would need to develop code on these new architectures or platforms to attract business from new customers. As a result, this is a vendor's cost of doing business. Additional license fees are only justified if such changes add value with new functionality that you need and want.

8. Fair Relationship of Price to Value

Organizations should feel that they're paying a fair price for the value derived from the software. This is probably the most difficult criterion to evaluate. From a licensing perspective (not including installation, integration, training or professional services), this evaluation involves such activities as return on investment (ROI) analyses, comparing the prices of competitive offerings, comparing the cost of building vs. buying the solution, and projecting license and maintenance fees over several years.

Similarly, when determining pricing, the software vendor should examine such factors as the availability and functionality of competitive offerings, the ROI to its customers, and the ability of the software to enable its customers to increase revenue, reduce costs, improve service, avoid future costs, and to increase profits, revenue or other key performance indicators. However, vendors have little incentive to take these considerations into account without direct market competition from alternatives (see "Long-Term Trends That Will Radically Alter Licensing in the Software Market").

Market forces can only regulate software markets if customers leverage them and lock contractual protections into their contracts before they commit to the vendor's product. Finally, remember that changing your licensing metric will not, on its own, allow you to reduce or better control costs. In our experience, vendors respond to these requests with licensing metrics that are designed to optimize revenue, rather than help customers contain costs. Proper software asset management capabilities and processes are the only real way to understand, control and optimize costs (see "Cost Optimization: Classify Costs to Achieve Sustainable Savings").

RECOMMENDED READING

"The Advantages and Disadvantages of Different Software License Models"

"Toolkit: The Desktop Guide to Software Licensing"

"Will Pay per Use Help to Cut Software License Costs?"

"Optimize Your Software Licenses for Multicore x86 Systems"

"Long-Term Trends That Will Radically Alter Licensing in the Software Market"

"Cost Optimization: Classify Costs to Achieve Sustainable Savings"

Note 1
Reasons for the Decline in Traditional Licensing Metrics

Named-user licensing continues to be common for many applications, but it can become problematic when the user communities are extended to include customers and business partners, because their numbers are larger and less predictable. In addition, software vendors are realizing that the license revenue derived from named-user pricing diminishes as more processes become automated, and as the number of named users associated with processes declines.

The concurrent-user model suffers from similar problems, and it's difficult to count users accurately in a Web-based environment. Existing capacity-based metrics are under pressure because of the complexity of managing them with multicore processors, and because of the virtualization of computing.

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