

## THE JOURNAL REPORT: TECHNOLOGY

The Revolt of the Corporate Consumer

How companies are squeezing tech suppliers to get a bigger bang for their software bucks

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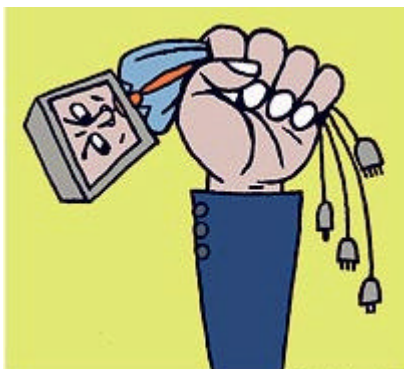
January 17, 2005; Page R1

The power has shifted.

For more than two decades, software vendors have been in control, selling tech-hungry companies a steady stream of new products and services largely on the vendors' terms.

No longer. In the four years since the collapse in corporate technology spending, the tables gradually have turned -- to the point that now, it's the buyers who are clearly calling the shots. They are wrangling for better prices, demanding software that's more reliable and secure, and resisting software companies' push for constant -- and expensive -- upgrades.

All this represents a seismic shift in power to tech buyers from sellers. Limited tech budgets have given chief information officers more negotiating clout with vendors, who know that many buyers already feel burned by disappointments with previous purchases. Meanwhile, open-source and subscription Web-based software services have emerged as more-serious competitors to the established software giants, putting downward pressure on prices. Combined, these trends mean that customers are demanding -- and getting -- more and better software for their money.



Scott Menchin

"They're economic tectonic plates and they're moving," Mitchell Kertzman, a venture capitalist with Hummer Winblad Venture Partners in San Francisco, says of the forces propelling the customer revolt. The power shift is permanent, he adds. "There isn't any way to go back."

For software companies finally being forced to improve security, simplify maintenance, reduce costs and deliver measurable business results, Mr. Kertzman says, the shift "will be really punishing." But customers are already reaping rewards. Meta Group Inc., a Stamford, Conn.,

market researcher, last month predicted prices for packaged software will slide over the next three to five years. And nearly two-thirds of companies expect to negotiate lower prices for their annual software maintenance contracts -- which entitle them to updates, bug fixes and technical support -- according to a survey late last year by Tech Strategy

**Partners LLC, a San Francisco-based consulting firm.** Software vendors have cut their published billing rates for consulting services -- before discounting -- to an average of less than \$190 an hour from more than \$200, according to InfoProv Inc., a research firm based in Marietta, Ga.

Motorola Inc. already has saved millions since it renegotiated its software licensing deals with Oracle Corp. in 2003. Toby Redshaw, Motorola's corporate vice president for information-technology strategy, says he was surprised at Oracle's level of cooperation. "This was more than talk. They backed this up with action," he says. "This is an example among many we have seen over the last 18 months where the balance of power is moving back over to the consumer."

### **Demanding Standards**

One result of customers' new clout is that software vendors are adhering more closely to common industry standards, making their products more compatible and interchangeable. Such inexorable commoditization is a well-rehearsed pattern in the technology industry, and it results in lower prices.

"Customers are clearly pulling the whole market toward standards," says Steve Mills, who heads International Business Machines Corp.'s software business. "You can't ignore them."

### **DEMANDING CUSTOMERS**

According to tech-industry experts, software buyers want suppliers to:

- Deliver software that meets the standards of other commercial products, namely that it work out of the box
- Be accountable for agreed-upon service levels develop and maintain secure products and services that place minimal burden on users
- Responsibly alert users when new vulnerabilities are detected
- Integrate security throughout the design, manufacture and upgrade cycles
- Ensure compliance with security requirements before release
- Develop more secure and less costly patch-management processes
- Test common software configurations for security vulnerabilities and bugs
- Provide innovations more specific to their business

Sources: IDC, Business Roundtable, **Tech Strategy Partners**

Indeed, longtime enemies Microsoft Corp. and Sun Microsystems Inc. acknowledged that pressure from customers played a role in forcing them to end their antitrust battles and other bickering with an out-of-court settlement last April. Tony Scott, chief technology officer of General Motors Corp., says he told rival chief executives Steve Ballmer of Microsoft and Scott McNealy of Sun to reach agreement on technical standards and other issues that were costing customers time and money. GM is one of many companies that use software from both Microsoft and Sun.

"We've got the reputation as being the cranky customer who is rather demanding in terms of what we need our technology vendors to do," Mr. Scott says.

Customers also are using their new clout to force vendors to deliver software that is more secure and reliable. Such demands have become more urgent as efforts to comply with a welter of new government regulations and fend off ever more sophisticated cyber-attacks have exposed the vulnerabilities of existing systems.

The Sarbanes-Oxley financial-reporting law mandates that companies must certify the accuracy of their financial reports, requiring them to attest to the ability of their computer systems to prevent or detect tampering. Meanwhile, hospitals and insurers must more closely guard the confidentiality of health records. In California, a new law that went into effect Jan. 1 requires companies that maintain personal information about state residents to maintain "reasonable security procedures and practices."

Legal considerations aside, companies are increasingly troubled by the cost of poor-quality software. A 2002 study commissioned by the National Institute of Standards and Technology found that software bugs cost the U.S. economy \$59.5 billion each year, with more than half of the burden borne by software users and the remainder by software developers and vendors. Cyber-attacks and the software patches needed to avert them cost the U.S. financial-services sector alone about \$1 billion a year, says Bits, a Washington-based consortium of more than 100 large financial institutions.

### **Sharing the Burden**

"There's a lot that has to be done in the software industry," says Catherine Allen, chief executive of Bits. Her group and the Business Roundtable, an association of chief executive officers, are demanding what has come to be known as "shared responsibility" between software vendors and users. The phrase is shorthand for a list of demands including easier patch management, more-secure code and better testing by software makers to ensure smoother interaction among their products. In a manifesto issued last May, the Business Roundtable told software companies to "develop and maintain secure products and services that place minimal burden on the end-user."

Behind such bland language is the unspoken threat of litigation or new laws that would make software makers liable for glitches in their products, a terrifying prospect for companies selling software installed on tens of millions of machines. But there are signs that vendors are more inclined to work with customers to avert such a showdown.

Bits, for example, has engaged Microsoft, which says it has made security its top priority, in a cooperative effort to ensure that banks' business requirements for software products and services are met. Microsoft has shown a "significant change in culture and level of responsiveness," Ms. Allen says. "But we have a long way to go."

Mike Nash, who heads Microsoft's Security Business & Technology Unit, says he agrees with both characterizations.

"We certainly carry the liability" for security breaches, Ms. Allen says, "and we feel the software industry has to step up to the plate to share responsibility to deliver more secure software."

Software vendors are embracing the notion of shared responsibility -- up to a point. "All of us need to do a far better job of building more solid, more secure products, and products that don't have vulnerabilities," says John W. Thompson, chief executive of Symantec Corp. But software companies won't accept liability for damage that might result from improper configuration or implementation of systems by customers themselves, he says.

"We're not willing to accept undue liability for implementation, for sure," Mr. Thompson says. "That is a chasm the software industry has not crossed, and I'm not sure we want our company to be the first one across that chasm."

### Deep Discounts

The clearest indication of increasing customer clout is price discounting much steeper than even many industry insiders had realized. Documents released in the court battle over Oracle's hostile takeover of PeopleSoft Inc. reveal that customers of the two companies in recent years were able to extract discounts of 70%, 80% and even 90% on the published list price for software to manage functions such as financial reporting and human resources. And it appears the trend is only accelerating. According to the Meta Group report, a raft of low-price innovations -- open-source software, the advent of Web-based services and low-cost offshore development, to name a few -- will cause software revenue to shrink over the next five years.

"Software prices are in a permanent deflationary cycle," according to Meta.

Charles A. Peters, senior executive vice president of Emerson Electric Co., testified at the antitrust trial spawned by Oracle's takeover of PeopleSoft that he negotiated a deep discount from Oracle, along with a five-year price freeze, in part by reminding the company that he didn't really need new software at all. A company acquired by Emerson Electric was using a home-grown system built in the 1960s. When Mr. Peters suggested the company switch to an Oracle financial-reporting system, executives at the unit couldn't see the point. "You're going to increase my costs and I get no more functionality out of it?" they asked, according to Mr. Peters's testimony. The division is still using the old system.

Companies are now able to keep old systems running, or build new features themselves, because of the availability of cheap offshore programming talent. "Changes the entire game," Mr. Peters testified. Ten years ago, he said at the trial, technology consultants from the Big Five U.S. systems integrators charged \$200 an hour. But he found that similar services from providers in India "started at \$40 and went to \$25, and we got them down to \$21, and we push them to \$18. On my latest software venture, I've got a Filipino group at \$12. So, right now, I'm at \$12 versus \$200."

A similar effect is being felt from the maturation of open-source software -- nonproprietary software that many providers are packaging with services and selling for much less than the more-established options. When Sabre Holdings Corp. in Southlake, Texas, first started moving its big airline-reservation system from the massive mainframe computers it ran on for decades, Chief Technology Officer Craig Murphy figured he'd shift to Oracle's database software running on Unix-based server computers. Then, last year he found he could cut his technology costs sharply by switching part of the reservation system to open-source database software from the Swedish company MySQL AB on standard Intel-based personal computers running the Linux operating system.

"Oracle runs great, but it's very expensive," Mr. Murphy says. "We found that open-source works just as well."

### **Cutting Maintenance Costs**

Customer dissatisfaction over both the cost and complexity of software is forcing other changes in the way software is distributed and sold. Instead of paying a large upfront software-licensing fee, customers are increasingly seeking to pay only for what they use, through various subscription-based models. Some companies, such as Salesforce.com Inc. and NetSuite Inc., offer such pricing for Web-based services, managing their own centralized data centers rather than installing software on a customer's own network. But even traditional packaged-software vendors are experimenting with pay-as-you-go pricing, reducing customers' upfront outlays.

Customers are also starting to pressure software companies to cut, or at least not raise, prices for annual maintenance contracts. Such contracts, typically priced at between 15% and 25% of the price of the original software license, represent one of the software industry's last remaining cash cows. But high prices have created an opportunity for third-party support providers to undercut the major software companies.

Even before Oracle completed its takeover of PeopleSoft this month, dozens of Peoplesoft customers had cancelled their maintenance contracts with the company and signed up for product support from TomorrowNow Inc. in Pleasanton, Calif., which is staffed mainly by former PeopleSoft employees.

The company started out providing software updates for products that PeopleSoft itself no longer supported, appealing to customers who wanted to forgo expensive upgrades of their systems. But it claims it can support even newer PeopleSoft releases, at about 50% of PeopleSoft's own price. A PeopleSoft spokesman said the company doesn't view TomorrowNow as a significant threat.

Customers who prefer to stick with their software providers for maintenance can still use such competition to renegotiate their contracts. "Maintenance pricing is going to be under severe pressure for the next few years," says Vinnie Mirchandani, head of Deal Architect Inc., a technology consultant in Tampa, Fla. By the time he explains the gross profit

margins that software companies enjoy on their maintenance revenue, he says, people "are ready to negotiate more aggressively."

Meanwhile, many companies -- including Germany's SAP AG, the largest provider of applications for managing manufacturing processes, supply chains and other business functions -- are extending their maintenance coverage for older products, so that customers aren't compelled to upgrade their systems sooner than they might like.

### **Demanding Results**

Regular upgrades not only are costly and time-consuming, but also don't result in a clear business benefit for many customers. And customers increasingly are insisting that their vendors deliver on the business benefits promised from their systems.

At Eastman Chemical Co., in Kingsport, Tenn., the information-technology department now works more closely with executives running individual business units, and executives sit on a "governance council" that reviews big tech projects. One casualty was a customer-relationship management, or CRM, system that Eastman had been considering since 2001 to help its salespeople keep track of their accounts. The program failed to win approval again last year. "We don't think we would get the business value" from the software, says Jerry Hale, Eastman's chief information officer.

Vendors are starting to get the message. Mike Lawrie, who last year took over as chief executive of Siebel Systems Inc., which provides such customer-relationship management systems, said the company had lost sight of the need to deliver business results, rather than just software, to its customers. The "value proposition" has shifted, Mr. Lawrie says. "It's not just about making the best software," he says. "It's also about helping companies get to that business outcome, get the value from the investment they've made."

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