

ENTERPRISE LICENSING AGREEMENT

The State Failed to Exercise Due Diligence When Contracting With Oracle, Potentially Costing Taxpayers Millions of Dollars

REPORT NUMBER 2001-128, APRIL 2002

Department of General Services and Department of Finance's responses as of October 2002¹

Audit Highlights . . .

On May 31, 2001, the State entered into a six-year enterprise licensing agreement (ELA), a contract worth almost \$95 million, to authorize up to 270,000 state employees to use Oracle database software and to provide maintenance support.

Our audit of this acquisition revealed the following:

- By broadly licensing software, a buyer that has many users, such as the State, can achieve significant volume discounts.*
- The State proceeded with the ELA even though a survey of departments disclosed limited demand for Oracle products.*
- The departments of General Services, Information Technology, and Finance approved the ELA without validating Logicon's cost savings projections; unfortunately, these projections proved to be significantly overstated.*
- Logicon apparently stands to receive more than \$28 million as a result of the ELA.*

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The Joint Legislative Audit Committee (audit committee) requested the Bureau of State Audits (bureau) to examine the State's contracting practices in entering into the enterprise licensing agreement (ELA) with Oracle. Specifically, the bureau was asked to review the sole-source justification for the ELA and the roles of the Department of General Services (General Services), the Department of Information Technology (DOIT), and the Department of Finance (Finance) in developing and executing the ELA. We were also asked to review the terms of the agreement and determine whether they were in the best interests of the State and assess the methods used to justify the technical and business need for the ELA.

Further, we were asked to identify the fixed and variable costs of the ELA, the funding sources that will pay for it, and the reasonableness of the projected savings from the ELA. Lastly, the audit committee requested we obtain a legal opinion on whether the contract is null and void if it was executed in violation of state law.

Finding #1: Surveys conducted by DOIT and Finance indicated a limited need for Oracle database licenses.

The three departments involved in the ELA—DOIT, General Services, and Finance failed to conduct a comprehensive analysis to gauge or confirm the level of statewide interest in the ELA. However, at least two months before the ELA was executed, DOIT ignored preliminary survey data that strongly suggested most departments had no immediate need for Oracle database licenses. Specifically, of the 127 surveys it sent to state entities,

¹ The Department of Information Technology was sunset on July 1, 2002.

- ☑ *Nearly 10 months after the ELA was approved, no state departments had acquired the new licenses, which may be due to the fact that General Services had not issued instructions to departments on how to do so.*
 - ☑ *General Services used an inexperienced negotiating team and limited the involvement of legal counsel in the ELA contract. As a result, many contract terms and conditions necessary to protect the State are vague or missing.*
 - ☑ *Our legal consultant has advised us that a court might conclude that the ELA contract with Oracle is not enforceable as a valid state contract because it may not fall within an exception to the State's competitive bidding requirements.*
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DOIT received only 21 responses, 5 of which indicated a possible interest in purchasing any additional Oracle products under a consolidated agreement in the near future.

In November 2001, five months after the ELA was approved, Finance sent out another survey to assess the need for Oracle database licensure and to establish a basis for allocating the cost of the ELA. This survey explicitly required all departments to respond. Preliminary survey results indicated that for the 12 state departments with the largest number of authorized positions, 11 use Oracle database products to some extent. However, while the ELA will cover up to 270,000 users—more than the total number of state employees—according to the survey, 113,000 of the authorized positions at just these 11 state departments will not use the Oracle database software.

Finance administered the survey as a preliminary step to appropriately allocate the ELA's cost among the various departments, and the information obtained on current and planned use of the Oracle enterprise database licensure was to be used to develop a cost allocation model. However, as of April 2002, 10 months after the ELA was approved, the analysis of the survey was incomplete. Furthermore, state departments have not been informed of how to acquire the database licenses using the ELA. Thus, it is not surprising that no state department had acquired new licenses under the ELA as of the end of March 2002.

Finance's survey was to provide necessary information about whether state departments have purchased any Oracle database licenses or entered into any maintenance contracts since the ELA was signed. The absence of an allocation model along with the lack of any specific pricing information or ordering instructions informing departments how to purchase the database licenses through the agreement may further reduce any cost savings or utility from the ELA. In reviewing the preliminary results of the November 2001 survey, we identified 12 state departments that have entered into their own maintenance contracts with Oracle—totaling \$1.1 million for products covered by the ELA—since it was signed on May 31, 2001.

In order to take full advantage of the Oracle ELA, we recommended that Finance complete its survey and develop a method to allocate the ELA's cost to departments.

Finance Action: None.

The Department of Finance has elected not to complete its survey since the ELA was rescinded in July 2002.

Finding #2: DOIT and Finance did not adequately evaluate the ELA proposal's merits.

The State negotiated and ultimately approved the ELA proposal without sufficient technical guidance, assessment of need, or verification of projected benefits. According to officials at DOIT, General Services, and Finance, the State had never before considered a statewide software purchase, nor did it have any specific guidance in identifying the extent of the need for the software and in negotiating the key provisions to include in the contract. In fact, DOIT had looked at the concept of statewide software licensing as early as June 2000, when it hired Logicon Inc. (Logicon) to research and present information on enterprise licensing. Nevertheless, DOIT and Finance routinely evaluate IT proposals, including those involving software purchases. Although both possessed the expertise needed to evaluate aspects of the ELA proposal—DOIT the need to license 270,000 users and Finance the cost projections—neither did so, citing a lack of suitable procedures and inadequate time. To its credit, Finance's Technology Investment Review Unit (TIRU) identified specific concerns with the ELA proposal, and on May 10, 2001, communicated these concerns to the directors of Finance and DOIT. It also recommended that the proposal be postponed until the following year, giving the State a chance to develop appropriate policy. However, TIRU's concerns and recommendation were not heeded. As a result, the State committed almost \$95 million without knowing whether the costs and benefits of the ELA were justified.

Before pursuing any future enterprise agreements, we recommended the State take the following actions:

- DOIT, Finance, and General Services should seek legislation establishing the authority to enter into an ELA that protects the State's interests and clarifies each department's respective role and responsibility in the process.
- Finance should notify the Legislature at least 30 days in advance of any state department executing any future ELA.

- DOIT should continue its efforts to create a statewide IT inventory, including software.

Finance, General Services, and DOIT Action: Partial corrective action taken.

In March 2002, Finance, General Services, and DOIT developed a draft process for statewide software licenses that defined specific roles and responsibilities for the three departments and prescribed specific analytical and approval procedures. However, this process was not formally approved due, in part, to the sunset of DOIT and the adoption of Control Section 11.10 of the Budget Act of 2002 that will fulfill some of the recommendations.

Specifically, Section 11.10 requires a 30-day legislative notification before any department can enter into a statewide software license agreement of \$1 million or more, regardless of future costs or savings. Additionally, the agreement must be reviewed by Finance. This section also states that any department considering entering into such an agreement is required to submit to Finance a business plan with specific components, including an analysis of base and current usage of the license, rationale for statewide license versus an alternative type of agreement, cost-benefit analysis, and funding plan.

DOIT ceased to exist on July 1, 2002, thereby ending its efforts to create a statewide IT inventory. Currently, no other state department has been assigned the responsibility to continue these efforts.

Finding #3: The Oracle ELA could cost the State added millions in taxpayer resources.

The Oracle ELA could cost the State \$41 million more in database license and maintenance support than what the two would have cost in the absence of the contract. This is because the State did not validate the projections of costs and savings prepared by Logicon, who, acting in an undisclosed capacity as an Oracle reseller or licensing agent, would benefit significantly from the contract. Logicon, whose only role according to the contract was as the designated lender, and who apparently stood to make more than \$28 million as a result of the ELA, developed the business case analysis General Services used to justify the State's decision to contract with Oracle. However, Logicon's analysis, which projected a savings to the State of \$111 million over

10 years, was seriously flawed. Specifically, it was based on costs that should have been excluded because they were outside the ELA's coverage or did not follow the analysis' stated methodology. Further, Logicon's calculations contained numerous errors and many of its assumptions were questionable.

To ensure that future enterprise agreements meet the State's best interests, we recommended DOIT and Finance develop policies and procedures on how to evaluate future ELAs. To be effective, one state department needs to take responsibility for developing and justifying the ELA proposal.

Finance, General Services, and DOIT Action: Corrective action taken.

As previously stated, Finance, General Services, and DOIT developed a draft process for statewide software licenses that defined specific roles and responsibilities for the three departments and addressed analytical and approval procedures. However, because of the closing of DOIT and the adoption of Section 11.10 of the Budget Act of 2002, the process was not formally approved. Further, information technology experts have informed Finance and General Services that ELAs are not generally considered a best practice, especially with state governments. These experts state that such an environment is better suited to a volume purchase agreement (VPA). According to Finance, in the event that a VPA is being considered, General Services has agreed to take lead responsibility.

Finding #4: The State did little to protect itself against risks associated with the contract.

The State rushed into the Oracle ELA without negotiating strong provisions to guard against the risks inherent in long-term software contracts. The term of these types of contracts generally ranges between three to five years, partly because of the rapidly changing nature of the software industry. However, the State's contract with Oracle was for six years with a maintenance option for four more years. Our technical consultant observed that by entering into such a large long-term contract, the State increased risks such as the following:

- The vendor going out of business, being purchased, or otherwise becoming unable to perform.
- Technology changes that leave the State with a prepaid, long-term contract for a product that has diminishing value.

- Future software upgrades that are not supported under the contract.
- Lack of funding to make all future payments required under the contract.
- Demand for the software licenses not meeting expectations.

To protect against such risks, buyers normally try to negotiate mitigating safeguards as part of the terms and conditions of a contract. For example, a buyer would normally want to ensure that contract terms clearly define the support level the vendor will provide, including how upgrades and subsequent versions of the software will be furnished at no additional cost. Unfortunately, the State's hastily negotiated contract with Oracle lacked adequate provisions to minimize these risks.

The increased risks associated with this long-term contract largely occurred because General Services failed to properly prepare for contract negotiations with Oracle. For example, General Services did not include on its negotiating team anyone with expertise in the area of software licensing agreements or anyone with an in-depth knowledge of Oracle's past business practices. Moreover, General Services' legal counsel's role in the negotiations was limited to a few hours review of the contract's terms and conditions occurring the day before and the day it was signed. Consequently, the contract does not adequately protect the State's interests.

We recommended that, before negotiating any future enterprise licensing agreements, General Services should assemble a negotiating team that possesses all the types of expertise necessary to protect the State's interests. Further, if deemed enforceable, General Services should renegotiate the contract to ensure it includes adequate protections for the State. We also recommended that the Legislature should consider requiring all IT contracts over a specified dollar amount to receive a legal review by General Services.

General Services' Action: Partial corrective action taken.

On July 23, 2002, the ELA for Oracle database licenses and maintenance support was rescinded. However, General Services stated that it would ensure sufficient resources and expertise are assigned to any future ELA proposals.

In support of recommendations made on August 30, 2002, by the Governor's Task Force (task force) on Contracting and Procurement Review, an assessment will be performed to determine the knowledge, skills, and abilities needed by acquisition professionals. This information will be used to determine course content for a comprehensive training and certification program for state contracting and purchasing officials. General Services specifically identified the urgency for targeting training in the complex realities of IT contracting.

The task force also recommended that General Services ensure active legal participation in all high-risk transactions. General Services stated that full implementation of this recommendation will require additional legal resources. However, in the interim, General Services' Office of Legal Services has implemented processes that ensure the review of all non-competitive bid and large-scale system integration contracts.

Legislative Action: None.

We are unaware of any legislative action implementing this recommendation.

Finding #5: The State's contract with Oracle may not be enforceable.

Our legal consultant has advised us that a court might find the ELA is not enforceable as a valid state contract because it may not fall within an exception to competitive bidding requirements. However, further analysis is required to understand the impact of a finding that the Oracle contract is unenforceable. For example, our legal consultant cautioned that even if a court found that the ELA contract is void for failure to comply with competitive bidding requirements, additional questions are raised by the financing arrangements for the \$52.3 million dollar loan under which Logicon assigned its rights to Koch Financial Corporation (Koch Financial). Because Koch Financial apparently acted in good faith and the State has received the full consideration for the loan—the enterprise license and one year of maintenance support—under the financing provisions, Koch Financial is likely to assert that the State is obligated to repay the loan. Also, the State has agreed to stop using the ELA's enterprise database licensure if the Legislature does not appropriate funds for the loan payments or the State does not otherwise make payment and the ELA contract is terminated. More importantly, under the ELA

contract the State also agreed not to replace the Oracle license with substantially similar database licenses for one year from the termination date.

Logicon's role, actions, and compensation from the ELA also raise troubling questions about the validity of the ELA contract. Specifically, the amount of compensation Logicon has or will continue to receive—more than \$28 million—for its undisclosed role in the ELA is too much to be merely compensation for being a lender and for the limited support services it will provide.

Finally, Logicon's erroneous savings projections may make the contract voidable. We arrived at vastly different numbers in reviewing the data that supports the costs and projections that Logicon presented to the State. For example, although Logicon projected that the State would save as much as \$16 million during the first six years of the contract, using Logicon's data and assumptions, we project that the State could spend as much as \$41 million more than it would have without the ELA.

For these reasons, we recommended that General Services should continue to study the ELA contract's validity in light of the wide disparities we identified in Logicon's projections of costs and savings and consult with the Office of the Attorney General (attorney general) on how to protect the State's best interests. General Services should also work with the attorney general in further analyzing the ELA contract; all amendments, including any and all documents pertaining to side agreements between Oracle and Logicon; and the laws and policies relating to the ELA, including the potential legal issues that this audit has identified.

General Services' Action: Corrective action taken.

As previously discussed, on July 23, 2002, the ELA with Oracle for database licenses and maintenance services was rescinded. General Services notified state departments of the rescission through the issuance of a management memo.