Guidelines for Lease vs. Purchase

Purpose

The Department of Information Resources (DIR) provides these guidelines related to the issue of leasing versus purchasing information technologies as directed by the General Appropriations Act of the 75th Texas Legislature. These guidelines are meant to offer agencies and universities key criteria in evaluating lease versus purchase decisions to determine cost alternatives.

Issue

The rate of technology change is increasing, with an emphasis on client/server technology, faster system development, and shorter life cycles. This has led to spiraling information technology (IT) budgets, driving the need for a re-evaluation of IT management issues. Organizations must find new ways to accommodate technological change. Leasing and seat management have emerged as a feasible, cost-effective alternatives to purchasing equipment, particularly in the desktop and laptop areas.

The decision on whether to lease or purchase equipment must be made by:

- Examining the IT management processes at the agency/university
- Determining agency/university business needs regarding IT
- Conducting a cost-benefit analysis of the leasing, seat management and purchasing alternatives

Each agency and university has unique business needs, operational requirements, and budgeting practices. These guidelines provide general direction for assessing and comparing alternative solutions for acquiring information technologies required for your agency.

The guidelines address the benefits and limitation for each procurement solution that may be considered for information technologies:

- Purchase
- Lease
- Seat Management

Overview

The acquisitions of new technologies for government require a number of considerations including: what is to be acquired, how to pay for it, and what is actually included in the contract under which it is acquired. When considering procurement options, agencies need to compare the advantages of purchasing information technologies outright, leasing the equipment (no permanent ownership), or Seat Manage/Managed Services contracts (no permanent ownership but additional services). There is no “easy” comparison due to the various hidden costs or additional services that each method presents. There are risks and benefits with all three of these methodologies, and the following guidelines address each of them.

Purchase

Outright purchase of information technologies provide the simplest procurement to achieve assuming an agency has the budget to make such purchases. Direct technology purchases tend to be costly acquisitions requiring agencies to conduct in-depth research to ensure the right toolset is purchased to satisfy your agency’s needs.

Before purchasing information technologies, there are precise procurement terms that must be verified to support a purchasing decision. Do you understand the warranty for the product, especially the length of the warranty, and “who, how, & where” maintenance will be performed? How many additional units will have to be procured to have adequate stock to keep everyone productive while a unit is being serviced? Warranty service is not always performed locally or by the original vendor’s representatives. Will you have to ship the equipment for repair? If so, it will probably be at the agency’s cost.

As an alternative, agencies might consider the extra cost of an extended maintenance contract which incurs significant additional costs. It is not unusual to have maintenance contracts costing 20% of the original purchase price annually. Useful life of most modern IT

equipment is 5+ years. That equates to agencies spending double the original equipment costs over 5 years. That does not take into consideration technology refresh due to changes in technology capabilities.

Other Important Considerations:

- Who maintains Operating system monitoring and patching?
- Will there be a budget for hardware upgrades?
- If no maintenance contract is purchased, who supports these units?
- What would be the estimate annual cost for such support?
- Does your agency have the expertise to provide such support?
- What is the current estimated useful life of these units?
- How many backup units should be purchased and stocked to keep affected staff productive?
- At end of useful life of these units, what is their residual value?
- What would be the agency cost estimate to "properly" dispose of units?
- Service Levels are totally internal to your organization or non-existent.

Lease/Lease Purchase

Not all leases are created equal. An agency should carefully evaluate lease agreements, including a General Counsel review, to add any necessary language into the agreement to protect the agency and state. Many standard lease agreements are typically skewed in the favor of the Lessor in early drafts.

Lease or Lease/Purchase is a beneficial option if an agency has a limited budget to purchase equipment. Spreading technology acquisition payments into consistent annual or monthly amounts can support an agency's ability to acquire needed technologies. For financial consideration, leases may be used as an expense rather than a capital expenditure. An agency's executive management can best determine the proper accounting practice based on relevant statutes and agency practices.

Like a purchase, some in-depth research is required to ensure the agency is acquiring the correct toolset to satisfy an agency's mission and business needs. The terms and specifics of warranty coverage are just as important for leases as they are for purchases. Does the lease allow for financial relief if a warranty repair by the manufacturer takes too long to complete? Are warranties and extended maintenance contracts available within the lease contract?

Leasing usually provides the advantage of accelerating the pace of technology refresh due to changes in technology capabilities. Negotiating a three-year lease will generally allow agencies an easier path to staying current with technology changes. However, long term planning is required to determine future cycles of lease renegotiation, change management, and training.

Another important aspect of a lease to consider is what to do with the equipment at the end of the lease. Technically the lessor still owns the equipment. Agencies desiring to negotiate a buy-out of the lease at the end of the term should be careful to get a reduced fair market or residual value. It is important in the original lease agreement to negotiate the expense of returning the equipment to the Lessor at their cost. Providing proper boxing, packing, and shipping of retired equipment can make for significant additional cost for one party or the other in a lease.

Many of the other considerations listed under purchasing still exist:

- Who maintains Operating system monitoring and patching?
- Will there be a budget for hardware upgrades?
- Can those upgrades roll up under the lease?
- If no maintenance contract is purchased, who supports these units?
- What would be the estimate annual cost for such support?
- Does your agency have the expertise current to provide such support?
- What is the current estimated useful life of these units?
- How many backup units should be purchased and stocked to keep affected staff productive?
- Service Levels Agreements within the lease are usually straightforward and limited in scope.

Seat Management/Managed Services

Seat Management contracts go beyond simply leasing of information technology assets, to encompassing outsourcing the complete management of those assets—from inventory to software distribution to enterprise wide technology refresh. Seat Management is a

managed service form of contracting for IT that is structured around the functional requirements of agencies. This creates an environment where the vendor manages the technology to support agency personnel, while personnel can concentrate on supporting the agency's constituencies and core mission.

Seat Management contracts often require challenging negotiation and review. Some Seat Management agreements are similar to leases with additional hardware support built into the agreement. Others may provide hardware and a whole suite of services including productivity software and help desk support. These types of agreements also help agencies (particularly small agencies) which face challenges recruiting, training, and retaining skilled Information technology staff. There are costs to doing all three of those activities and those costs should be considered when looking at possible "cost avoidance" factors when estimating the total cost of Seat Management contracts. Off-loading these responsibilities to a contractor or vendor may be the agencies best solution to acquiring reliable information technology hardware and software to conduct daily business.

Before carefully evaluating Seat Management agreements, agencies must examine current operations to determine which activities of the organization might be outsourced to a vendor. There can be many levels and types of services included in such an agreement. The range and type of equipment and services desired from the Vendor will determine the complexity of the agreement. Due to the complexity of these types of agreements, the term of the agreement is often for a long time period.

Seat Management tends to be the most expensive information technology over time due to the wider range of services supplied by the Vendor. In evaluating Seat Management contracts, agencies should consider any savings or cost avoidance that might be achieved through outsourcing.

Some of the items to calculate in the savings and cost avoidance considerations include (but are not limited to):

- Replacing current support FTEs
- Avoiding adding new FTEs to staff to support new technologies.
- Keeping existing personnel trained on new technologies.
- Finding expertise for specific short term issues.
- Tracking movement of non-state owned equipment can be outsourced
- Keeping up with Operating system changes and patching
- Will there be a budget for hardware upgrades
- Can those upgrades roll up under the lease?
- Maintenance of equipment generally becomes Vendors responsibility.
- Maintaining stock of backup units to keep affected staff productive

Carefully assess your mission, personnel, and current capabilities to provide technology support within the organization. Negotiations with a vendor should not only include the specific technology offered, but also the roles and responsibilities of all parties and service levels of support that are traceable and enforceable. Significant research on specific agency requirements must be undertaken in preparation to negotiate an agreement with a vendor.

Like Lease or Lease/Purchase, Seat Management/ Managed Services can offer agencies the capability to break a high dollar Technology purchases into smaller consistent annual or monthly amounts. As with Leases, Seat Management contracts are often entered on the financials of an agency as an expense rather than a capital expenditure. Warranty, maintenance, and Service Level Agreements are crucial considerations in developing a Seat Management Contract. Transition planning for end of agreement must also be developed to address the role of vendors and agency staff for the proper handling of equipment at end of term.

What to Compare/How to quantify

There are many different methods to compare various information technology solutions. Hard numbers like hardware, software, and maintenance contracts are relatively simple to calculate. Other measures such as cost avoidance are more difficult to quantify. A Decision Matrix can be a helpful tool to compare and contrast the options of purchasing, leasing, or utilizing seat management contracts. However, a Decision Matrix should be considered a starting point for your deliberations.

Useful Life and Residual Value

Whether you ultimately purchase or lease with option to own at the end of the lease, you will need to estimate the equipment value at the end of the contract. Normal usage will take a toll on the equipment's ultimate value, but so will the pace of technology change

in any given class of equipment. Your agency's list should include all equipment that would be included in any contract that you commit to. Useful Life, usually stated in years, can be based on your agency's experience or can be gathered from you vendors or industry standards.

For the purposes of the example provided later in this document the Useful Life in years is converted to months to populate the Estimated Useful Life The Residual Value Percentage is usually estimated as a percentage of the origin purchase or lease costs. It too can be set by professional experience or from third party resources. The Residual Value is a product of the Purchase Price multiplied by the Residual Value Percentage and only applies to Purchases or Lease Purchases.

Immediately below is an example of a useful life table provided to a Texas state agency.

Category	Useful Life	Residual %
HUB	5 years	0.5%
Routers	5 years	0.5%
UPS	5 years	0.5%
DASD	5 years	2.0%
Modems	5 years	0.5%
DSU	5 years	0.5%
Mainframe Systems	5 years	2.0%
Desktop Computers	4 years	5.0%
Desktop & LAN Printers	5 years	5.0%
Servers	3 years	5.0%
Laptop Computers	4 years	5.0%
Vehicles	10 years	8.0%
Materials Handling Equipment	10 years	8.0%
Printing Equipment	10 years	8.0%
Mail Handling Equipment	10 years	8.0%
Telephones Systems	5 years	2.0%
Other Electronics Equipment	5 years	5.0%
Controlled Property	3 years	0.5%

Maintenance and Training

These are usually hard numbers that are provided by a vendor to account for *Maintenance* costs. Many vendors include this in their bids and quotes at an average of 20% of original purchase price. For some types of high usage equipment (high maintenance types of equipment like printers) that percentage can be considerably higher. Leases can include *Maintenance* costs in the lease price, but not always, thus the Decision Matrix includes a Maintenance cell under leasing.

Training costs should also be negotiated as hard (fixed) or not-to-exceed numbers with the vendor. In some cases the vendors will direct you to third party training providers to provide such numbers and services.

Cost to Sell and Cost of Return

These are usually estimates of the costs to dispose of any agency owned equipment after useful life. Under Purchases or Lease Purchases the agency will normally be responsible to properly dispose of equipment. This *Cost of Sell* can include cleansing of data, hard drive destruction, recycling, packing, transportation, and advertising for or locating a legal entity to transfer the salvaged equipment. The agency will need to be mindful of best practices, rules, policies, and statutes on disposal of electronic equipment.

In the case of a pure Lease or Seat Management/ Managed Services where equipment is provided under the contract, *Cost of Return* of equipment at the end of the contract can also be an issue. Since the disposed equipment will no longer be under the agency or an agency's contractor's control, you will most likely be responsible for the same best practices, rules, policies, and statutes on the disposal of electronic equipment as if you owned it. As with the previous *Cost of Sell* calculations, it could be expensive to box, pack, and ship hundreds of desktop computers. Generally that is negotiated into the original contract costs.

Discount Rate

The *Discount Rate* could be any additional discount your vendor might apply to any component cost of a contract. This could be applied against the Purchase Price, Maintenance, Training, Lease Costs, or any other individual cost.

Offsets

Managed Services Offsets refers to costs that might be avoided due to some services being provided under a contract. Some of the costs provided in the example later in this document is direct labor costs (Reduced Support FTE Costs), recruiting, training, or reporting costs. Any activity that can be moved to the vendor's responsibility under the contract's monthly cost could be considered a deferred cost or cost avoidance. Any work that current staff does or might have possibly

taken on due to a technology refresh should be estimated and considered when comparing cost structure of a procurement methodology.

It is not uncommon for agency personnel to go through training to adopt new technologies, databases, or applications. If the vendor is willing to supply their staff to conduct that activity under a *Lease* or *Managed Services* contract, internal agency staff will not be required to train or spend time on development. While this does not reduce the actual price you pay your vendor for the contract, you might find that the *Managed Services Offsets* make the cost for such services a better value by reducing the Total Cost of Ownership (TCO) for that contract. This could make the Seat Management contract more competitive than other options in the long run.

Immediately below is an example of a Decision Matrix that could be used for a side to side comparison for Purchase, Lease, Lease/Purchase, and Seat Management. Gray fields represent calculations explained in the narrative in the sections above this example.

Decision Matrix

	PURCHASE	LEASE	PURCHASE ADD-ON TO LEASE	SEAT MANAGED/ MANAGED SERVICES
Estimated Useful Life (months)	60	60	60	60
Purchase Price:	$76,775.00			
Maintenance:	$352,343.00	$0.00		
Training	$0.00	$0.00		
Residual Value Percentage	2.00%		2.00%	
Residual Value:	$1,535.50		$1,535.50	
Cost to Sell:	$250.00	$250.00	$250.00	
Contract or Lease Term (months):		60	60	60
Contract or Lease Cost (monthly):		$4,651.60		$8,140.30
Cost to Return:		$2,000.00	$0.00	$0.00
Lease-Purchase (monthly)		$0.00	$500.00	$0.00
Discount Rate:	5.25%	5.25%	5.25%	5.25%
Actual Contract Costs Subtotal	$424,066.99	$265,411.88	$29,724.94	$464,055.11
Actual Contract Costs Total	**$424,066.99**		**$295,136.82**	**$464,055.11**
Managed Services Offsets: (1)				
Reduced Support FTE Costs (2)		$0.00		$110,000.00
Reduced Recruiting Costs (3)		$0.00		$2,000.00
Reduced Training Costs (4)		$0.00		$5,000.00
Reduced Reporting Costs (5)		$0.00		$5,000.00
Comparison Total	**$424,066.99**		**$295,136.82**	**$342,055.11**

(1) Sub-notes 2-4 are just some examples of some cost avoidance items that might be offloaded to the Managed Services Vendor. Agencies should look at their internal processes to determine what might become a managed service vendor responsibility and could be estimated as cost avoidance and subtracted from the actual cost of the Managed Services total as an offset for comparison purposes.

(2) Reduce Support Staff by 2 FTEs @ $55,000 each. Not hiring new support staff for new technologies.

(3) Dollars of agency time that might have been spend on recruiting staff for new technologies or temporary staff to stand up new technologies.

(4) Reduce Agency staff to create status , root cause analysis, or other types of reporting

(5) Potential Training Costs not incurred if internal staff not trained to support new technologies.