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July 16, 2010

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VIA HAND DELIVERY AND ELECTRONIC TRANSMISSION (McLean)
VIA FEDEX AND ELECTRONIC TRANSMISSION (Hicks)

Re: Notice to Cure Breaches of the Master Services Agreement

Dear Cynthia:

As you are aware, the State of Texas issued a Request for Offer for Data Center Services on March 31, 2006 ("RFO"). One of the underlying principles of the RFO was the migration of data center operations for twenty-seven (27) agencies into two consolidated data centers. The State described its requirements in detail and permitted the bidders to conduct a thorough due diligence. IBM responded to the RFO and proposed in part "*a lower risk, cohesive, cost-effective, and scalable enterprise foundation, and an information technology and business innovation structure that is integrated into our entire delivery model.*" In addition, IBM specifically proposed a transformation effort pursuant to which the above-described consolidation would be achieved within twenty-four (24) months. The State relied on the representations made by IBM in its proposal in entering into that certain Master Services Agreement with International Business Machines Corporation ("IBM"), effective as of November 22, 2006 (as amended, the "MSA").

The centerpiece of the State's initiative to achieve the benefits of aggregating data center and disaster recovery operations of twenty-seven (27) agencies has not been achieved. IBM knowingly accepted the obligations and responsibilities necessary to allow critical operations and infrastructure of the State to be placed in its care. IBM promised an investment in people, processes and technology to achieve the State's goal of a flexible, secure and reliable environment. In fact, IBM affirmed in the MSA terms that it "*has carefully reviewed DIR's and the DIR Customers' requirements, has performed all due diligence it deems necessary, and desires to perform and manage such services for DIR and the DIR Customers.*" The accumulated effect of under-investment by IBM, poor performance, and continual disregard for the protective obligations of the MSA, has resulted in harm to State agencies, exposure to unnecessary risks, and failure to achieve the objectives set and agreed by IBM. In short, IBM has failed to perform in accordance with the terms of the MSA. Such failures include material breaches of the MSA, numerous other breaches of duties and obligations set forth in the MSA which



collectively constitute a material breach of the MSA, and chronic failures of agreed Service Levels, each as more particularly described below.

IBM was aware of its inability to meet its contractual obligations and entered into discussions with the State. On December 31, 2009, these discussions resulted in the non-binding Agreements in Principle ("AIP"), to be used as a framework to develop solutions to improve service delivery. DIR notified IBM on June 25, 2010 that the AIP framework had failed. IBM has been unable and unwilling to bring itself into compliance with the MSA.

Notice of Material Breaches of the MSA

IBM has committed the following material breaches of the MSA:

Transformation. IBM has failed to complete Transformation Services in accordance with the terms of the MSA, including **Exhibit 20**. Specifically, IBM failed to complete Transformation of the twenty-seven (27) agencies into the consolidated data centers within the applicable timeframes. To date, only five (5) agencies are completely transformed. Data from IBM's monthly personnel turnover report demonstrates that IBM removed IBM personnel from Transformation activities without DIR direction or approval to do so starting in October 2009. At the same time, IBM cancelled standing planning meetings and significantly withdrew from other planning activities for those agencies whose Transformation projects were in progress without DIR direction or approval to do so. Since that time DIR has repeatedly pressed and requested IBM to resume and complete its Transformation obligations. IBM is currently undertaking Transformation activities with only five (5) of the remaining twenty-two (22) agencies, and plans for those five (5) reflect only partial Transformation of selected systems. There are no current schedules in place to fully transform any of the remaining twenty-two (22) agencies. In the plainest terms, IBM has abandoned its contractual obligation to perform Transformation services.

Backup and Recovery. IBM is required to perform nightly backups on all defined systems in accordance with the Policies and Procedures Manual ("PPM") (**Exhibit 2.3, Section 2.11, Item 3**) and to verify within twenty-four (24) hours that backups were performed without error (**PPM 8.3.1**). Despite the essential nature of backup and recovery services, IBM frequently fails to perform all required backups on systems under IBM management, including systems implemented in the consolidated data centers. IBM also fails to provide verification for all managed systems whether backups are in fact performed as scheduled and completed successfully. IBM is required to verify that backups are completed without error within 24 hours of the scheduled backup. However, adherence to this obligation is inconsistent. IBM has failed to respond in a timely manner to backup failures despite urgent requests from agency staff. As a result, backup failures remain undetected, unreported for SLAs and uncorrected except for efforts by DIR and state agencies to check daily logs and escalate backup failures for response. IBM also fails to transport all backup media from remote offices to a secure off-site location on a daily basis as required by the MSA. Most recently, IBM refused to perform this obligation despite explicit directions to do so from DIR and the affected agency during the approach of Hurricane Alex. Accordingly, IBM is in material breach of its contractual obligations with respect to backup and recovery of State data and systems.

Disaster Recovery. IBM has failed to deliver a final interim disaster recovery plan for agency applications that did not have an existing disaster recovery plan as of the Commencement Date that meets the requirements of **Exhibit 16, Section 3.0, Item 4**. The final plan was due within nine (9) months from the Commencement Date (by December 31, 2007). DIR rejected the

deliverable as failing to meet the acceptance criteria on September 26, 2008, January 23, 2009, and January 27, 2010. A corrected disaster recovery plan deliverable has not been submitted in the nearly six (6) months since the last rejection. Significant deficiencies noted in the latest rejection included, among other things: runbooks and technical recovery guide sections are populated with boilerplate language not specific to the agency, the server or the application; applications installed and business functions supported on a server are missing from runbooks and recovery guides; recovery and dependency information related to applications is typically not documented; and recovery details associated with backup and recovery are not sufficiently documented to enable step-by-step recovery. In addition, for those agencies that had disaster recovery plans in place as of the Commencement Date, **Exhibit 16, Section 2.0, Item 5 and Attachment 3-C, Section 19** required IBM to perform disaster recovery testing for all D0 and D1 applications within twelve (12) months after the Commencement Date and annually thereafter. More than three years following the Commencement Date, IBM has still not completed disaster recovery testing of all D0 and D1 applications. Nor does IBM have a process in place to schedule, track and document tests for all D0 and D1 applications. With regard to enterprise disaster recovery services, the MSA specified that IBM would leverage the two consolidated data centers to provide failover capabilities for each other (**Exhibit 20 – Part A, Section 1.5.6**). IBM has failed to implement the enterprise disaster recovery design, notwithstanding that five (5) agencies are currently fully transformed to the consolidated data centers. Instead, IBM continues to operate under the interim disaster recovery model, relying on third-party disaster recovery services providers even for the five (5) agencies transformed to the consolidated data centers. Accordingly, IBM is in material breach of its contractual obligations with respect to disaster recovery services.

Staffing. IBM has failed to provide sufficient and suitably qualified personnel to perform the services, causing severe procurement, project and service request backlogs that have materially and adversely affected the ability of the agencies to serve their constituents and fulfill their missions. IBM has continued to remove staff from this account despite the growth of the backlogs. **Section 8.8(a)** of the MSA requires that IBM assign sufficient IBM personnel to perform the Services. Notwithstanding this express requirement, starting in October of 2009, IBM steadily removed IBM personnel from the account. The service request backlog is today double the volume reported by IBM for July 2009. Although IBM has recently added staff, this has not compensated for the numbers of staff lost through reassignment, layoffs and attrition. The steady degradation of services, as reflected in the material increase in backlogs, declining performance in SLAs for incident response times and lack of Transformation activity, occurred simultaneously with the IBM staff reductions. IBM has also failed to provide IBM personnel with suitable competence, ability and qualifications to perform the Services, as required by **Section 8.8**. At times IBM has left entire service categories for specific platforms or competencies unstaffed. Compounding the shortage of qualified personnel, IBM has failed to meet its obligation in **Section 8.8(d)** to make reasonable efforts to reduce the rate of turnover of assigned personnel below the contractual threshold of 15%. As reported by IBM, the annualized 12-month turnover rate has consistently been between 20% to 45% since the contract Commencement Date. IBM is in material breach of its contractual obligations to provide adequate numbers of suitably qualified personnel to perform the Services.

Security. **Exhibit 17, Safety and Security Procedures, and Exhibit 2.1, Section 10, Logical Security Administration**, describe IBM's specific responsibilities for the performance of data security services under the MSA. IBM has breached these contractual obligations by repeatedly failing to adequately track and monitor its activities associated with off-boarding IBM personnel from this account. IBM has also failed to fully implement required Antivirus Software and to

timely and consistently apply software patches for all managed systems in accordance with the obligations of **Attachment 17-A, Section 7.2; Exhibit 2.2, Section 8.3, Items 1 and 2; and Exhibit 2.3, Section 3.4, Item 2.** In addition, IBM has failed to implement adequate network intrusion controls for the architecture and volume of data transmission for those networks for which IBM has responsibility under the MSA. With respect to the obligations at **Attachment 17-A, Section 8.0** to daily parse and review system logs for anomalous activity, IBM cannot guarantee that it consistently performs this obligation. Each of the above-described failures is a material breach of IBM's obligations under the MSA.

Service Level Failures. IBM has chronically failed to perform the Services in accordance with applicable Service Levels. For the most recent report provided by IBM, May 2010, IBM has failed to attain seven (7) of thirty (30) reported Critical Service Levels, and eight (8) of twenty (20) reported Key Measurement Service Levels. Since December 2008, IBM has not met the Expected Service Level for Critical Service Levels 1.1.4, 1.1.6, or 1.1.8. IBM has not met the Expected Service Level for Successful Backups (Critical Service Level 1.3.1) since June of 2007. IBM has not met the Expected Service Level for Key Measurements 2.2.1 (Resolution Time Severity 3 Incidents) since February 2009, 2.7.2 (Fulfillment of Instance/Server/Mainframe Service Requests) since November 2008, or 2.7.5 (Resolution of Invoice Disputes) since February 2009. Furthermore, IBM has failed to complete the required corrective actions described in **Section 7.3** of the MSA after failing to attain Service Levels. Likewise, IBM has failed to provide adequate performance improvement plans upon failing to achieve Key Measurements in accordance with **Exhibit 3.** On June 23, 2010, IBM submitted duplicate improvement plans for Key Measurements missed in February and March of 2010. These plans were essentially the same as previous monthly plans since November 2009, despite DIR rejection of previous plans and direction to IBM to revise the plans to attain improved SLA performance. IBM has failed to revise the required improvement plans, and SLA Key Measurement attainment has continued to deteriorate. With respect to measurement and reporting of SLA metrics as specified in **Exhibit 3,** IBM has failed to measure and report the following Service Levels: (i) Security Vulnerability Remediation (Key Measurement 2.6.1), (ii) Security Patching Status (Key Measurement 2.6.2), (iii) Projects Delivered to Approved Budget (Key Measurement 2.7.1), (iv) Fulfillment of Service Requests Within Committed Timeframes (Key Measurement 2.7.3), (v) Project Management Delivery Customer Satisfaction Survey (Key Measurement 2.7.4). IBM's chronic failure to attain service levels, disregard for required corrective actions and failure to implement the tools and processes necessary to measure all Service Levels places IBM in material breach of its obligation to provide the Services in accordance with the Service Levels.

Each of the foregoing is a material breach of the MSA. This letter serves as notice from DIR of each such material breach. Accordingly, under **Section 20.1(a)(ii)** of the MSA, IBM must cure each such material breach within thirty (30) days.

Notice of Other Breaches of the MSA

In addition to the material breaches set forth above, IBM has committed numerous other breaches of IBM's duties or obligations set forth in the MSA as more particularly described below, any combination of which constitutes a material breach of the MSA.

Asset Management. IBM has failed to fully implement all of the data elements required to be recorded and tracked in the Configuration Management Database (the "CMDB") in breach of **Exhibit 2.2, Section 9.1.** In addition, IBM has chronically failed to meet Key Measurement

2.6.8, Asset Inventory Accuracy, failing to meet the Expected Service Level for every reported month since March 2009 except one (i.e., 14 of 15 months).

Chargeback IBM Tivoli Usage and Accounting Manager Data Collectors (ITUAM) System. IBM has failed to implement the Chargeback ITUAM system in accordance with the completion criteria specified in the applicable milestone (TF-E126). Specifically, IBM has failed to complete implementation of automatic feeds for storage and tape billing data.

Systems Monitoring and Management. IBM fails to monitor all Systems in accordance with its contractual obligations, resulting in avoidable and repeated unplanned outages. IBM fails to monitor system components such as storage and CPU utilization that are critical to application availability, as required by **Exhibit 2.3, Section 3.1, Items 16 and 17.** IBM has failed to fully implement tools and processes for automated and remote systems management and restoration of servers in accordance with **Exhibit 2.3, Section 3.4, Items 3 and 4.** IBM has failed to fully implement monitoring and notification processes in accordance with **Exhibit 2.3, Section 2.1, Items 16 and 17.** Additionally, IBM fails to consistently monitor database performance and availability which has also resulted in avoidable and repeated unplanned outages. IBM has failed to install automated monitoring tools to monitor database performance as required by **Exhibit 2.3, Section 2.4.1, Item 3** and has not consistently monitored the availability, resource utilization and performance of databases in accordance in **Exhibit 2.3, Section 2.4.2, Item 9.** Furthermore, for those systems where monitoring is in place, IBM fails to act on alerts and notify DIR Customers as required by **Exhibit 2.1, Section 2.2, Item 2; Exhibit 2.3, Section 2.1, Item 17 and Section 2.3.1, Item 1;** and PPM 4.4 .

Efficient Use of Resources. The MSA provides explicit performance obligations designed to improve the cost-efficiency of the systems and services provided and managed by IBM – none of which IBM has performed:

- Obligation at **Exhibit 2.2, Section 9.3, Item 2,** on a semi-annual basis, to formally identify and review with DIR the efficiency opportunities that IBM has observed during the course of providing the services, and/or reviewing changes that have already been made with the approval of DIR.
- Obligation at **Exhibit 2.2, Section 2.0, Item 9,** to proactively identify strategies and approaches for future IT delivery that IBM believes (i) will provide DIR and DIR Customers with competitive advantages, (ii) will improve customer or constituent satisfaction with the services provided by the State of Texas, or (iii) will result in increased efficiency, performance, or cost savings.
- Obligation at **Exhibit 2.3, Section 3.1, Item 17,** with respect to both application and utility servers, to proactively monitor and report to DIR on resource shortages and report utilization statistics and trends to DIR on a monthly basis for all servers.

Procurement. IBM has failed to procure the necessary DIR Customer requested Equipment in a timely manner as outlined by PPM 5.5, **Section 5.5.3** and required by Key Measurement 2.7.2, which has materially and adversely undermined the ability of the DIR Customers to serve their constituents and fulfill their missions. IBM has chronically failed to meet Key Measurement 2.7.2, Fulfillment of Instance/Server/Mainframe Service Requests for every month reported since November 2008. IBM's self-reported performance level for this metric has dropped as low as 9.5%, compared to a minimum target of 90%.

Capacity Planning. IBM has failed to perform its obligations to manage, forecast and report capacity in accordance with the MSA. **Exhibit 2.3, Section 2.3.3** comprehensively describes proactive forecasting, monitoring, planning and consulting obligations with respect to System capacity that IBM does not currently perform consistently or completely. **Exhibit 2.3, Section 3.1, Item 17**, with respect to Application and Utility Servers, requires IBM to proactively monitor and report to DIR on resource shortages, and report utilization statistics and trends to DIR on a monthly basis. **Exhibit 2.3, Section 3.1, Item 25**, requires very specific Server status and trending reports, including CPU (avg. peak utilization for the period); memory (avg. peak utilization for the period); disk (avg. peak utilization for the period); and Servers that exceed defined thresholds. IBM has provided a limited set of reports in accordance with this requirement, but the reports do not include all Servers, and IBM does not take appropriate action based on the information in the reports as detailed in **Section 2.3.3 of Exhibit 2.3** (e.g., advising DIR and DIR Customers of the need for additional capacity and proposing capacity planning models and methodology).

Project Analysis and Reporting. IBM fails to collect and report to DIR on a monthly basis all of the minimum data required by **Exhibit 4, Section 13**, with respect to performance of projects (both ongoing projects and discrete Projects). Consequently, and in further breach of the obligations of **Section 13**, IBM also fails to organize and analyze the data to establish the volume, nature and timing of project activity and the trend lines, time of year profiles and the degree of variability of project activity. IBM's lack of performance of required data collection with respect to projects is further reflected in IBM's failure to measure and report applicable project SLAs (Key Measurements 2.7.1 and 2.7.4).

Technology Refresh. IBM fails to perform all obligations for technology refresh in accordance with **Section 4.0 of Exhibit 2.2** and has not developed or provided plans to migrate systems for which IBM has financial and operational responsibility to newer platforms to maintain third party vendor support as required by **Section 4.1, Item 1 and Section 4.2, Item 1.2 of Exhibit 2.2**.

Subcontractors. IBM has engaged subcontractors (most recently, Mail-Gard) without first providing the documentation to DIR as required by **Section 9.11** of the MSA and seeking DIR's prior approval.

Reports and Forecasts. IBM fails to provide the quarterly reports specified at **Exhibit 4, Section 17** in accordance with the report descriptions and requirements set forth in PPM 5.4. The analysis described in PPM 5.4 is critical to DIR and DIR Customers' ability to identify trends in consumption and manage costs and resources. IBM fails to provide the quarterly report specified at **Exhibit 2.2, Section 8.1, Item 7**, giving notice to DIR and all DIR Customers of all Upgrades and other changes relating to Software that are planned to occur in the following quarter. IBM fails to provide the Application Server Asset Plan required by **Exhibit 4, Section 5.2(e)**. IBM fails to provide the forward-looking by twenty-four (24) months capacity forecasts required by **Exhibit 2.3, Section 2.3.3, Item 7**.

Each of the foregoing is a breach of an IBM duty or obligation set forth in the MSA. This letter serves as notice from DIR of each such breach. In addition, this letter serves as notice to IBM that DIR views any combination of the foregoing breaches, in the aggregate, as a material breach of the MSA. Accordingly, under **Section 20.1(a) (iv)** of the MSA, IBM must (i) develop within ten (10) days a complete plan reasonably acceptable to DIR for curing the breaches and correcting the deficiencies causing such breaches on a permanent basis, and (ii) cure each such breach within thirty (30) days. With respect to each breach described above, DIR reserves the

right to re-assess to determine whether such breach constitutes a material breach of the MSA. Accordingly, any reference to a breach in this section shall in no way constitute or be construed as an acknowledgement that such breach is not currently or may not hereafter become a material breach of the MSA.

Notice of Critical Service Level Failures

Section 20.1(a)(vi) of the MSA provides that DIR may terminate the MSA for cause upon notice if IBM fails to perform in accordance with the Minimum Service Level for the same Critical Service Level for three (3) consecutive Measurement Windows or for four (4) of any six (6) consecutive Measurement Windows. The applicable Measurement Window is one month. IBM has failed to meet the Minimum Service Level for Critical Service Level 1.2.1.1 (Severity 1 Incident Resolution-Servers High Complexity) for four (4) of the past six (6) months for which final SLA metrics have been reported by IBM – January, February, March and May of 2010. Additionally, IBM has failed to meet the Minimum Service Level for Critical Service Level 1.1.8 (Servers - 7x24 Single Application Infrastructure Outage not to Exceed) for each month since June of 2009. IBM has also failed to meet the Minimum Service Level for Critical Service Level 1.1.4 (Servers - High Single Application Infrastructure Outage not to Exceed) for four (4) of the previous six (6) reported months. Each of these sustained SLA failures gives DIR the right to terminate the MSA for cause, in whole or in part. DIR is not currently opting to terminate the MSA for these failures; however DIR reserves the right to do so, in whole or in part, upon further written notification to IBM.

Please be advised that this letter does not constitute a waiver of any of the rights or remedies that DIR may have pursuant to the MSA, and that no failure or delay in exercising any right or remedy on the part of DIR shall operate as a waiver of any right that DIR may have pursuant to the terms of the MSA or otherwise. Further, any reference to breaches material or otherwise specified above shall in no way constitute or otherwise be construed to be a waiver of any other breach or default which may now exist or hereafter arise under the MSA.

Finally, IBM previously acknowledged in the MSA that any interruption to the Services may cause irreparable harm to DIR and/or DIR Customers and may adversely impact the ability of the State of Texas to carry out vital public safety and other governmental functions. To that end, IBM expressly agreed that, pending resolution of any dispute or controversy, IBM would not deny, withdraw or restrict IBM's provisions of the Services. Specifically, DIR expects all current operational activities, meetings, planning, and all other day-to-day efforts as currently scheduled to continue as scheduled while IBM dedicates resources to correct the deficiencies identified in this letter.

Sincerely,



Karen Robinson
Executive Director, Texas Department of Information Resources

cc: Mark Hicks

