# Data Center Pay To Stay?

## The Changing Market Dynamics of Colocation Contract Renewals

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**"The internet doesn't change everything." That's according to Andy Grove, former Intel chief executive. "It doesn't change supply and demand," he went on to say. He's correct, and current supply constraints plus spikes in demand for data center space have affected the colocation contract renewal process.**

*Data center leasing volume has exploded in 2022-2023, decreasing availabilities and increasing rental rates in almost every major market.*

In fact, many corporate IT departments are facing a startling challenge: Renewal rates have increased and other contract provisions are much less friendly than in previous renewal cycles.

These market realities reflect a significant shift in general colocation supply and demand conditions. The vacancy rate is below 2% in Northern Virginia and San Jose, California, and almost as low in most other major data center markets worldwide. Customers leased a record 650 megawatts of US data center capacity in 2022, and this year's pace points to another record year. With supply dwindling, colo providers are reaping the benefits of having leverage over their users, a shift emerging as impacts of the COVID pandemic fade.

**However, astute enterprises can still improve their colo contract terms by properly planning the renewal process and utilizing specific strategies to improve renewal outcomes.**

The primary goal for any colocation contract renewal is continuity of hardware placement for reliable operations, but most enterprises have several additional objectives.

Colocation users that can shrink their power and space footprints can negotiate these reductions with the colocation provider in an effort to contain cost increases, while users needing to expand face additional obstacles. With increasing processor efficiency and migration to public cloud, colo power requirements for

most existing applications are shrinking while new applications generally require more power, often balancing out the overall load variations. Many IT departments that originally migrated applications to public cloud are shifting some of these applications back to colo as users discover unexpected cloud costs or underperformance of the applications, adding to colo quantity needs.

Flexibility in the age of cloud adoption and AI evaluations is key since most enterprises have challenges quantifying their long-term capacity requirements. This challenge is the main driver of IT groups trying to negotiate flexibility in contracts to avoid long-term commitments to data centers that over- or under-serve their needs.

Making modifications to a colocation contract's managed services provisions can help customers use their corporate IT staff more efficiently. In most cases, a colo provider's managed services can be provisioned in increments as small as 15 minutes to efficiently execute basic IT operational functions without incurring significant costs.

Cost containment is a pervasive obstacle in current market conditions, where costs are continuing to increase in virtually all colocation markets worldwide.

## A Brief History of Colo

It's advantageous to anyone negotiating colocation contract renewals to understand historical milestones of the colocation industry to appreciate how the current market conditions evolved and identify strategies enterprises can use to improve their renewal terms.

*While new data center construction is at an all-time high, supply chain disruptions have pushed some completions several years into the future.*

Founding (1998-2006) - The colo industry emerged in the late-1990s among the explosive growth of start-ups in the dot-com era as corporate users realized they needed data center and telecom placement nationally or worldwide but in quantities than would prove economically unviable if delivered with owned/self-operated facilities. Startup providers built data centers that offered small cages and individual cabinets to users. Some startups survived and merged, but many others closed following the internet boom years.

Growth (2007-2017) - Subsequent years saw continuous growth in colocation facility sizes and improved provider sophistication. This "first industrialization" phase gradually reduced construction unit costs, and providers improved the reliability and operating efficiencies of the facilities. Users consistently reduced occupancy costs during contract renewals as the providers' average costs per constructed megawatt fell, leading to a "buyer's market".

Demand Explosion (2018-2023) - Beginning in 2018, providers enjoyed a dramatic increase in colo demand while simultaneously facing supply-chain challenges in constructing additional capacity. This one-two punch created a decrease in immediately available capacity and a corresponding spike in colo pricing.

Compounding the cost impacts from the seismic shift of the supply/demand inversion in colocation facilities, worldwide inflation has increased to levels not seen for 40 years. Finally, adding insult to injury for colo

budgets, pass-through charges for electricity have spiked due to both political green energy decisions and the Russian invasion of Ukraine, causing rates to almost triple in some European markets in 2022 alone - ouch!

## Market "Reality Bites"

Unprecedented demand for data center space coupled with fewer options has created headwinds for favorable renewal outcomes.

As available colocation options have been leased by users and the markets' occupancies have tightened, providers are seeking significantly higher colo rates, mainly because they can. To be fair to colo providers, their construction costs for new facilities and operating costs have increased significantly since 2020, so part of price increases can be attributed to higher cost inputs.

In a few isolated markets, colo providers are willing to have customers vacate space which can be resold at higher rates to cloud service providers and AI users. Generally, however, providers prefer keeping installed customers in place with contract terms that reflect the recent market dynamics.

*Power deliveries from utilities have been slowed by transmission and distribution bottlenecks, further decreasing availability of new data center capacity.*

With lower vacancies, the number of options with superior power, connectivity, and other attributes to consider for relocations have been substantially reduced. This also decreases the leverage that can be used as a negotiation tactic in the effort to get a better economic deal. While data center occupants rarely seek to relocate solely to reduce costs, since relocations are expensive and risky, some providers are suggesting that they prefer that the user vacate its facility as a negotiating tactic (and often an effective one).

## Intelligent Renewal Process

To improve colo contract renewal outcomes, astute users should carefully create and execute a renewal plan, usually including several sequential phases.

**Scoping** - Quantify requirements for space and power, reliability metrics, connectivity, managed services, audit/compliance, and contract duration. Power requirements should be projected for each year of the future contract period, including any growth or reductions as forecasted by the application users.

**Identify Alternatives** - The key to legitimately asserting that an enterprise user can relocate its installation from a legacy provider includes identifying alternative options, although relocations rarely make financial sense. However, in a few cases, potential operational improvements – such as better cloud on-ramp circuit access, lower PUEs, or cheaper electricity sourcing – could offset move costs.

**Request for Proposal** - Especially if the contract size and duration are large, users should request a formal proposal or a less formal, but detailed email with all relevant renewal terms from the provider, as it's generally wise in negotiations to get a proposal from the counter-party before making a proposal. This also sends the message to the provider that the customer is shopping around to get the best overall deal. Whether issuing a formal RFP or Emailing a questionnaire, use the RFP process to get additional information about the provider's expectations. Ask about possibilities to maximize flexibility in delivery of data center capacities and spend-shift among services during the renewal term.

**Negotiate Terms** - The provider's proposal should be the starting point for pricing negotiations, coupled with strategic use of market data on other providers' prices and incentives. Non-financial terms should also be negotiated – especially around flexibility of contract sizes, term durations, and additional services.

**Edit the Contract** - While colo providers often assert their boilerplate contract form includes "market standard" terms, much of the contract verbiage is negotiable. However, there are usually several "deal killers" from the other side, such as liability limitations and consequential damage caps. Advisors and lawyers specializing in data center contracts can assist greatly in suggesting document revisions.

"In many larger data center markets, we have transitioned to a more provider-favorable market for those providers that have available space with available power" said Jeffrey Moerdler, Member at law firm Mintz, Levin, Cohn, Ferris, Glovsky and Popeo and expert on data center contracts. "The ability to consider alternative markets, particularly secondary and tertiary markets, and even looking at more than one market for a particular need, will give a customer much more flexibility to create competition among providers and thereby achieve better pricing and terms. It also helps to be able to move quickly and have very responsive business and legal teams without lengthy approval process delays."

## Renewal Strategies and Tips

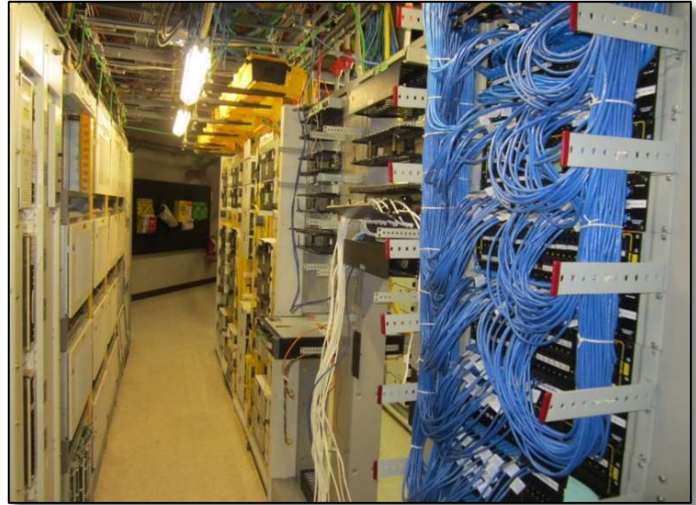
As part of a wise renewal strategy, enterprises can maximize value by considering the following tips:

- Start planning early, especially in seeking scoping information (quantities and services) from internal sources. The data center relocation process takes a long time, and users wishing to credibly assert the possibility of non-renewal and relocating should start the planning process at least two years before the current term expires.
- Right-size the contracted quantity of space and power, which is typically the single most effective way to reduce colocation costs for customers whose needs have shrunk over time.

*Accurately projecting future data center needs allows some enterprises to shrink their space and power quantity during colo contract renewals, reducing overall costs.*

- Scour the existing colo contract for renewal option language - sometimes buried in the "fine print" - which can significantly improve renewal negotiations. In some cases renewal language is ambiguous, and savvy customers can argue successfully in their favor on issues not clearly delineated in the existing document.
- Negotiate non-financial contract terms favorably, even when a desirable rental rate is prescribed in a renewal option to be exercised.
- Cite the lower rent increases offered by similar older data centers in the metro area where the colo data center is located in order to negotiate lower periodic increases in the occupancy rate.
- Seek many different types of quantity and duration options for the renewal term, including expansion, contraction, and early termination options with minimal fees, plus spend-shifting among services. In an increasing-rate environment, renewing customers may be allowed to shrink over time if the colo provider anticipates that they can re-lease the vacated space at a higher rate in the future.

- Get multiple short-term extension rights beyond the renewal term under discussion, facilitating adjustments between hybrid delivery paths including colocation, cloud, and on-premises placement. Forecasting needs accurately many years into the future can be difficult, so seek a series of shorter-term renewal options to maximize occupancy flexibility.
- Explore cloud-friendly connectivity options, especially if planning migration of applications to public cloud during the next few years. Many colo facilities now offer direct connect circuits, campus sharing with cloud companies, and private cloud that shifts easily to public cloud later.
- Use managed services like rack-and-stack, cable swaps, and systems monitoring by the colo provider wisely, which may allow reductions in other IT operating costs or fewer IT operations staff.
- Seek reductions in cross-connect or equipment rental fees for any equipment where the provider's initial infrastructure investment was recovered long ago.
- Ask about efficiency initiatives at older data centers undertaken by providers to improve their overall "green" messaging across their portfolios, which may enable a reduction in operating cost reimbursements.
- During negotiations, use the fact that a renewal of your enterprise's contract will sustain a continuity of monthly income to the provider. When a user vacates a colo suite, the provider generally expects to have several quarters during which the space and power will be on the market and not generating revenue.
- Adjust definitions of Service Level Agreement trigger-events to match the provider's marketing materials, and update SLA credits to more accurately reflect costs of outages.
- Structure any required utility rate pass-through adjustments to be effective in both directions. We've received several reductions for European clients facing huge utility rate spikes in 2022 as the market settles back closer to a traditional rate level in 2023.
- Engage an experienced advisor to maximize negotiations results. Consultants bring expertise and experience in negotiating colo contracts plus market knowledge essential for a successful outcome. Advisors also provide information helpful in internal presentations for the project and help set reasonable expectations for IT and corporate management.



*Users should seek reductions in miscellaneous charges like cross-connect fees for services no longer needed.*

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