Memo

To: Mike Hallman, Jeremy Butler, Joachim Kempin, Richard Fade, Rich Macintosh, Mike Negrin, Mike Maples

From: Lewis Levin

Date: October 22, 1990

Re: OEM Pricing Recommendation for Applications

This memo recommends OEM pricing for high end applications and discusses issues for OEM pricing from an Applications perspective. Special pricing for bundling applications is recommended to help establish our Windows applications.

Two major goals for OEM Applications pricing are:
- avoid price conflict across channels that occurs when the same product reaches the same customer at different prices;
- maintain positive price/value perception to prevent the general perception that the going price for our product has declined because it is heavily discounted or available bundled

We can achieve these goals by making it harder for the end user customer to calculate the effective price of the software offered by the OEM. The customer can readily calculate the effective price of the software and compare it to "retail" prices:
- if a specific model of cpu is offered at one price with software and a different price without software;
- if the software is sold separately from the hardware, even if it is sold only to purchasers of a given OEM's hardware;
- if it is possible to determine an approximate price for a bundled package by comparing nearly identical hardware configurations from different manufacturers.

The pricing recommendations below try to be channel neutral. An OEM should not be able to offer our software at a price which is much better than customers can get purchasing hardware and software separately. A major exception is made for "hard" bundles in which a given model of CPU can only be purchased bundled with software. In addition, we are prepared to be very aggressive with bundles of Windows applications to help expand the market.

Applications OEM Pricing v. Systems OEM Pricing

In general, discounts will not be as great on applications as systems software. Systems software involves several special considerations:
- near universal penetration is crucial to establish a standard development platform for packaged software;
- everyone has got to have an OS, so achieving nearly 100% penetration is actually possible;
- most users don't evaluate different operating systems so they will use the OS that comes with the machine.

These conditions mean that nearly every hardware mfg. will bundle an operating system or distribute at essentially 1:1 ratio and that we can be very aggressive on royalty business.

The fundamental differences for applications are:
- Users are confronted with many competing products in major application categories and attempt to choose the product which is best (in some sense) for them, often performing a lengthy evaluation to do so.

- In major software categories end users decouple the hardware and software decisions. Nothing we do is likely to change that.
- Few hardware manufacturers offering PC compatibles have sought to use applications software to differentiate their otherwise identical machines (real differences do exist in terms of price/performance, available configurations, reliability, warranties, service, distribution, etc. but none of these have anything to do with running software).
- Even when a machine comes bundled with an application, customers do not automatically adopt the bundled product if they prefer a different product.
- If the customer does prefer the bundled product then the OEM bundle is essentially a price deal from the end user's standpoint.

Motivation for OEM Pricing

Different prices are needed for different kinds of deals. In general, the most aggressive prices are available for deals with one or more of these advantages:

- massive penetration
  This is the traditional reason for an OEM arrangement with large discounts for "per system" (bundled) pricing. If you can reach a large percentage of end users (either in the universe or in a special class) then aggressive pricing can be worth it to achieve dominance, widespread recognition, block sales of a competing product, or establish a new product. Selling Laplink very cheaply on laptops is a great strategy for Traveling Software. When the same customer looks for file transfer software for his desktop machine he is going to choose Laplink.
- long term positioning win
  It is possible to shift the longterm perceptions of a product with OEM deals. For example, after enough OEM deals on laptops we might successfully position Works as the ideal product for laptops because it is advertised and sold that way so often. Long after a deal has lapsed or even on a machines that never bundled Works, customers and dealers may view Works as the default choice on any laptop.
- access to distinct channel or customer
  We have bid our government business through OEMs at very low prices because we would never have obtained the business any other way. The federal government represents both a special channel and a special customer. Education is another example of a distinct channel and customer.
- true value added
  When the OEM adds proprietary software, modifies our software, or offers special services like systems integration or installation then it bears additional costs which partially offset the lower per unit or per system price we offer the OEM. In addition, when the service, hardware, and software are bundled, the customers sees the price of the package, not the price of the software. Simply bundling widely available hardware and widely available software does not constitute adding value.
- special products ideal for OEM
  Some of our products are strategic in nature or complement our operating environments or are low priced which makes them ideal for OEM sales, especially where they can be sold in high ratio to another product. Learning Windows is an example of a product that complements Windows and could be sold to OEMs bundling Windows.
- incremental revenue
  It is often tempting to say that there should be little concern about the OEM price if all of the revenue is incremental. It is easy to make the incremental revenue argument if we sell on 100% of an OEM's systems because we would never reach 100% penetration otherwise. This seems like a good argument for offering a very low per system price and it's the primary reason we have recommended aggressive pricing for "hard bundles." There is a big risk of channel conflict or of affecting the price/value perception of the product. This is why we have been careful to define "hard bundle" below and why we recommend the most aggresive pricing for a limited time for Windows apps.

To the extent an OEM deal offers one of the major advantages described, we should offer special pricing. However, when an OEM arrangement offers us little more than an alternative form of distribution to customers we can already reach, then we should treat the OEM no better than a distributor.

Bundles
The price recommendation includes different discounts for "hard" and "soft" bundles.

"Hard bundle" means that all of the systems of a given model are sold with software and that the cost of the software to the customer is not stated. A model is defined as the CPU chassis and processor. Many of the mail order PC sellers vary the hard disk capacity, monitor, and other options. Hard bundle means that all of these various configurations would come with software. The key test is when the customer asks, "What is the price without any software?" the OEM replies, "You can't get it without the software." A hard bundle reduces most of the pricing and channel conflict issues in OEM pricing. Whether we sell licenses or finished goods is simply a pricing issue.

Some concerns remain even with hard bundles. If our products are widely available bundled with many different manufacturers' hardware, especially the manufacturers that sell on price, then we have more difficulty selling our products at full price through conventional channels. This is particularly severe if the bundled hardware is offered to the same customers we try to reach via the channel or via our corporate account sales force. Finally, Microsoft is the product support of last resort, no matter what the OEM's support policy.

"Soft bundle" means that the software must be purchased with hardware, but a specific model of CPU is offered with or without software. A soft bundle clearly enables the end user to calculate the purchase price of the software. The OEM discount in this case can't be more favorable than the discounts available to hardware resellers and other resellers.

Unbundled sales of finished goods are essentially distribution arrangements and should be treated as such.

Volume Pricing & Minimum Commitments
Our reseller pricing does not offer significant volume discounts. The same should apply to OEM purchases. We should require minimum commitments from OEMs that are in line with business volumes for our retail customers. For small volumes many OEMs will actually do better purchasing from distributors. The recommended minimum annual commitment is $1 million which can be a total for more than one Applications product.

Discount Recommendation
The attached spreadsheet shows the proposed discounts. These discounts are meant as a standard schedule which can be used without additional approval from Applications. Exceptions may be proposed to the VP of Applications.

A "channel neutral" discount policy for OEMs means that an OEM cannot offer our products to end users at better prices than any other type of reseller except for bundles. Because many OEMs to sell directly to end users (via direct sales force or mail order), the discount is set to reduce the likelihood an OEM will find it profitable to sell unbundled product at lower prices than a direct or indirect dealer. For unbundled product the OEM discount is less than the distributor discount.

Electronic Distribution by OEMs
Some OEMs selling server hardware/software may want to distribute workstation applications software which end user customers can access from the server. There is no default discount policy for this case; each deal must be considered individually. It is difficult to establish whether the workstation applications are hard bundled with the workstations, especially when the OEM may be selling the server, but not the

workstations. Offering a "hard bundle" price would permit customers accessing software electronically to obtain a far better price from the OEM than even from Microsoft. Short of a unique contract, all we can offer an OEM is sales of MLPs for a given product at the base OEM discount (optionally with Windows promotional discount).