Microsoft Proposal for Active Desktop (June 27)

- AOL will receive one of six pre-configured First Tier Channels (others include MSN, MSNBC, PointCast)
  - AOL content limited to 10% advertising
  - Users, OEMs and others (including AOL) have ability to reconfigure but MS will use reasonable efforts to require OEMs not to reconfigure
  - MS will determine AOL's placement among six First Tier Channels
- AOL will receive 3 channels on Channel Guide -- entitled to stronger promotion than other content providers on Active Desktop
- AOL will promote IE as exclusive browser
- MS has proposed one year term and limited territory to U.S. -- AOL requires longer term (3 or 4 years) and international distribution but no less than MSN
- Issues not addressed by MSN Proposal
  - AOL request for preference on Internet Referral Server
  - AOL ability to place links within Active Desktop that would automatically launch AOL client

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EXECUTIVE SUMMARY OF MICROSOFT ACTIVE DESKTOP STRATEGY

I. Goals for Participation in Active Desktop

- Subscriber Acquisition
- Revenue generation
- Co-opt competitors
- Content distribution
- Brand promotion
- Combating MSN
- Distribution of IP's content
- Less time online

II. Recommended Strategy

- Participate in Active Desktop (and other major push products) and Distribute Engaging Promotional/Teaser Content

II. Risks

- Building a Competitive Online Service.
- Lose Partial Control of Online Experience.
- Cannibalization of the AOL Service (including Driveway) -- less subscribers, ad revenue and market share.
- Level the Playing Field with Competitors.
- Assist in Validating Distribution Channel.

III. Proposed Deal Terms

Proposed Consideration to AOL

- AOL to receive one of 5-7 default icons on first screen (Platinum Channels) and MS to conrol placement of AOL icon. OEM's can reconfigure but MS will use reasonable efforts to prevent.
- MFN as to Third Parties.
- AOL wants preference on Internet Referral Server. MS intends to treat all access providers including MSN equally. But AOL is disadvantaged because its Online Services Folder deal with MS entitles it to preferred positioning. Legal arguments (as described below) may improve negotiating leverage with MS.
- AOL version of Active Desktop with only AOL selected content for all users who select "AOL specifications."
- AOL and its IPs permitted to include link within content that automatically launches AOL client. [MS offered this in return for no preference on Internet Referral Server.]

Consideration to MS.

- MS has requested promotion of IE exclusive of any other browser.
- Inclusion of MS Technology (DirectX, DirectPlay, FrontPage, etc.) in AOL content tools like ARTPress, slideshows, etc.
- High profile pilots of certain MS Technology (Windows NT servers, Java AFC and Netshows)
- Upsell of MS Products.

Miscellaneous

- Term – AOL wants 3 or 4 years. MS proposal of 1 year is unacceptable.
- Territory – Need International distribution and at least parity with MSN.

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IV. Operational Issues

- Users with multiple means of access (e.g. AOL and an ISP)
- Allocation of real estate between AOL-N and AOL-S
- Fees for AOL IPs to be included in Active Desktop
- Balancing amount of content required to promote member acquisition without causing cannibalization of AOL

V. Legal

- Contractual -- Existing AOL/MS deal requires "substantially equivalent prominence" for AOL if MS alters its interface structure. Existing deal provides alphabetical listing with AOL at or near the top. AOL has strong argument that it is entitled to front screen icon positioned at top and preference in the Internet Referral Server rotation comparable to the preference of the OLS folder on the Windows 95 desktop.
- Antitrust Leverage – MS is especially sensitive about antitrust issues, and a government investigation of MS remains open, but terms currently under discussion do not trigger antitrust issues. Terms that may trigger issues include (a) requiring AOL to give MS an exclusivity and (b) negotiating terms which give MS an advantage with no reasonable business justification.

VI. Alternatives

- Participate only in Driveway and OEM Versions of Driveway.
- Netscape's Netcaster In Lieu of Active Desktop.
- Include "Killer Content" on Active Desktop.
- Don't Participate in Push Product Distribution Channel.

VII. Overall Relationship

Impediments to Close Relationship

- Development Process. Poor coordination between the two companies. AOL always seems to be months behind MS in the development process, e.g., IE4 is being released in beta and AOL is just finishing its integration of IE3.
- Competition. Due to MSN's competition as an access provider and its continuing foray into the content field, AOL continues to have problems getting into a closely aligned relationship with MS similar to the "Wintel" relationship.

Potential Solutions to Closer Relationship

- General -- Integration of key AOL technology into MS technology (e.g., ART into Netshows, Instant Messenger into MSN).
- Alternative 1 -- MSN gets out of access business and distributes MSN only on AOL, in exchange for AOL adopting certain MS technologies.
- Alternative 2 -- MSN gets out of access business and uses a short list Internet Referral Server (listed in alphabetical order) for Windows users and potential MSN subscribers needing an access provider. AOL would distribute MSN and parties would determine MSN fee split and subscriber acquisition bounties.

Risks of Closer Relationship

- AOL would be forced to adopt MS technology so that MSN site works on AOL – the ultimate co-opt.
- Once out of the access business, MS could take MSN to every ISP and offer MSN as the content "front-end" for the ISP, with a revenue split between the two. This creates a network of ISPs all with the same "front-end" that can ultimately be brought together to form one large online service, which is similar to the way MS defeated Apple -- ubiquity.

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- Need to understand the amount of incremental network costs due to MSN users' usage (mostly daytime or nighttime, number of incremental usage hours and type of usage - high or low bandwidth).
- Potential conflict with AOL IPs and commerce partners over exclusivities and other issues.

VIII. Status and Timing

- Negotiations are moving slowly given the potential risks and the inability to solve, at this point, the main issue - Microsoft states they cannot give AOL any preference in the Internet access registration process. Also, Disney has approached AOL to see what AOL is doing on the Active Desktop – there might be an opportunity to do something with Disney here.
- MS sent a draft contract on June 27. We are contacting MS to determine the deadline for our decision on participation in the Active Desktop, but we expect the deadline to be within the next two weeks.

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