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Sent: Friday, January 02, 2004 4:19 AM
To: DL BOARD; DL FMT; Baumgartner, Bern; Hommel, Uwe; DelMonte, Thomas
Cc: DL PR-NETWORK INTERNTL. (PR ONLY)
Subject: Negative Wall Street Journal Article -- 2 Jan. 2004

Importance: High

Dear Colleagues,

following is the Wall Street Journal article I emailed many of you about two weeks ago. The story appeared in today's WSJ and despite our efforts to influence the story and include more positive SAP customer input (Dow Corning), the article has a negative tone and calls into question the entire software industry's upgrade and maintenance practices.

For your use in possible upcoming discussions with customers, following are a few facts to refute some of the comments in the story:

- The first paragraph is somewhat misleading regarding the situation with Fluor. A bit further into the article, the fact that Fluor had internal management challenges as well as third party implementation challenges are mentioned, but the first paragraph is more sensational that accurate in an effort to grab the readers attention. Additionally, SAP followed standard procedures in notifying Fluor well in advance of the end of their current maintenance agreement and this should not have been a "shock" to the customer as the article leads one to believe.

- The article includes the statement "since software doesn't wear out" -- which is again misleading. Through continued R&D and ongoing demands from clients, SAP software is continually evolving (as is that of our competitors) to better meet the changing needs of customers. In addition, legal requirements often change requiring companies to upgrade their software to remain compliant -- these upgrades are covered in SAP's standard maintenance agreements and not viewed as means for increasing license revenues.

- The article refers to a Henning Kagermann email to employees where " He stressed the importance of "safeguarding" maintenance revenue, which represents one-third of SAP's sales and "has become increasingly important." -- what is not included in the article are additional statements from the same email: "SAP is committed to supporting the continuous business improvement of our customers, offering superior business solutions such as mySAP ERP, continuously up-to-date best practices, and support services that go far beyond a help desk or support packages. Our internal and external unified message: "**Support never ends**" and "No restrictions exist anymore for SAP R/3 maintenance extensions in 2004."

The article as it appeared today:

Large Software Customers
Refuse to Get With the Program

Some Corporate Buyers Start
To Resist Forced Upgrades,
Higher Maintenance Fees

By **KEVIN J. DELANEY** and **DAVID BANK**
Staff Reporters of THE WALL STREET JOURNAL

GOVERNMENT EXHIBIT P3150

PENGAD-Bayonne, N.J.

Fluor Corp. has joined a growing revolt against the software industry.

The engineering and construction giant had so many problems installing software from one of its biggest suppliers, SAP AG of Germany, that Fluor ditched parts of the products it had licensed, replaced its own chief information officer and took a $13 million charge. Then SAP said it would soon stop providing standard technical support for the software -- meaning Fluor, based in Aliso Viejo, Calif., would have to install a new version or pay even higher annual fees to get updates, fixes for bugs and access to SAP's technicians.

Fluor's response: In late 2002 its new CIO, Ray Barnard, suspended monthly maintenance payments to SAP, which already totaled hundreds of thousands of dollars a year. Then, last February, over a sandwich lunch in San Diego, Mr. Barnard told SAP CEO Henning Kagermann that the German company had to overhaul how it charged for software.

After a long slump in corporate technology spending, software buyers have more power than ever before -- and they're using it to force software makers to change the way they do business. Some customers are refusing to upgrade and are demanding their suppliers continue to support old software. Others are dumping their suppliers and shopping for more-accommodating vendors. Still others are training their own employees to handle tech support.

After months of negotiations with Fluor, SAP, which was receiving a chorus of complaints from other big customers about the upgrade, blinked. It cut a deal on upgrades and other issues with Fluor, which agreed to resume payments. Shortly after, SAP announced an offer for all its customers: Those who don't upgrade can receive a lower-level maintenance option for no extra charge.

An SAP spokeswoman concedes Fluor had "issues" with SAP's software, but says Fluor's problems were partly linked to its own management changes and to the external company Fluor hired to help install the SAP system. She says many customers have been happy to upgrade, and SAP doesn't abandon those who decide to wait. She also says the new lower-level maintenance offer was technically available earlier, though few SAP salespeople or customers had been told about it.

SAP, the leader in the $40 billion market for application software to manage financial data, manufacturing, customer relations and other activities, is only the latest vendor to wave a white flag. In 2002, a customer revolt forced **Microsoft** Corp. to overhaul its plans for sweeping changes in how it charges for upgrades. **PeopleSoft** Inc. this spring extended support for an old version of its software by an additional nine months; the company also extended support for software from newly acquired J.D. Edwards & Co. to as long as six years, from four.

The widespread retreat signals that software companies may no longer be able to count on boosting the revenue streams that helped them through the technology downturn. With markets saturated, software companies have tried to dig deeper into the wallets of existing customers, using a variation on the "planned obsolescence" U.S. car makers invented in Detroit's tail-fin era. Car makers designed vehicles that wore out quickly, to ensure replacement purchases.

Since software doesn't wear out, software makers set timetables for phasing out programs. Just when big clients work out the kinks in complex software systems, the software companies tell them they need to install new versions. This gives software companies a chance to impose fresh licensing fees and a big chance to sell existing customers on new features, usually unavailable for older versions.

Sometimes software companies provide upgrades free, generating additional revenue by selling users on new add-ons or increasing maintenance fees. These fees have crept up to as much as 22% or even 25% of the original license fee, from about 15% a few years ago. For example, a company that paid **Oracle** Corp. its standard licensing fee of $3,995 per user for its "e-business" suite of business-software applications would also pay an annual fee of $599 for software updates and $280 for product support, or 22% of the license fee.

Some software companies now get the majority of their profits from such recurring revenue, with original license fees serving as an introductory loss leader. For SAP, more than four out of every five euros in license revenue come from a veteran client.

Technical support also becomes a powerful stick for software makers to wield against customers. If buyers don't want to upgrade, software makers can raise the fees for supporting the old product, or yank support for it altogether The latter move also saves software companies a bundle, by shifting support personnel from old products to current ones.

"We all do it," says Oracle CEO Larry Ellison. "If we have too many old versions, that moves engineers from working on a new product to working on a seven-year-old product."

When times were good and technology was advancing rapidly, customers accepted the forced upgrades as a fact of corporate life. Now customers aren't swallowing it. "Most of us don't buy it anymore," says Fluor's Mr. Barnard, who plans to wait until at least 2005 to upgrade the company's SAP system.

Some software customers have left their suppliers and defected to rivals. In 2000, French fax-and-messaging software company Esker SA installed a customer-management system from **Siebel Systems** for use by 165 employees. Siebel dropped regular support, which includes updates and technical help, for the version Esker was using in June -- but offered to extend that support for about $94,000 a year, or 50% more than the original price. The upgrade itself would have been free, but Jean-Michel Berard, Esker chief executive, estimated that additional hardware, consultants and training would have cost another $175,000, not including Esker's own staff time.

"In the '90s or 2000, it was a practice that was accepted, because companies were rich, or thought they were," Mr. Berard says. "That's no longer the case."

Esker dropped Siebel and switched to Salesforce.com, a Siebel competitor that runs software systems on its own computers, freeing customers from upgrade worries. Clients use the Internet to connect to Salesforce.com's computers.

A Siebel spokesman says Esker is trying to make Siebel look bad because Siebel rebuffed its 2000 request to partner up in selling its fax software, a charge Mr. Berard denies.

The threat of dropped support also spurred the Los Angeles County Museum of Art to switch software suppliers. For four years, the museum had used a PeopleSoft offering to prepare its general ledger, accounts payable, accounts receivable and other reports. In 2002, PeopleSoft gave the museum a year's notice that it was ending support at the current price for version 7 of the software and encouraged an upgrade to version 8.

"It's not prudent to run software without support," says Ann Rowland, the museum's chief financial officer, who oversees information technology as part of managing the museum's $40 million operating budget. Ms. Rowland held discussions with PeopleSoft, seeking a cut in the price increase for product support, but "we didn't see any concessions," she says. In July, the museum switched from PeopleSoft's financial-accounting software to archrival Oracle's. A few months later -- too late for the museum -- PeopleSoft extended its support offer.

PeopleSoft said in a statement that its support policy is the "longest and most comprehensive" in the industry, but it limits support for older versions because most customers "prefer to see PeopleSoft invest in research and development for future releases."

Some customers are happy to upgrade. The recent versions of most business applications, for example, allow better Web access to company data than previously possible. Dow Corning Corp. plans to finish upgrading in 2005 an SAP software system it installed for $100 million in 1999 and which is used by more than 8,000 staffers. CIO Abbe Mulders says the upgrade, which should take six months and cost several million dollars, will be worth it for the Midland, Mich., maker of silicon-based products, partly by making it easier to serve customers over the Web.

But even Dow Corning, which SAP cited as an example of its good relations with users, says the German company has to soften its demands. Ms. Mulders says Dow Corning wouldn't be able to upgrade by SAP's deadline at the end of December 2003 -- and is still negotiating the extra maintenance fees that SAP wants to impose to provide full support in the interim.

Geoff Penney, chief information officer for **Charles Schwab** Corp., says he's happy to install upgrades from Siebel and others, as long as the pain of an upgrade is outweighed by the value of the innovation. "It only becomes an issue when that stops, or when they're producing stuff we don't want," he says.

That's the problem. Many companies say the systems they installed in the 1990s are still up to the task and they can't make a business case for the hassles of installing a new version or adding on the latest bells and whistles. A J.P. Morgan survey of SAP users published last year found that only 28% of the companies polled believed SAP's latest version "delivered value" over what they already are using. An additional 19% said it "partly delivered value."

Just weeks before SAP toned down its upgrade campaign, SAP executives insisted few customers had complained about the plan to boost fees. Mr. Kagermann, the chief executive, said increasing maintenance fees to 19% of the original license cost, from 17%, for those who don't upgrade was reasonable. "We cannot maintain mainstream maintenance" for older software that fewer and fewer clients use, Mr. Kagermann said at a conference in Paris in late September.

But in Sept. 26 e-mail to staff outlining SAP's softened policy, Mr. Kagermann acknowledged that customers had pushed back. He stressed the importance of "safeguarding" maintenance revenue, which represents one-third of SAP's sales and "has become increasingly important."

Customers are pushing back against other software vendors as well. A survey by Goldman Sachs in August found that more than half of respondents had renegotiated their maintenance contracts for 2003. Nearly one in five cut their bills more than 15%.

Some companies are shifting to Linux and other open-source software, in which bug fixes and upgrades can be downloaded free. Linux customers aren't immune from pressure, though: **Red Hat** Inc. will stop providing updates for its original version of Linux in April 2004, partly to spur upgrades to a new edition that includes updates and product support -- and costs more.

Other customers try supporting the software on their own. That's what Electronics for Imaging Inc. of Foster City, Calif., did in 2002 after support expired on its PeopleSoft human-resources software. The 1,000-person digital-printing company pocketed the $300,000 to $400,000 it would have spent on an upgrade and had its own tech staff field any problems with the software. It is considering switching to SAP's HR software, but says the expense involved means any such move could take some time.

Some software companies are responding to the revolt by trying to make their applications faster and cheaper. Siebel has launched an "on demand" service, similar to Salesforce.com's, in which customers tap into applications run by Siebel at centralized data centers and pay a monthly fee for just the software they use, rather than spend millions of dollars on risky installations.

Fluor's Mr. Barnard and some fellow clients are pushing SAP to let them pay monthly service fees for only the software they need. But he doesn't expect bruising battles this year over upgrade deadlines. "I hope not," says Mr. Barnard. "Based on the way SAP has begun responding this year, I think we can work through that."

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