Linux took on Microsoft, and won big in Munich Victory could be a huge step in climb by up-and-comer

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USA TODAY

On the brink of losing a pivotal account to an ascending rival, Microsoft last March dispatched CEO Steve Ballmer to the rescue.

The German city of Munich was balking at a $36.6 million proposal from Microsoft to upgrade 14,000 desktop PCs to the latest versions of Windows and Office. Instead, Munich -- Germany's third-largest city and a technology hub for Central Europe -- was leaning toward a switch to Linux, the upstart computer operating system whose open-source code is continually improved by volunteer programmers worldwide.

A Linux victory in Munich would be a stunning blow. So Ballmer visited Mayor Christian Ude to assure him Microsoft would do what it takes to keep the city's business. Documents obtained by USA TODAY show Microsoft subsequently lowered its pricing to $31.9 million and then to $23.7 million -- an overall 35% price cut. The discounts were for naught.

On May 28, the city council approved a more expensive proposal -- $35.7 million -- from German Linux distributor SuSE and IBM, a big Linux backer.

The vote wasn't just another win for Linux, as it continues to gobble chunks of the computer server software market -- a market Microsoft does not dominate. Munich is about to become the largest tech user to deploy Linux for everyday use on desktop PCs, the wellspring of Microsoft's profits.

USA TODAY obtained government and corporate documents that provide a rare insider's look at Microsoft's efforts to keep from losing a key customer. Among other things, it:

* Agreed to let Munich go as long as six years, instead of the more normal three or four, without another expensive upgrade, a concession that runs against its bread-and-butter software upgrade strategy.
* Offered to let the city buy only Microsoft Word for some PCs and strip off other applications. Such unbundling cuts against Microsoft's practice of selling PCs loaded with software.

* Offered millions of dollars worth of training and support services free.

The result in Munich shows that the world's largest software company is again under attack from a powerful outside force. But this time the encroacher isn't government antitrust lawyers or a rival tech giant.

Instead, Microsoft is defending itself against the open-source-code movement. In the past two years, dozens of government agencies and schools across Asia, Europe, Australia and the Americas, along with financial institutions and moviemakers, have helped establish open-source software on beefy computer servers that display Web pages and crunch numbers. Now they have begun embracing open-source software running on ordinary desktop computers.

"What's striking about the Munich deal is the use of Linux on the desktop," says Paul DeGroot, tech industry analyst at research firm Directions on Microsoft. "It's a threat to Microsoft's real source of strength, the desktop, where it has no competition and is used to winning all sorts of battles."

Should its desktop software sales stagnate or, worse, decline, Microsoft's profit could plummet, and it could find itself with a diminished ability to bankroll promising, but costly, new ventures, such as tablet PCs, smart phones and online video games.

Anchored by the Linux operating system, open-source software is the antithesis of Microsoft's proprietary codes. It includes a growing number of freely distributed applications, such as OpenOffice, a Microsoft Office clone, and Mozilla, a Web browser that can perform basic workplace tasks. Created and honed by volunteer programmers worldwide, open-source alternatives are generally cheaper to acquire and easier to customize, and cost nothing to upgrade.

Though Microsoft underbid IBM and SuSE by $11.9 million in Munich, city officials were concerned about the unpredictable long-run cost of Microsoft upgrades, says Munich council member Christine Strobl, who championed the switch to Linux. And the more Microsoft discounted, the more it underscored the notion that as a sole supplier, Microsoft could -- and has been -- naming its own price, she says.

"Microsoft's philosophy is to change our software every five years," Strobl says. "With open-source, it is possible for us to make our own decision as to when to change our software."

Munich must still prove that Linux is ready for prime time on the desktop. Research firm Gartner cautions it won't be until 2005 before it is known how well it works in Munich.
Whether other big tech buyers follow Munich's lead remains to be seen. Analysts say Microsoft has the will and resources to vigorously defend its turf. Windows and Office run on more than 90% of the world's desktop computers and command gross profit margins of up to 80%. The company has $46 billion in cash and will spend $5.2 billion this year, up 20% from last year, on research to improve its offerings.

"Product-wise and installed-base-wise, they're very well positioned," says Gartner analyst Mike Silver.

**Microsoft issues call to arms**

Open-source advocates counter that Munich proves tech buyers are beginning to demand price cuts from Microsoft while giving Linux a serious look.

"What the Berlin Wall was to politics, Munich is to technology," says SuSE CEO Richard Seibt. "I believe we are now witnessing that dramatic break to freedom of choice."

Ballmer declined interview requests. A week after Microsoft lost in Munich, however, he issued a call to arms. In a June 4 companywide memo, Ballmer cast open-source software as having "no center of gravity" and suggested IBM adds "an illusion of support and accountability" to Linux. But he also warns that Linux "requires our concentrated focus and attention."

In a recent interview, Microsoft Chairman Bill Gates said Linux is just the latest in a long line of competitors, adding that the company has no plans to allow its products to run on Linux.

Munich "reinforces for us that we operate in a very competitive marketplace," says Maggie Wilderotter, Microsoft senior vice president of business strategy.

What happened in Munich also shows how profoundly tech buyers' mindsets have changed. Five years ago, as Linux was just starting to appear on the tech landscape, companies routinely snapped up expensive technology with minimal due diligence. Today, they have become assiduously frugal. And Microsoft, analysts say, has forced the issue by eliminating discounts for upgrades, cutting off support for older versions of its products still in wide use, and steering customers to a controversial 2-year-old software licensing plan under which corporate and government customers pay upfront for software and upgrades.

"Microsoft's biggest enemy is themselves," says Gartner's Silver. "They do things that make people very upset and engenders a lot of resentment."

**Comparing Microsoft, Linux**

The opening salvo for the battle of Munich was fired from Microsoft's Redmond, Wash., headquarters. Last October, the
company announced it would no longer support Windows NT server software, which is used by businesses to network groups of desktop PCs.

That meant Munich needed to do something about its Windows NT-based network of desktop PCs running Office 95 and 98. Microsoft wanted to upgrade the city to its newest products: Windows XP and Office XP. But the city balked, and hired technology strategist Unilog Integrata, to review its options.

In comparing Microsoft with Linux, Unilog outlined the trade-offs: Microsoft generally requires a customer to buy one copy of its Windows operating system for each worker, along with a "full stack" of basic programs, such as a word processor, spreadsheet calculator, e-mail, calendar and Web browser. Each worker's Windows PC then serves as a gateway to other programs. Munich, for instance, uses 175 Windows applications for such tasks as managing police records, issuing permits and collecting taxes.

While Linux is easier to customize than Windows -- so each PC doesn't have to have a full software stack -- and upgrades are free, it does not work well with Windows programs. Another layer of connection software is required, adding complexity.

Unilog judged Microsoft's proposal -- to swap out all existing versions of Microsoft Windows and Office for the newest versions -- as cheaper and technically superior. But the offer from IBM-SuSE better met "strategic" criteria set forth by the Munich council, says Harry Maack, Unilog project manager.

For instance, the council wanted the city's computers to be very flexible and provide a return on investment over a long period of time. Unilog first recommended that the city select a $39.5 million Linux package from IBM-SuSE over a $36.6 million standard upgrade package from Microsoft.

"On price and technical criteria the advantage was Microsoft's, but the gap was not that big," Maack says. "On strategic issues, it was clearly open-source, and the gap was very great."

With battle lines drawn, Microsoft turned to a freshly hired recruit, Jurgen Gallman, steeped in Linux. Until last November, Gallman had been IBM's top Linux executive in Germany. IBM has pumped more than $1 billion into marketing Linux, including opening more than a dozen Linux training centers in cities such as New York, London and Beijing.

With Unilog, the consultant, recommending IBM-SuSE, Gallman stepped up lobbying for Microsoft. He arranged technical briefings with city tech staffers to elaborate on the advantages of Microsoft's bid. At a workshop, Microsoft "gave detailed answers on all the issues and concerns in the (Unilog) study in exactly the same order" as listed in the study, Maack says. "They must have had a hard copy."

Gallman denies that Microsoft obtained a copy. He says it could provide thorough answers based on its expertise. According to city
Despite Gallman's efforts, it became clear by late March that a majority of the 80-member city council would follow Unilog's recommendation and select IBM-SuSE, says Ernst Wolowicz, Mayor Ude's chief of staff. Near the close of business on March 25, Gallman arrived at city hall, escorting Ballmer to a meeting with the mayor.

**Some drinks and some persuasion**

According to Wolowicz, who attended the meeting, Ballmer told Ude he came from a skiing trip to pay his respects. Microsoft now says Ballmer was on a scheduled business trip in Germany.

Drinks were served. Ballmer advised Ude not to be too hasty in his support for Linux, and tipped the mayor off to a deal in the works with Germany's federal Ministry of Interior that would provide a 15% price discount for all public sector customers in Germany, including Munich.

The 45-minute meeting transpired with little fanfare. But a week later, someone leaked an account of Ballmer's visit to the German press, and suddenly Munich's impending decision, handled as routine city business to this point, became a cause célèbre.

German media depicted Ballmer dashing from the Swiss ski slopes to steer Ude into rethinking his decision. Some stories credited Ude for cagily maneuvering the American tycoon into making concessions.

Not long after that, the *International Herald Tribune* ran a story based on a leaked e-mail by Orlando Ayala, a top Microsoft executive for foreign sales. In the memo, Ayala declares, "Under NO circumstances lose against Linux." He authorizes $118 million in "consulting service discounts" for different regions, including $5.4 million to win business in Germany, according to excerpts published by *The Register*, an online publication that covers the tech industry.

"It was clear they were prepared to do whatever they needed to do not to lose, and that they wanted the customer to feel that way," says Jim Stallings, IBM's vice president in charge of Linux.

When recently asked about that e-mail and whether Microsoft was improperly undercutting competitors in Europe, Gates said, "We will never have a price lower than Linux, in terms of just what you charge for the software," adding that Microsoft's value is in the overall benefit of systems including hardware and services.

In Munich, meanwhile, government documents obtained by USA TODAY show Gallman prepared a 350-page offer slicing $4.7 million off the price mentioned in Unilog's report. Microsoft's bid was now $31.9 million.

Microsoft made the cuts by agreeing to provide free or sharply discounted training for city workers, and by sponsoring school programs such as allowing teachers to use Microsoft software.
programs, such as allowing teachers to use Microsoft software purchased for the workplace at home for no extra charge, the documents show.

In a noteworthy concession, it also agreed to support Windows XP for six years -- a year beyond the five-year base contract, and said the city could skip the next Office upgrade, too. That meant Munich could use Windows XP and Office XP until 2010, and would not have to upgrade in 2009. That would save the city, by Microsoft's estimate, $1.8 million.

This ran counter to a controversial licensing policy Microsoft's introduced in 2001, which makes Windows and Office more expensive for customers who do not upgrade every three to four years.

The offer from the Linux camp improved, as well. SuSE CEO Seibt -- also an IBM alum who hired Gallman at Big Blue in 1996 -- shaved the Linux bid by $3.8 million to $35.7 million.

Though IBM-SuSE's bid was still $3.8 million higher than Microsoft's, Unilog on April 28 called the offers a tossup. On May 21, council members met separately by party to discuss the upcoming vote. It became clear that two of three political parties, representing a clear majority, favored the open-source offer.

**Microsoft makes one last offer**

On May 27, the day before the council was scheduled to formally make its choice, Microsoft's Gallman faxed Ude a letter accusing the Linux camp of cheating, according to a copy of the letter obtained by USA TODAY. "That our competitors SuSE and IBM were given a one-sided opportunity to improve their April 28th offer, based on detailed knowledge of Microsoft Germany's offer, is not in accordance with our legal understanding of the ground rules of fair process," Gallman wrote.

David Burger, the SuSE vice president in charge of the Linux bid, says he never saw Microsoft's bid, nor did he offer the city any sweeteners after the Linux camp's one-time cut. "That ploy is a little poor coming from a company like Microsoft," Burger says. "I find it ironic that Microsoft could actually be trying to be seen as if it were being dealt with unfairly."

Gallman extended one final "improved offer," slicing another $8.2 million off Microsoft's standing bid, according to Ude's letter.

Among other sweeteners, this time Microsoft reduced its license fees for Windows XP by $912,600 and lowered its charges for helping the city make the upgrade by another $3.6 million, according to a separate letter Microsoft faxed to Wolowicz.

Microsoft also took the unusual step of offering to let Munich buy Microsoft Word -- normally bundled with Excel spreadsheet, PowerPoint slide presentation, Access data base and Outlook communications software to make up Microsoft Office -- a la carte.
In explaining that concession in its letter, Microsoft indicated it possessed data showing that many workers don't need a full stack of basic programs. "This applies in particular to our proposal to put only Word on 4,000 workstations because the other Office products are not used on approximately 30% of workstations, based on our experience," says the letter from Microsoft. The projected savings: $778,050.

Gallman, in an interview, said the last-minute offer stemmed from Microsoft's wish to communicate "a better understanding of Microsoft's licensing model."

"It was not a discount," he says.

Gallman's appeal fell mostly on deaf ears. Councilwoman Strobl, for one, was skeptical. "Our consultant had no time to double-check the offer, whether it was really cost effective, or whether there were hidden costs," she says. "We did not take it seriously."

Other council members shared her doubt.

"Microsoft came too late," says Wolowicz, Ude's chief of staff. "The perception of the majority of the city council was now (Microsoft) wants to put pressure on the decision. Psychologically it was not good."

On May 28, the council voted 50 to 30 to switch to Linux.