

INDUSTRY DEVELOPMENTS AND MODELS

Policy Is the Best Policy: Ten Software Licensing Policies Every ISV Should Consider

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IDC OPINION

The art and science of software pricing and licensing is becoming more of a discipline. As software technologies and the way that customers use them have changed, ISVs have created custom exceptions to software licensing terms and conditions to accommodate customer needs. This IDC document explores some of the common exceptions to software licensing practices that ISVs grant customers, and it presents a case for developing policy that can be broadly applied, instead of allowing these custom exceptions to proliferate. In addition, to develop this list of "must have" policies, IDC has reviewed key trends in buyer and market behavior and selected those that are having the greatest impact on the software industry. Findings include:

- ☒ One benefit of policy is that it can help reign in rogue sales behavior and save time and money that result from negotiating, administering, and tracking custom arrangements. However, the presence of policy may only be the carrot; a stick may also need to be applied in situations where sales is used to doing whatever it wants.
- ☒ There are always going to be situations that are so customer specific that creating a policy for all customers would be ludicrous. There are also situations where exceptions are granted in situations that are leading edge — as customer adoption of virtualization technologies was back in 2006. However, there should be a mechanism in place for centrally tracking key elements of these custom arrangements, and for determining when a leading-edge behavior has reached a tipping point such that broad licensing policy is the best way to address it.
- ☒ IDC is observing increased proactiveness and transparency in the communication of licensing policy as a means of competitive differentiation. Public articulation of customer-friendly licensing practices not only sends the message that the vendor is listening to customer concerns but also challenges competitors matching license-friendly policies.
- ☒ As always, IDC can help companies develop and implement software licensing policies that meet the needs of the marketplace.

IN THIS STUDY

This IDC document makes the case for developing licensing policy for customer situations that are typically handled on a one-off custom basis. Ten software licensing policies are identified that many ISVs handle via custom agreements. Software vendors should consider developing or refining policy to address these increasingly common scenarios. In addition, software vendors should articulate key policy elements in communications with customers and other stakeholders.

SITUATION OVERVIEW

Let's face it, in the software industry, there isn't much that hasn't already been done. Subscription? Almost every ISV offers it, even if most don't have a written policy that outlines the principles of subscription for that ISV. Virtualization? Almost every customer is using it, even if most vendors haven't changed their policies to reflect the impact of the use of virtualization on the relevancy of its licensing. Disaster recovery? Cloud computing? Indemnification? There are a host of new use cases for software that have evolved over the past decade, but software policy has not.

Now is the time to change this. In the past decade, IDC has seen software licensing move from a decentralized to a centralized activity. Companies now have licensing professionals charged with overseeing licensing companywide and are applying discipline to the way that software policy is administered and managed. However, while ISVs have centralized licensing, there is still a great deal of power at the edges of the company, where "elephant hunter" account executives make a killing by selling multi-gazillion-dollar deals to customers that want to "buy the way they want to buy." Software licensing professionals that are trying to make a difference in that kind of environment can get frustrated pretty quickly.

The reality is, there are always going to be big, strategic deals to customers that buy the way they want to buy. Then, there's everyone else, which makes up the vast majority of the customer base. And for those folks, there should be a uniform structure that can be applied across customer segments and even across product. In general, custom policy created on the fly is done so in the spirit of what is good for that account executive (and his/her manager) in that specific case at that specific time (probably end of quarter), as opposed to what is good for the company over time.

The benefits of having policy in areas where custom has always been the rule should include:

- A shorter and more efficient sales cycle
- Reduced time spent inventing the wheel
- Reduced contract administration time and costs
- Reduced opportunity for error

- ☒ The ability to create a strategy for addressing important issues that impact the way software is licensed that works for the vendor from a profitability perspective while addressing the needs of the customer

In short, a policy allows ISVs to communicate to their customers the company's business practices and terms and conditions, and help them understand the rationale behind these. In today's more transparent software industry, more and more companies are being more proactive in clearly communicating their policies.

IDC has developed this policy document based on conversations with ISVs over the years. In addition, to develop this list of 10 "must have" policies, IDC has reviewed key trends in buyer and market behavior and selected those that are having the greatest impact on reshaping software licensing policy. IDC has also taken into account thousands of end-user surveys that reveal how customers would like to license software, which also helped IDC design a list that covers policy changes that will address the most pressing and prevalent customer needs.

FUTURE OUTLOOK

Top 10 Licensing Policies to Consider

Following are the 10 software licensing policies that every ISV should consider formalizing.

1. Subscription

IDC defines subscription as an offering consisting of:

- ☒ A recurring (often annual) fee, which must be paid for the customer to continue using the software
- ☒ The right to use (RTU) and maintenance for the software, bundled in a single cost
- ☒ Upgrades and updates

Subscription is often associated with software as a service (SaaS), although licensing and delivery are mutually exclusive and the majority of subscription deals (sizewise) are done for software that is on-premise at the customer site.

IDC has written a lot about subscription over the years, with the most recent prescriptive document for ISVs being *Subscription Software Licensing: The Future Is Now* (IDC #217096, February 2009). Almost every ISV out there does some subscription, a large portion of which is custom. More and more companies are developing policy to try and use subscription as a way to gain market share, improve customer satisfaction, and penetrate new markets. IDC has spent lots of time helping ISVs develop licensing policy around subscription, dealing with sticky issues such as pricing, sales compensation, operational impacts, revenue recognition issues, cannibalization of existing revenue streams, channel issues, and cultural changes. It's not easy to navigate these challenges and develop policy, but it is possible. And, in many markets, a competitive necessity.

2. Use of Your Software in Virtualized Environments

If you license your software according to some machine-based metric (CPU, number of servers, etc.), customer use of your software in virtualized environments has some impact on the price/value equation for your software and/or the ability of the customer to comply with your software licensing policies. IDC has written recently about this in *IDC's Worldwide Software Licensing in Virtualized Environments Taxonomy, 2010* (IDC #221737, January 2010).

Some vendors have chosen to develop policy that changes the way that customers need to license their software when it is utilized in virtual environments. Others have written policy to disallow use of their software in a virtualized environment (technology is available that can detect virtual machines and will stop the software from working if a customer tries to deploy it on one). However, a very large number of software vendors have made no changes at all to their licensing policy in light of virtualization, and, realizing that most customers are virtualizing, know that their existing licensing policy is probably being broken and customers are out of compliance.

Like subscription, developing policy around software running in virtualized environments isn't easy. However, with IDC research showing that by 2012, virtual machines will outnumber physical servers 2 to 1, ISVs need a strategy, and ideally a policy, to address the proliferation of VMs in the customer environment — and the potential licensing implications. It's an oversimplification to outline all the elements of this strategy here, but possible approaches are:

- ☒ The creation of different packages or editions that allow varying levels of virtualization, with the highest level of flexibility on virtualization costing the most
- ☒ An approach that distinguishes between physical machines and virtual machines, and that allows customers to pay for only what is used, versus the total available capacity (Technology will play a role here in metering/tracking the use.)
- ☒ No change to existing licensing policy, but require customers to utilize metering/tracking tools to help manage software running in virtual environments so that they can stay within the confines of their licensing agreements
- ☒ An ISV deciding not to allow its software to run in virtualized environments, which is not broadly recommended but may be best short-term approach in some cases

3. Service Provider Licensing Agreement

Customers have several choices when it comes to accessing the software functionality they need to run their businesses. An increasing number of customers are turning to SaaS firms or other service providers, and these firms are now often the licensee for ISV software rather than the end customer. Recognizing that this trend will continue, ISVs should develop or refine licensing policy that helps support the use of their software by service providers.

This is another area where there is quite a bit of activity, yet most of the engagements are custom. IDC did some research in early 2010 to understand what the predominate policies were for licensing software to service providers and found that while most engagements were custom, there are some time-proven practices at firms such as Microsoft, Informatica, and Progress Software.

Service Provider Licensing Agreement

A service provider licensing agreement (SPLA) is designed to enable the use of software to support commercial hosting services. The SPLA would come into play when the service provider:

- ☒ Provides customers with software-based services that interact with the ISV's licensed products (The service provider, not the end customer, is the licensee.)
- ☒ Facilitates the customer's business, including business transactions with third parties, through software-based services that interact with the ISV's licensed products
- ☒ Provides customers with access to and use of any application, and the application is running on a server and interacts with a licensed ISV product on that server (A service provider licensing agreement is designed to enable the use of software in commercial hosting services. The definition of commercial hosting service typically includes SaaS and application service provisioning [ASP].)

As the sole licensee of the software, the service provider obtains licenses for the ISV software that it requires.

Pricing for the SPLA is based on a recurring fee that includes the right to use the most recent version of the software, which helps the service provider match software-related expenses with its revenue, which is typically annuity based. Costs typically scale with operations in some way — if more software is used or sold, the service provider pays more; if less, then it pays less. IDC has seen SPLAs where cost is determined based on usage as well as revenue-share models that are calculated on a percentage of the service provider's offering that is based on the software.

The licensing metrics vary by type of software. For applications, it is common to see licensing on a per-subscriber basis. IDC has also observed per-transaction pricing in SPLAs, as well as machine-based metrics such as storage capacity or CPU for systems infrastructure or tools software. It is important that the metric be easy for the service provider to track and accurately report usage on a frequent basis. Additional detail on SPLA as well as licensing for business process outsourcers can be found in *Licensing Software for Commercial Use by Service Providers and Outsourcers* (IDC #214993, November 2008).

4. Disaster Recovery Rights

The extent to which this policy is important to you depends on whether your customers are using your software to complete mission-critical tasks. For software that is highly mission critical, the company may wish to have a replica of the production system — aka a "hot backup" — so that data can be accessed while the production system is being restored. A full license is usually required for these hot backups; while they aren't the primary systems, they are active and accessible as if they were.

A "warm" disaster recovery environment is equipped with the hardware needed to run the software in the case of a failure but may need to be updated with data for the software to run, and is not simultaneously active at the same time as the production system in the way that a hot backup is. The policy for warm backups varies:

- ☒ Some allow customers to run a backup instance as long as they remove their license keys from the primary system (and use them in the backup system during the time it is needed) so that it is clear that the primary system is not being used.
- ☒ Some simply specify that as long as the additional server is not concurrently receiving traffic with its production counterpart, an additional license is not required.
- ☒ Finally, some allow customers to temporarily run a backup instance with some restrictions, such as a requirement that the customer be current on maintenance.

A "cold" disaster recovery environment is, as the name implies, not running the software in any state. The same type of policy that typically applies in the case of "warm" is also extended to "cold" — to use it without needing a license for it, the customer needs to ascertain that the license on the primary system is not being utilized and must stop using the backup system once the primary system has been restored.

5. Buying Programs

While this is technically a program, not a policy, this analyst feels it's important to include.

Excluding savvy negotiating (and a down economy), there are typically two levers that impact the level of discount a customer receives — volume and commitment. Commitment is coming into play more frequently as subscription agreements increase as there are pricing benefits to customers that sign a three-year contract versus an annual or month-to-month contract.

Most vendors formalize the process and parameters for giving customer discounts in a "buying program," which is made up of policies that help dictate the kinds of benefits to customers that purchase in volume. The benefits usually include substantial savings, ease of deployment, flexible acquisition models, and numerous payment options.

Buying programs should be designed to help simplify the software purchase process for customers by including consistent messaging and discounting, a common membership available through any channel, and detailed volume license certificates. These programs should include low thresholds to entry so that even those customers that are in the position to make only limited commitments can still benefit. At the same time, high-volume purchasers expect special treatment. Vendors are designing these programs with increasing benefits at higher tiers, such as price protection, maintenance, and home use rights.

While buying programs are designed to encourage customers to make a volume commitment, they are often complex to navigate. In addition, vendors frequently make changes to these programs that, even if they are small alterations, can potentially have a large and unpredictable impact on the customer. Finally, there are no industry standards, which means that no two vendor programs are alike.

While some of the "shades of gray" that vendors have deliberately introduced into their volume licensing offerings make sense for vendor and clients, other leftover programmatic relics from acquisitions or past programs can just confuse clients, partners, and internal staff alike. IDC suggests that, where possible, the same volume benefits should apply across product lines.

6. OEM

An original equipment manufacturer (OEM) agreement states the rules of engagement for a relationship between a component supplier and a company that incorporates this component into its own branded product (referred to as "the partner" in this section). While many firms have long considered OEM a key part of their strategy, IDC has consistently fielded a sizable number of inquiries from firms that are either revamping their agreement or looking to expand their businesses through OEM agreements. OEM agreements can impact sales, marketing, services, and engineering.

Key elements of the OEM agreement include:

- License agreement.** Component suppliers' products are typically sold by the partner under an OEM sublicense rather than requiring a separate license agreement to cover the component.
- Pricing.** The price that the partner pays to license the software component is typically far below the average selling price or standard retail price. A number of variables help determine pricing:
 - Percent of contribution to the total solution
 - Unique nature of the product
 - Time-to-market considerations for the OEM
 - Exclusivity
 - Support/training
 - Market power
 - The partner's cost of developing comparable product internally

- ☒ **Contract length.** Most OEMs agreements stipulate terms at one to three years and have them renew automatically, unless either party wants to terminate. Many companies would like to have long-term contracts to provide security and restrict the need for negotiations, but auditors need fixed-period contracts so that they can amortize license agreements.
- ☒ **Intellectual property (IP).** Companies need to share technology secrets in order to do OEM deals, which puts a premium on protecting the intellectual property that passes between them. Typically, this is resolved through nondisclosure agreements (NDAs). The NDA process should also be extended to make it easy (and required) for partners to regularly and safely share sensitive information about product developments and timetables. In addition, the partner also needs to protect its rights — and may stipulate that source code be placed in escrow.
- ☒ **Competitive terms.** How can the partner protect itself against a component supplier expanding its product capability and competing with the partner in its core market? The same applies to the partner developing the component itself and incorporating it into its own products. The rough rule of thumb is that either should be expected and neither should be prohibited by an agreement but that advance notice be written into the deal.

Forms of payment can include:

- ☒ **Royalties.** Typically quarterly and based on product sales (These vary greatly, ranging from <25% to >60% of the final selling price.)
- ☒ **Up-front.** Covers software publisher's cost of developing a new product, modifying an existing product, or simply making an existing product available for integration into an partner's offering.
- ☒ **Maintenance.** The partner pays an ongoing maintenance fee to the component supplier.

Many vendors have made strong businesses from selling components to other vendors, and this portion of the total software industry continues to post strong growth rates. Future growth will come in a changed environment, however, particularly as companies change their pricing and payment strategies. The best relationships have a well-articulated spirit, including guidelines for measuring success, roles and responsibilities, and operating principles.

7. Pay-per-Use Licensing

Pay-per-use (PPU) licensing software pricing provides customers with an annuity license model where cost is based on metered use of a software resource. In particular:

- ☒ Cost is determined by a periodic measure of resource utilization.
- ☒ An agreed-upon metric is used as a proxy for value, and a system or process is put in place to track usage of that metric.

- ☒ Cost scales up or down according to resource utilization.

Other features of a PPU pricing model can include an up-front flat-rate charge and the possibility of fees/rebates associated with over- or under-utilization.

IDC has also written on this topic in detail (see *Pay-per-Use Software Pricing — What You Need to Know Before the Meter Starts Running*, IDC #221517, January 2010).

Growing interest in PPU models — in both vendor and customer communities — is driven by a number of factors including a shift in how software is valued. Instead of a cost-plus/feature-function approach where the customer is handed a giant toolbox where the price is equal to the value of all of those tools, PPU models enable vendors to capture the value of how customers use the tools. Thus value becomes equal to the ease, intuitiveness, and seamlessness of the overall customer experience.

Software vendors that want to enable this type of value creation and unique experience by increasing the granularity of their packaging and pricing must first immerse themselves in the activities of their customers to determine what they are hoping to achieve with the software. Additional granularity should lead to the development of PPU pricing. Once the vendor understands how the customer is using its software, determining the metric that is most appropriate for per-use measurement will be easier.

8. Global Licensing Policy

For software companies, maintaining a global pricing strategy requires balancing several dynamics, including:

- ☒ Centralized management versus regional autonomy
- ☒ Responsiveness to volatility in exchange rates versus price stability
- ☒ Concerns relative to arbitrage versus price competitiveness in specific regions

With different regions and markets often requiring different price points based on a myriad of factors, a key global software pricing question is how to manage this. In particular, where there are different regional prices, and how are they all linked so that there is some global consistency?

IDC has found that most companies establish a global reference price based on the local currency where the company has its global headquarters (e.g., U.S. dollars). The global reference price is different from the list price.

Each region uses this global reference price as a starting point, and from there adjustments are made to account for exchange rates as well as any uplifts to account for regional market conditions or product-specific considerations.

Within a region, these uplifts are usually similar, but the list price is determined by country. The final list price may reflect higher costs or different product values in a particular country but is driven mainly to accommodate discounting practices that are appropriate for a country's business culture. ISVs must maintain a delicate balance

between offering a competitive price out of the gate and meeting discount expectations, which can be very steep in certain cultures.

Periodic review of list and net prices by a central body (usually at headquarters) is a best practice. In addition, some firms will review specific deals if the deal size or discount is above a certain threshold. Some firms establish exchange rates for volatile regions at a corporate level as well, which should also be the responsibility of the central pricing body.

Finally, dealing with volatile exchange rates is a challenge, but customers need to feel confident that prices will not change on a frequent basis. This is particularly true for volume licensing customers. In addition to committing to price stability, ISVs should plan to periodically review exchange rates and local market prices to help maintain consistency.

9. IP Indemnification

Most conventionally licensed products offered by software vendors include an intellectual property indemnification section. In short, this protection spells out how the vendor will assist the customer in the event another company alleges IP infringement. In a cloud era, indemnification is also important to help ensure that the service provider has the right to provide the service to the customer, and to protect the customer against claims that it doesn't.

Many vendors now offer indemnification protection. By and large, most vendors agree to replace, modify, or even continue use of the infringing product at their discretion (based on requirements behind a claim). Some provide in-depth information openly on their corporate Web sites, boasting about how their policies eliminate end-user concerns. Others proceed with more discretion, sharing the information as requested. Past IDC research has shown that while many vendors consider indemnification a basic customer obligation, it isn't always clearly stated.

Proper indemnification can help a client limit or eliminate litigation concerns while still allowing the customer to embrace a broad range of software. With respect to these protections, key components to evaluate and consider include the type of IP protection that is covered, the way in which coverage/assistance is obtained, the specific coverage for legal costs and court-awarded damages, product/IP replacement warranties (and the procedure to trigger such warranties), and the party that controls the legal case and settlement.

Other components to clarify include when indemnification actually takes effect and how a product replacement program might ultimately impact the end user's business. In addition, qualification criteria can vary significantly by vendor.

IDC expects vendors will provide a much higher degree of clarity regarding the commitment requirements, the process to obtain and engage coverage, and the specific coverage that will be provided.

10. Licensing Communications

Having looked closely at software licensing in the past decade, this analyst has seen an important change in how licensing policy is perceived by customers and vendors. Licensing used to be a backroom activity, a necessary evil, and a means to an end — rather than a strategic differentiator or value enabler. As vendors offer more choice, understanding the key elements of various options and determining which option the customer should choose can be a challenge for customers. At the same time, licensing is increasingly being viewed as a competitive differentiator. For these reasons, licensing communications is becoming an important tool for vendors to help customers understand policy and the rationale behind it, as well as to challenge competitors to match customer-friendly policies.

An example of this is RightNow Technologies' March announcement of a Cloud Services Agreement (CSA). Cloud business models combine elements of some of the topics we've already discussed — namely subscription and pay per use, with Web delivery of software. From a business model perspective, this is very similar to what we've seen for the better part of a decade with SaaS business models, with cloud being the next architectural evolution.

RightNow Technologies articulated several policies that aim squarely at some of the major issues that customers have with traditional software licensing. What was so interesting about RightNow's campaign was not just the policy that was articulated — not very different from what we see in the industry at large, but quite different from what is offered by traditional enterprise application vendors — but that it was strongly supported by the company's marketing department, which even created a tongue-in-cheek video posted on YouTube that highlighted its competitors' less customer-friendly policies. From this analyst's perspective, this was a successful campaign that garnered media and influencer attention and clearly demonstrated the degree to which software pricing policy can not only be newsworthy but also sit alongside technology as a key differentiator for a software publisher.

IDC isn't suggesting that every publisher needs to launch a campaign but that the industry is moving toward a more transparency in licensing and pricing approach. Putting a price list up on a Web site is not that relevant — we all know customers rarely pay list price — but from a customer perception perspective, it's information customers are nonetheless thrilled to have. In general, licensing communications should:

- Outline the key elements of your policy.
- Show sample scenarios to help customers navigate choice.
- Explain the rationale behind your approach.
- Offer a tool or calculator to help customers make choices and understand what they might need to pay.
- Make it easy for customers to obtain this information — don't put it behind a registration page.

ESSENTIAL GUIDANCE

As always, IDC can help companies develop and implement software licensing policies that meet the needs of the marketplace with sensitivity to individual vendor constraints and requirements.

LEARN MORE

Related Research

- ☒ *Worldwide Software Business Solutions 2010 Top 10 Predictions: The "New Normal" for Enterprise Software* (IDC #222024, February 2010)
- ☒ *Pay-per-Use Software Pricing — What You Need to Know Before the Meter Starts Running* (IDC #221517, January 2010)
- ☒ *IDC's Worldwide Software Licensing in Virtualized Environments Taxonomy, 2010* (IDC #221737, January 2010)
- ☒ *Going Hybrid With SaaS: Managing Perpetual and Subscription Businesses in the Same Chassis* (IDC #218998, June 2009)
- ☒ *Worldwide Software Subscription 2009–2013 Forecast: Getting Better All the Time* (IDC #218516, June 2009)
- ☒ *Subscription Software Licensing: The Future Is Now* (IDC #217096, February 2009)
- ☒ *Licensing Software for Commercial Use by Service Providers and Outsourcers* (IDC #214993, November 2008)
- ☒ *Thinking Globally — Software Licensing Strategies That Help Span the Divide* (IDC #210397, February 2008)

Synopsis

This IDC study makes the case for developing licensing policy for customer situations that are typically handled on a one-off custom basis. Ten software licensing policies are identified that many ISVs handle via custom agreements.

"IDC is observing increased proactiveness and transparency in the communication of licensing policy as a means of competitive differentiation," said Amy Konary, director of Software Pricing and Licensing at IDC. "In addition, licensing communications is becoming an important tool for vendors to help customers understand policy and the rationale behind it, as well as to challenge competitors to match customer-friendly policies."

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