

Assignment 2

Competition Analysis - AOL/Time Warner Merger

Section 1: Relevant Background

The merger between AOL, the largest ISP in America, and Time Warner, one of the largest content providers and cable operators, was the largest ever in America at its time in 2001 (Faulhaber p. 453). AOL serviced 40% of all online subscriptions in the US with 27 million customers. The closest competitor, EarthLink, had only 4.7 million customers (Faulhaber p. 455). AOL also ran the largest Instant Messaging system, AIM, which when combined with ICQ, a system AOL purchased, accounted for 90% of the instant messaging market (Mackie-Mason 2000, p. 19)¹. Time Warner was the provider of cable services to 18% of American homes, making it the second largest provider after AT&T. Time Warner was also the owner of a vast array of cable networks including CNN, HBO, TBS, TNT, and the WB (Faulhaber p. 455). Due to the vast number of issues presented with this merger this paper will focus primarily on the ISP and cable access integration and instant messaging service.

Section 2: Case for Regulation

Because of the dominance of AOL with its customer base from its ISP service and Time Warner's large share of cable service, AOL-Time Warner would have incentive to act anti-competitively in the ISP and content provider market. One practice AOL-Time Warner might engage in would be charging a very low rate, possibly under cost, for its ISP division but charge a much higher rate for the cable access to the internet. In areas where cable is the dominant form of broadband connectivity consumers would be forced to choose AOL as their ISP. This would be due to the fact that no other ISP could be able to compete with AOL-Time Warner on price. This condition provides lower costs to the consumers from the merged company, but at a sacrifice of competition in the market (Kwoka and White p. 12). A regulatory solution to this problem would be mandating that AOL-Time Warner offer "the same price for conduit services to any ISP on its system, and ... offer its ISP service on other broadband systems at the same (incremental) price as it offered over Time Warner systems" (Faulhaber p. 460). This system may still present regulatory problems, but it is one method which was considered by the FTC. Another option is mandating open access, allowing 2 or 3 ISPs to use Time Warner's cable lines for Internet access. This is unlikely to produce an oligopoly due to the fact that the ISPs other than AOL will need to heavily compete with AOL to garner a large enough market share to be sustainable (Kwoka p. 7).

AOL's dominance in the Instant Messaging market with the benefit with having customers on its broadband connection provided by Time Warner would allow AOL to develop and consequently dominate next generation IM technologies (video chat). With AOL-Time Warner in control of the conduit that many use to connect to traditional and next generation IM services there would be incentive to discriminate against other next generation IM services. Doing so would make AOL's own service a better overall experience than its competitors. Discrimination against other services would be detrimental to next generation services which necessitate a high quality of service (QoS) to make audio and video fluid

1 Access to the Mackie-Mason article: <http://applecon.com/publications/aol-tw00-public.pdf>

and useful. This would compound on the network effect that AOL already has in its large customer base and make market entry by others practically impossible.

Section 3: Case Against Regulation

One proposed regulation mentioned for the AOL-Time Warner deal was the condition of open access on the Time Warner cable lines (FCC p. 22-23). This regulation would have put Time Warner cable in a special position with respect to other cable internet providers, namely Comcast, because only Time Warner would be required to allow more than one ISP to use their lines. AOL-Time Warner would have to “unbundle” their service from the cable conduit to provide this service to the other ISPs. By doing this AOL-Time Warner could potentially lose revenue that could be used for research and development of new services for their customers.

In addition, there is the possibility that having more than one ISP using the Time Warner cables would not increase consumer welfare through lower prices. Without regulation AOL-Time Warner could engage in price discrimination offering added services at above cost rates thus enabling lower rates for basic service. Added services could include guaranteed QoS or faster data transfers. Product versioning is one method of increasing consumer welfare by serving varying markets efficiently (Varian p.17). However, under the “open access” provision AOL-Time Warner would need to recoup all the costs associated with the cable conduit access by increasing that price instead of through price discrimination. Third party ISPs would then add their service on top of that cable conduit access, and the resulting combined price would be higher than what AOL-Time Warner could offer through a vertically integrated service. This is similar to the argument which is used by phone companies losing revenue used to ensure universal coverage by third party providers taking away the low cost but high return customers.

Regulation of the Instant Messaging service provided by AOL-Time Warner could in fact decrease the innovation in the market. The reasoning is that making AIM interoperable with other services would level the playing field to a point where the need for a new IM service to be revolutionary is lowered. The serial monopoly characteristic of Instant Messaging is what spurs radical innovation; taking away that characteristic could in effect reduce radical innovation thereby hurting consumers in the long run.

Section 4: Outcome

The outcome of the application for merger by AOL and Time Warner was approved, with conditions pertaining to its ISP service and Instant Messaging service. The FTC also “appointed a Monitor Trustee to act on its behalf to supervise AOL-Time Warner's conduct in implementing the agreement” (Faulhaber p. 470).

The regulation imposed on AOL-Time Warner to remedy the IM dominance situation stated they “may not offer an AIHS application ... over the path of AOL Time Warner broadband facilities, of one- or two-way streaming video communication using NPD protocols ... that are new features, functions, and enhancements beyond those offered in current offerings such as AIM 4.3 or ICQ 2000b, unless and until AOL Time Warner has successfully demonstrated it has complied with one of the following grounds for relief” (FCC p. 81).

There are three options that AOL-Time Warner could choose to fulfill to then be able to offer

AIHS (or next-generation IM) services. Option one is demonstrating “that it has implemented a standard for server-to-server interoperability” (ibid) which is accepted by either the IETF or other recognized standard-setting organization. Option two is entering into written contracts which enable “significant, unaffiliated, actual or potential competing providers” (FCC p. 82) interoperability with AOL-Time Warner NPD servers. Option three would allow AOL-Time Warner to develop AIHS services if it no longer was the dominant provider of NPD services, based on market data “for at least four consecutive months” (ibid).

The conditions imposed on AOL-Time Warner by the FCC when offering ISP service are as follows: customers must have a choice of what ISP to use over AOL-Time Warner cable facilities, third party ISPs can choose the first screen for their customers independently of AOL-Time Warner, third party ISPs are allowed direct billing to their customers, and AOL-Time Warner cannot engage in preferential treatment in the Quality of Service in favor of affiliated ISPs with AOL-Time Warner (FCC p. 55).

The combination of these conditions and the FTC Consent Agreement provided enough assurance to the FCC that the merger of AOL and Time Warner would benefit the public good.

Section 5: Author's Stance

I believe that while the regulations imposed on AOL-Time Warner were based on solid reasoning, their implementation is too drastic. For example, the conditions imposed on AOL-Time Warner to provide proof of interoperability, either through standard or contract, before it can offer next generation services is an artificial limit on innovation without need. There were, at the time of the merger, a few third party Instant Messaging programs which could communicate with more than one service at once, enabling some one to talk to one contact on AIM and another on MSN at the same time within the same program interface². These programs did have problems with AOL changing their protocol and thus breaking their interoperability, but each time AOL changed their protocol the third parties released new versions of their programs which were compatible with AOL's changes³. In light of this it is likely that AOL and other IM service providers would realize the vast cost of trying to ensure vendor lock-in is not justified when the third party applications can continually adjust to the changes, thus they would likely offer interoperability in response.

In addition the open access conditions are very similar to the regulations which telephone companies must work under when offering DSL service. However, by singling out AOL-Time Warner and not all cable companies this makes the broadband market unbalanced and favorable to cable companies other than AOL-Time Warner thus legalizing unfair advantages to those other firms. It is hard to quantify with information available at this time, but it appears that this may have given Comcast an advantage in the market, evident in its current dominance in cable Internet access.

2 One example is Trillian: <http://www.ceruleanstudios.com/> which offered AIM, ICQ, and MSN Messenger interoperability in November of 2000.

3 See “9.3 Standards leader” in Varian, page 41.