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EX PARTE OR LATE FILED

December 15, 2000

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Magalie Roman Salas
Secretary
Federal Communications Commission
445 12th Street, S.W.
TW-B204
Washington, D.C. 20554

Re: Applications of America Online, Inc. and Time Warner, Inc. for Transfer of Control (CS Docket No. 00-30) /

Dear Ms. Salas:

Enclosed for filing in the above-referenced docket please find a recent *ex parte* letter from me to Dr. Gerald Faulhaber dated December 15, 2000.

Should you have any questions regarding this letter or its enclosure, please do not hesitate to contact me at (202) 467-2504. Thank you for your kind assistance in this matter.

Sincerely,

Frederick Warren-Boulton

Frederick R. Warren-Boulton

cc: Magalie Roman Salas
Commissioner Michael Powell
Kyle Dixon
Susan Eid
Kathy Brown
Karen Onyeije
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December 15, 2000

Dr. Gerald Faulhaber
Chief Economist
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: Applications of America Online, Inc. and Time Warner, Inc. for Transfer of Control (CS Docket No. 00-30)
Notice of Ex Parte Presentation

Dear Gerry:

The purpose of this letter is to respond to the December 9, 2000 *ex parte* letter sent to you by the economists AOL has retained in this proceeding (the "Economists Ex Parte Letter") as well as the accompanying *ex parte* letter filed by AOL's lawyers with the Commission (the "AOL Ex Parte Letter"). As I describe in detail below, the AOL economists do not respond to the arguments actually made in my December 5, 2000 *ex parte* letter. I also address AOL's arguments that instant messaging ("IM") is not characterized by network effects. Finally, I respond to the AOL economists' assertion that a determination that AOL's share has recently declined would imply, or even would be sufficient to conclude, that this merger does not threaten to tip the IM market irreversibly to AOL.

The Misrepresentations Of My Prior Arguments. According to the AOL economists, I argued that the Commission should impose IM interoperability conditions because "there are no costs to imposing such regulation." Economists Ex Parte Letter at 1, 3. I said no such thing.

Rather, in my December 5 letter, I explained that the Commission should consider the relative costs of error, *i.e.*, the cost of imposing IM interoperability conditions if, in fact, the merger would not have the anticompetitive effects I have identified, relative to the costs of not accelerating IM interoperability if, in fact, the merger would have those effects. *See* December 5, 2000 Ex Parte Letter at 1. With regard to the former consideration, I did *not* claim that there were "no costs," but instead that those costs are likely to be much lower than the costs to the public from failure to act promptly. I wrote:

> If, in fact, the merger irreversibly tips the market in favor of AOL, but the Commission approves it without conditions, then the merger would threaten the development of a host of innovative applications. These innovations will not only be created for personal computers but for next-generation wireless devices and

> interactive TV as well. On the other hand, if the merger would not have any impact on IM competition, but the Commission nevertheless imposed interoperability conditions, then all that the Commission has done is to foster interoperability under which AOL would exchange traffic on same terms and on the same schedule as every other IM provider (which AOL claims it will do anyway in the near future).

Id.

The AOL economists do not deny that the costs of failing to impose IM interoperability conditions on AOL could be enormous if, in fact, failure to act would enhance AOL's IM market power. Nor do they dispute that whatever costs would be imposed by IM interoperability conditions would be borne by all the market participants, not just AOL. Thus, there is simply no sense in which AOL is being handicapped by regulation that differentially advantages its IM rivals. Further, the fact that all the market participants (but, apparently, not AOL) are willing to make their systems interoperable suggests strongly that a uniform timetable for interoperability would not impose the significant costs claimed (but not specified) by the AOL economists. Indeed, to the extent that AOL is currently incurring costs to actively block interconnection, AOL's costs could actually fall.

In this regard, in their letter, the AOL economists (or their attorneys) engage in sheer histrionics when they assert (without citation or explanation) that IM interoperability threatens IM "innovation." Economists Ex Parte Letter at 3. As I understand it, IM Unified is not advocating that AOL should be required to "unbundle" the component facilities it uses to provide the IM service so that AOL's rivals can offer competing IM services over AOL's facilities. Rather, my understanding is that IM Unified has argued simply for interoperability that permits customers of other IM services to communicate with AOL's IM customers. This is exactly the type of "interoperability" that already exists in telephone and other Internet networks and without any demonstrable negative impact on innovation. Indeed, interoperability, and the assurance that it brings that innovative efforts by all suppliers – whether of other IM services or of complements to those services – will not be appropriated *ex post* by the dominant firm, is what has spurred innovation in network industries. And it is *total* innovation by all participants that is relevant to the public interest analysis, not just innovation by AOL. In any market, granting a monopoly to one firm is likely to mean more output and more R&D expenditure by that one firm, but less output and innovation in the monopolized market or industry. A competitive market for IM, with many differentiated suppliers, each able (because of interoperability) to take full advantage of network effects, is likely to be far more innovative than a market controlled by only AOL.

The AOL economists also claim that I conceded in my letter that there is no "good information" regarding market shares in this case. AOL Economist Letter at 2. That is specious. As they well know, I was making the point that, *in general*, it is difficult to get good market share data in dynamic markets such as IM services. December 5, 2000 Ex Parte Letter at 1. And, even when precise data are available, it may not be clear how those data should be interpreted or what they imply. Thus, my argument is simple: in the absence of precise market share data with unambiguous implications, the Commission should take into account error costs in its decisionmaking. The AOL economists have no response to that claim.

Finally, it is also important to note that the AOL economists do not attempt to rebut my explanation of why the merger could facilitate tipping and discourage voluntary interoperability, although AOL's lawyers do respond in a footnote. AOL Ex Parte Letter at 3 n.4. Instead of addressing the argument that I actually made, AOL suggests that I maintain that Time Warner has a "content monopoly." No such allegation has been made. The relevant point is that once content is developed, it costs little (if anything) to distribute that content to additional subscribers. After the merger, AOL will be able to obtain Time Warner content for IM applications at the very low marginal cost of that content, whereas rival IM providers can access that content at market prices at best (assuming that such content is even offered to rivals), giving AOL a comparative advantage over its rivals. This point should hardly be in dispute. Indeed, this ability to transfer intellectual property between levels at prices closer to marginal costs is, as I understand it, the primary expressed motive for the merger. Given AOL's existing dominance and the strong network effects associated with IM, this create a substantial increase in the risk that, absent interoperability, the market will irreversibly tip in AOL's favor.

This merger has an additional, anticompetitive effect. *See* AT&T November 22, 2000 Ex Parte at 2-3. The merger may give AOL an incentive (that it did not have pre-merger) to foreclose rivals of Time Warner "intelligent agent" and other IM applications from AOL subscribers if the non foreclosed market could then be too small to allow competitive supply of substitute IM applications to AOL's IM rivals. This would allow AOL to monopolize the supply or raise the costs of these inputs to rival IM suppliers. With AOL controlling the lion's share of the IM market today, this is a serious concern.

IM Network Effects. AOL's economists contend that there are no network effects in IM because the various services are (today) free and because IM users voluntarily sort themselves into small, homogeneous groups, thereby making it easy to "switch" between services. Economists Ex Parte at 2-3. This argument ignores the increasing importance of IM applications for wireless devices where it is impractical for consumers to switch. As IM Unified explained, AOL has used its dominant position in PC-based IM to become the preferred IM platform for wireless devices. This has a strong feedback effect. If a PC user wants to communicate with a wireless IM user, he ore she can only do so using an AOL IM service.

Further, even where switching is technologically possible today, the AOL economists are not correct that there are no costs to switching between IM services. The purported "fact" that IM "buddy lists" are generally homogeneous does not mean switching costs are low. To the contrary, because of the overlap between IM groups and the need to accommodate in real time users leaving and joining IM groups it is very difficult to get all these users to switch back and forth between multiple IM services, as opposed to using the IM service that is likely to be the default choice for the overwhelming majority of the users – AOL. Moreover, it is inappropriate simply to assume that users have "voluntarily" segregated themselves into buddy lists that use competing services. To the contrary, as Media Metrix's president concluded, it is the lack of interoperability that is artificially causing "heavy users" to "adopt more than one brand in order to keep in touch with all of their friends and colleagues." November 16, 2000 Media Metrix Press Release (attached to AOL's November 17, 2000 *ex parte* letter). Finally, if it were as easy as the AOL economists suggest to use and switch between multiple IM services, none of the parties would care about interoperability, nor would the smaller IM services be committing themselves to interoperability in the near future.

The Relevance of the Market Share Data. Needless to say, there has been considerable debate between the parties as to AOL's share of the IM market, and whether that share has recently increased or decreased. As I understand it, the most recent battle centers on the Media Metrix press release submitted by AOL. AOL initially asserted that the results reported by Media Metrix conclusively showed that its IM competitors were rapidly gaining market share, but now appears to have retreated from that claim. According to Media Metrix, the "shares" it reported were based on "unique users" – *i.e.*, anyone who used an IM service just once in a month, an arbitrary definition that generates economically meaningless numbers.[1] In addition, I understand that Media Metrix has now confirmed that their results excluded millions of AOL ISP subscribers that use its IM service.

With the appearance of these facts, I understand that the debate has shifted to the usage data underlying the report. Not surprisingly, AOL and its opponents have conflicting views over these data. It is not the purpose of my letter to resolve this particular conflict. Rather, I am writing to respond to an *economic* argument that AOL has implicitly advanced with regard to the meaning of the data. More specifically, recognizing that the Commission may ultimately agree that AOL currently has a high market share, the AOL economists say that it is undisputed that AOL's share has declined over the past year. AOL claims that this "fact" conclusively demonstrates that market has not "tipped" to AOL. *See* Economists Ex Parte Letter at 3.

This argument is a *non sequitor*. Begin with a simple arithmetical observation. All markets that have "tipped" began with a single supplier, who had 100% of the market. After the service began, competitors understandably entered the market. The market share of the original, dominant firm declined. Over the long run, this entry was not sustainable. Competitors exited or transformed themselves into "niche" products where network effects were not critical, and the market "tipped," with the dominant firm acquiring all of the "general purpose" market and ultimately able to raise prices or otherwise exploit its monopoly position without fear of entry. Thus, it cannot be the case that a decline in a dominant firm's share over some short period of time implies that a market cannot tip, since all markets which have tipped have exhibited a period when that share declined. The history of PC (IBM-compatible) operating systems provides a vivid and unfortunate example of this process, and of the costs to consumers from a delayed policy response. And news of the recent exit of Tribal Voice and others from the IM business suggests that the retrenchment predicted by IM Unified in the absence of interoperability may have already begun.

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[1] Contrary to AOL's claim, "unique users" would not be the appropriate "share" metric even if the focus was not on the IM business itself, but on databases (or other IM inputs) or on applications that ride on the IM platform. With respect to databases, for example, the power wielded by a database owner would turn not on the sheer number of users who had used that provider's IM service once during a month (and may not even have established buddy lists), but on the number of *active* users in the database. Similarly, an application owner seeking distribution of its IM applications would focus on the number of active users of an IM service – *i.e.*, subscribers that might actually use the application – rather than on one-time users who, for example, used the IM service only to obtain access to free long distance service.

AOL points out that there has also been entry, but neither that entry nor the apparent share growth by Microsoft and Yahoo is inconsistent with AOL's dominance and the strong network effects that reinforce that dominance. First, I understand that Microsoft has explained that its recent share expansion came only after it began *paying* customers (with free long distance) to use its service. That is unlikely to be a sustainable long term strategy. Second, each entrant brings something unique to the IM market, and has the capability of appealing as the "best" IM product to a small section of a heterogeneous customer population. Third, Microsoft and Yahoo in particular have a "home base" of customers to whom they have a comparative advantage in marketing their IM product, or who purchase a product from them with which their IM product can be bundled, giving those suppliers an ability to gain a "toehold" in the IM market that may be unavailable to other providers.[2] Fourth, these IM entrants could reasonably have believed that interoperability would likely be required of AOL by some regulatory agency. Inevitably, as these (perhaps overly optimistic) entrants enter, AOL's share must (as a matter of arithmetic) decline – at least at first.

The relevant questions are thus: (1) Is there a significant risk that these entrants are not sustainable as more than niche providers (or that only an oligopoly would be sustainable), absent a regulatory requirement on AOL to become interoperable? (2) Would competition among IM suppliers benefit consumers in the form of lower prices, either for IM separately, or for the AOL or other suppliers' "bundles"? (3) As separate from the effect of competition on prices, would the product variety and differentiation provided by multiple IM suppliers be valuable to consumers? And (4) would an open, interoperable IM market encourage innovation in IM and/or in complementary products?

If the answer to question (1) is yes – as I believe it is – and if the answers to any of the next three are yes, then the Commission should act now to require interoperability from AOL on the same terms and timetable as agreed upon by other IM providers through an open standards formulation process. I believe that the answer to all four questions is yes, and that the error costs associated with failing to act now are quite high. Certainly, given the clear asymmetry in error costs – *i.e.*, the much higher costs of failing to act when action is warranted as compared to the costs of imposing a competitively unnecessary interoperability condition – the Commission should require interoperability.

Sincerely,

Frederick Warren-Boulton/LFB

Frederick R. Warren-Boulton

[2] Any suggestion that the Commission should turn a blind eye to the anticompetitive IM effects of this merger because, in AOL's view, Microsoft may also be able to obtain an anticompetitive advantage through the bundling IM with the Microsoft operating system should obviously be rejected. I am aware of no economic or public policy justification that supports any such "two wrongs makes a right" theory.