AOL Time Warner

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Steven Teplitz
Vice President and
Associate General Counsel

April 2, 2003

Via Hand Delivery

ORIGINAL

Marlene H. Dortch, Secretary
Federal Communications Commission
Office of the Secretary
c/o Vistronix, Inc.
236 Massachusetts Avenue, N.E.
Suite 110
Washington, DC 20002

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APR - 2 2003

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Re: CS Docket No. 00-30

Dear Ms. Dortch:

Attached, please find an original plus four copies of the Petition of AOL Time Warner Inc. for relief from the condition restricting AOL Time Warner's provision of streaming video advanced Instant Messaging high speed services via AOL Time Warner broadband facilities.[1]

Please do not hesitate to contact me if you have any questions regarding the foregoing.

Respectfully submitted,

Steven N. Teplitz

cc: Chairman Michael K. Powell
Commissioner Kathleen Q. Abernathy
Commissioner Jonathan S. Adelstein
Commissioner Michael J. Copps
Commissioner Kevin J. Martin
Susan M. Eid

No. of Copies rec'd 0+4

[1] *In the Matter of Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations by Time Warner Inc. and America Online, Inc., Transferors, to AOL Time Warner Inc., Transferee,* 16 FCC Rcd 6547 (2001) *("Order").*

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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PETITION

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Dated April 2,2003

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In the Matter of	)	
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Applications for Consent to the Transfer	)	
of Control of Licenses and Section 214	)	CS Docket No. 00-30
Authorizations by Time Warner Inc. and	)	
America Online, Inc. Transferors, to	)	
AOL Time Warner Inc., Transferee	)	

PETITION

AOL Time Warner Inc. ("AOL Time Warner"), pursuant to the procedures established by the Federal Communications Commission ("Commission") in the above-captioned proceeding, hereby petitions for removal of the condition restricting its ability to offer Internet users streaming video advanced Instant Messaging-based high-speed services ("AIHS") via AOL Time Warner broadband facilities (the "Condition").[1] When the Commission imposed the Condition, it recognized that its theory of merger-specific harm in the nascent instant messaging ("IM")[2] arena was based largely upon conjectural concerns. Accordingly, the Condition was specifically

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1 ***In the Matter of Applications for Consent to the Transfer** of **Control** of **Licenses and Section 214 Authorizations** by **Time Warner** Inc. **and America Online,** Inc., **Transferors, to AOL Time Warner** Inc., **Transferee,*** 16 FCC Rcd 6541 at ¶ 196 (2001) ***("Order").*** Specifically, the ***Order*** precludes AOL Time Warner from offering "an AIHS application that includes the transmission and reception, utilizing a NPD over the Internet Protocol path of AOL Time Warner broadband facilities, of one- or two-way streaming video communications using NPD protocols – including live images or tape – that are new features, functions, and enhancements beyond those offered in current offerings such as AIM 4.3 or ICQ 2000b." *Id.* at ¶ 191. The Condition was adopted by a 3-2 vote with Commissioners Powell and Furchtgott-Roth issuing strong dissents.

2 "IM' is a term used to describe Internet-based services that provide consumers with the ability to exchange short text messages that appear virtually instantaneously on each other's screen. While similar in many respects to e-mail, IM incorporates a number of additional enhanced features that make it possible to, among other things, maintain a list of online correspondents and monitor their online status.

crafted to include a mechanism through which AOL Time Warner could obtain relief by showing that, due to circumstances the Commission did not anticipate, the Condition is no longer necessary.[3] As shown below, and in the attached affidavit of Professor William P. Rogerson, there is clear and convincing evidence that the assumptions and predictions made at the time the Condition was imposed – which provided the factual predicate for the Condition itself – have proven to be incorrect. These material changes in circumstance make plain – individually, and clearly on a collective basis – that, even assuming *arguendo* that the Condition was justified at the time it was imposed, it is "no longer necessary in the public interest, convenience, and necessity."[4] Accordingly, AOL Time Warner respectfully requests that it be relieved of the obligations set forth in paragraphs 325-328 of the *Order*.

I. INTRODUCTION AND SUMMARY

America Online, Inc. ("AOL") and Time Warner Inc. ("Time Warner") announced their plans to merge on January 10, 2000.[5] At that time, the telecommunications, high-tech, media and entertainment industries were convinced of the unlimited possibilities that would quickly result from harnessing the power of an increasingly broadband Internet. It was in this

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3 *See Order* at ¶ 189 ("Our condition is balanced because it contains ways for AOL to show that, due to events we do not anticipate, the condition is no longer necessary."). The *Order* requires the Commission to issue its decision in this matter within 60 days from the date on which AOL Time Warner files its reply. See *id.* at ¶ 196.

4 *Id.* at ¶ 195. *Accord Fox Television Stations v. FCC,* 280 F.3d 1027, 1043-44 (D.C. Cir. 2001) *("Fox Television Stations"); modified*, 293 F.3d *537* (D.C. Cir. 2002) *("Fox Television Stations II"*) (holding that Commission's retention of a rule that could not be justified as "necessary in the public interest" was arbitrary and capricious). See *also infra* n. 100 and accompanying text.

5 *See* AOL Press Release, "AOL & Time Warner Will Merge To Create World's First Internet-Age Media & Communications Company," January 10, 2000, available at <http://media.aoltimewarner.com/media/newmedia/cb_press_view.cfm?release_num=15100390>.

environment that the instant messaging issue was introduced into the Commission's merger proceeding. For some, the IM debate became a debate over the future of the Internet itself.[6]

In the ensuing three years, much has changed: the dot.com bubble dramatically burst and the stock market has experienced significant losses from its record highs; broadband adoption has not grown as quickly as once predicted; and investment and growth are in retreat.[7] The passage of time also has served to show that the fears of those who predicted a combined AOL/Time Warner would somehow dominate the Internet have not come to pass. Rather, AOL Time Warner today is competing vigorously with others to find the right mix of content, applications, and services that will appeal to consumers in a broadband world.

It is against this backdrop of a changed – and still changing – environment that the Commission considers this petition. As a general matter, IM has continued to grow and evolve, but it has not become, as some had predicted, the platform through which all future Internet

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6 To put this in context, some critics of the proposed merger also predicted that Interactive Television, and specifically "AOLTV," would be the platform for the future and sought prophylactic regulatory protections to guard against a variety of imagined harms in this area as well. See ***Order*** at ¶¶ *238-39.* As with IM, the predictions and fears related to Interactive Television did not come to pass. In fact, as of November 2002, AOL stopped taking orders for the AOLTV services. See Jim Hu, "America Online confirms end of AOLTV," February **18,** 2003, available at <http://news.com.com/2100-1023-984920.html> (describing how, "[w]hen it launched, AOLTV was considered an initial glimpse into the potential of the merger between AOL and Time Warner," but quoting AOL spokeswoman Anne Bentley as stating that the choice to discontinue selling the AOLTV service was based "on not a lot of interest going forward in continuing to develop that particular platform"). Similarly, Microsoft has scaled back its ITV efforts. See, *e.g.*, Richard Shim, "Microsoft: Layoffs, changes in TV groups,'' April 24, 2002, available at <http://news.com.com/2100-1040-891413.html> (stating that "[flollowing a period of high expectations for companies in the interactive TV market, the market has cooled significantly").

7 See, *e.g.,* "Bubble: The Roots of the 90's Boom & Bust," Special Report of the ***Washington*** *Post,* available at **<http://www.washingtonpost.com/wp-srvlbusiness/bubble/series.htm>** (discussing, ***inter*** *alia,* Dow Jones average drop from over 10,000 to below *8,000).*

services will be delivered.[8] While Microsoft and Yahoo! have introduced streaming video **AIHS** services, IM has remained largely what it was in January 2000: a popular communications tool, offered to the public primarily for free by a variety of providers, typically as an adjunct to other interactive products and services.

* * *

As the ***Order*** makes clear, the Condition was premised upon an interrelated chain of conclusions and predictions:

- That **AOL** was the dominant provider of IM services and, absent interoperability, the "strong 'network effects"' associated with IM would cause **AOL's** unassailable lead in text-based IM to "swell" over time;

- That **AOL's** dominance in text-based IM would afford the merged company an anti-competitive first-mover advantage in streaming video AIHS,[9] creating bamers to entry and foreclosing competition; and

- That a sizeable Names and Presence Directory ("NPD")[10] is an "essential input" for **AIHS,** and no other competitor could attract a sufficiently large NPD so as to provide competition to **AOL** in the anticipated marketplace for **AIHS.**

Relying on these findings and predictions for the future, the Majority concluded that **AOL** would have the incentive and ability to stifle competition and innovation in future streaming video

[8] "Underlying the Majority's analysis is the clear view that IM is the new phone system – that it will be a mass market, public network. . . . [u]nlike the Majority, I find it cavalier to conclude or even suggest that IM is *the* essential platform for real-time interactive services.'' Statement of Commissioner Michael K. Powell, Concurring in Part and Dissenting in Part (***hereinafter Powell Separate*** *Statement)* at ***7*** (emphasis in original).

[9] **"AIHS,"** which is a term coined by the Majority, describes a potentially broad range of existing and future services. Streaming video **AIHS,** which is what the Condition prohibits **AOL** Time Warner from offering over **AOL** Time Warner broadband facilities, comprises only a small subset of that broader category.

[10] **A** NPD is a database of users' unique names and addresses combined with a "presence detection" function.

AIHS applications." The Condition was imposed to prevent the merger from causing or contributing to these outcomes." In addition to the restriction on the delivery of streaming video AIHS, the Commission also required **AOL** Time Warner to report regularly on the actions it has taken to achieve interoperability of its IM offerings and others' offerings.[13]

Today, after more than two years of real-world experience since the imposition of the Condition, there is clear and convincing evidence that IM has not evolved as the *Order* predicted, and none of the harms feared by the Majority have come to pass – nor would they occur if the Condition is lifted. Instead:

- Based on current share data, share trends and other competitive conditions, **AOL** is not dominant in the provision of IM services today and there is no danger of "network effects" causing **AOL's** share to "swell";
- **As** Microsoft and Yahoo! have each independently introduced streaming video AIHS, **AOL** does not have – and cannot obtain – a "first mover" advantage in this area; and
- By bundling Windows Messenger and Passport into Windows XP, in addition to offering its popular stand-alone MSN Messenger service, Microsoft has on its own become a significant competitor in IM- and presence-enabled services.

Given these material changes, there is clear and convincing evidence that the Condition today is not necessary to protect the public interest from the purported harms the *Order* sought to address. To the contrary, this artificial restraint on AOL's provision of streaming video **AMS** harms the

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11 *See Order* at ¶ 130; *see also id.* at ¶ 313 ("[w]hile the merger may well stimulate the development and deployment of new services, if the merger in fact diminishes competition and consumer choice with respect to advanced 'IM-based' services . . . as we predict, then the merger's potential stimulation of the development of new services will not guarantee that consumers will benefit from innovation, price competition, or diversity of choices with respect to these services.").

12 *See id.* at ¶ 188 ("To prevent **AOL** Time Warner, as a result of the proposed merger, from becoming more able or likely to dominate **AIHS,** we impose a prophylactic condition.").

13 *See id.* at ¶¶ 197, *321 ("Reporting Condition")*

public interest by negatively affecting investment and innovation.[14] Continued application of the Condition serves only to deprive consumers of the benefits of competition – namely, increased innovation and choice. When a merger condition that was intended to protect competition instead turns out to burden innovation and reduce competition, as is the case here, the Commission must remove it.[15] Based on the same set of materially changed circumstances, the *Reporting Condition* is no longer necessary and there is good cause to remove it as well.[16]

11. IN LIGHT OF MATERIALLY CHANGED CIRCUMSTANCES, THERE IS NOW CLEAR AND CONVINCING EVIDENCE THAT THE CONDITION SHOULD BE REMOVED.

Despite the *Order's* acknowledgment, highlighted below, that a large number of speculative assumptions were necessary to justify the Condition, the Majority found that "[on] balance, we find it appropriate to impose" the Condition." In so doing, the Majority nevertheless noted that "we recognize a number of factors that signal caution, including the relative novelty of the services . . . [and] because the markets are changing rapidly."[18]

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[14] In his dissent to the Condition, then-Commissioner Powell noted: "Our actions may very well affect innovation, by restricting AOL's incentives to innovate, and by favoring competitors, who can innovate without interoperating with AOL, thus restricting **AOL** in a market for future services . . . . Rather than preserving a competitive market, we may do nothing more than tip the market to another player." *Powell Separate Statement* at 11.

[15] *See Order* at ¶ 195 (Commission will remove merger condition if it is "no longer necessary" in the public interest). *Accord In re Application of GTE Corporation, Transferor, and Bell Atlantic Corporation, Transferee,* 16 FCC Rcd 16915, 16918 ¶ 7 **(2001)** ("*GTE/Bell Atlantic*") (Commission will remove merger condition that forecloses competition); ***In*** *re Application of Ameritech Corp., Transferor, and SBC Communications, Inc., Transferee,* 15 FCC Rcd 17521, 17523 ¶ 21 (2000) (same). The Commission's decision on the instant petition constitutes final agency action and is immediately reviewable by the Court of Appeals. *See Western Union Telegraph Co., et al. v. FCC*, 773 F.2d 375, 376 (D.C. Cir. 1985) (jurisdiction contained in 28 U.S.C. § 2344).

[16] **AOL** Time Warner has made four submissions pursuant to the *Reporting Condition.* No public comment has been received with respect to any of the filings.

[17] *Order* at ¶ 133.

[18] *Id.*

Accordingly, and appropriately, the ***Order*** set forth a mechanism (including a time deadline for Commission action) “for AOL to show that, due to events we do not anticipate, the condition is no longer necessary.”[19] Specifically, the Commission provided that:

> AOL Time Warner may seek relief from the condition by filing a petition demonstrating that imposition of the condition no longer serves the public interest, convenience and necessity because there has been a material change in circumstance, including new evidence that renders the condition on offering AIHS video services no longer necessary in the public interest, convenience and necessity. If AOL Time Warner proffers market share information as evidence that the condition no longer is necessary in the public interest, convenience and necessity, AOL Time Warner must demonstrate that it has not been a dominant provider of NPD services for at least four (4) consecutive months.”

As explained below, material changes in circumstances demonstrate that the Condition is no longer “necessary in the public interest, convenience and necessity.”

A. The Condition Was Based On Predictions, Assumptions And Conjectural Harms.

While the Majority examined the facts and circumstances related to IM that existed at the time of the merger review, it is without question that the Condition itself was based squarely on predictions of how text-based IM services – and yet-to-be implemented AIHS services – would develop in the future. That the Majority was cognizant of the speculative and predictive nature underlying its action is evident by the language used throughout its discussion and analysis of the Condition. For example, the ***Order*** notes that in an effort to promote the policies of the Communications Act, the Commission may ***“plan in advance of foreseeable events*** instead of waiting to react to them.”[21] Similarly, in failing to define with precision a relevant market for

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[19] *Id.* at ¶ 189.

[20] *Id.* at ¶ 195.

[21] ***Id.*** at ¶ 150 (citation omitted) (emphasis added)

purposes of its IM analysis, the *Order* relied on the well-established precept that the Commission does not need "tangible evidence . . . but is permitted to rely on its expertise to make *predictive judgments*."[22] In fact, the text of the *Order* is replete with examples highlighting the Majority's tacit recognition that the Condition was a "best guess" of highly uncertain future events, including statements such as:

- "IM-based services are relatively new but have shown enormous growth in popularity in recent years . . . . These features, besides being useful in their own right, *are predicted to have vast potential as a "platform" for the development of additional applications in the future,* particularly as users obtain high-speed Internet access";[23]

- "We then find that the proposed merger would give **AOL** Time Warner substantial, *and perhaps insurmountable,* advantages in providing advanced IM-based services over the high-speed Internet platform";[24]

- "Given these findings, the combination [of Time Warner and **AOL]** substantially *increases the probability* that **AOL's** dominance in the narrowband text-messaging world will persist in the world of high-speed interactive services";[25]

- **"AIHS** are novel services, *but we and many others believe that they will be significant in the near future*";[26] and

- "Seeing a *foreseeable and likely danger* to competition in **AMS,** we can act promptly and with confidence."[27]

Even assuming these predictions and conclusions were reasonable when the Condition was originally imposed, more than two years of actual experience clearly and conclusively show

[22] *Id.* at ¶ 152 n.421 (internal quotations omitted) (emphasis added). *See also id.* at ¶ 152 **("A** more precise definition of the relevant market is not necessary here, where the Commission *can accurately assess the competitive impact* of the merger *without such a detailed analysis.")* (emphasis added).

[23] *Id.* at ¶ 129 n.366 (emphasis added).

[24] *Id.* at ¶ 132 (emphasis added).

[25] *Id.* at ¶ 130 (emphasis added).

[26] *Id.* at ¶ 188 (emphasis added).

[27] *Id.* at ¶ 184 (emphasis added).

that the crystal ball through which the Majority gazed did not correctly forecast the future.[28] And stripped of the faulty assumptions and predictions that provided its very foundation, the Condition can no longer stand.

B. AOL Is Not "Dominant" In The Provision Of IM Today And IM Is Not Likely To "Tip" To AOL In The Future.

1. The Majority Predicated Its Decision To Impose The Condition On Its Belief That AOL Was The "Dominant" Provider Of Text-Based Instant Messaging.

The central pillar of the Condition was the assumption that AOL's then existing position of "dominance" in text-based IM would not only persist but grow, enabling AOL to leverage that position in an anti-competitive manner into AIHS. In particular, the Majority predicted that (1) a new category of services – AIHS – would emerge,[29] and *(2)* those services would build upon existing text-based IM offerings – and, specifically, their NPDs.[30] These assumptions, combined with the conclusion that "NPD services exhibit strong network effects,"[31] placed critical significance on AOL's "share" of text-based IM at that time.

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28 To be clear, it is not our intent to reargue the conclusions reached by the Majority. Instead, assuming ***arguendo*** that the Condition was reasonable at the time the ***Order*** was adopted, our point in this Petition is to demonstrate that material changes in the ensuing years provide clear and convincing evidence that a different conclusion regarding the necessity of the Condition must be reached today.

29 ***See, e.g., Order*** at ¶ 140 ("Many new services and applications based on 'simple text' IM are being developed. . . . Many experienced industry observers believe that these services, including AIHS, will be popular.") (citations omitted).

30 ***See id.*** at ¶ 145 ("Despite the quantum leap that all these new services represent beyond IM, they are like IM in one respect. That is, a provider of AMS depends on its NPD as much as a provider of IM does.") (citation omitted). The Majority concluded that an NPD is an "essential input" for IM services. *Id.* at ¶¶ 129, 138. ***See also id.*** at ¶ **138** n.376 (**"An** essential input is a component of a service or product without which the service or product cannot be created and provided to others.").

31 *Id.* at ¶ 158

During the merger review proceeding, AOL's IM rivals claimed that AOL enjoyed an 80-90 percent share of IM users.[32] AOL submitted data showing its share of IM users was approximately 65 percent.[33] Without relying on any specific data or methodology, the Majority concluded that "AOL, by any measure described in the record, is the *dominant* IM provider in America."[34] It also found that "the IM business is not competitive"[35] and that AOL would dominate NPD-based services for the foreseeable future.[36]

Based on these assumptions, the *Order* went on to conclude that AOL's NPD would "further swell" while its competitors' would "shrink."[37] This prediction served as the very foundation of the Condition, as then-Commissioner Powell explained in his separate statement:

> The Majority essentially employs a market "tipping" analysis in an effort to make this case, attempting to demonstrate that the IM market has nearly tipped, or will tip when AOL combines with Time Warner. The Majority avers, however, that it expresses no opinion on whether its conclusions can be read as a finding the market has tipped .... *Whatever the semantics of its conclusions, the Majority's market tipping analysis is a critical analytical underpinning for the IM condition.*[38]

More than two years of evidence demonstrates that this critical underpinning – that AOL's share of IM users would inexorably **grow** – is invalid today,

[32] *See, e.g., exparte* submitted by Gerard J. Waldron, Covington & Burling, counsel to Microsoft, October 13, 2000 (stating that AOL has "an 80-90% market share"); "Industry White Paper on AOL's Submissions to the IETF and the FCC," an attachment to an *exparte* filed by Tribal Voice, July 21, 2000 ("a commanding 90% share").

[33] *See exparte* submitted by Peter D. Ross, **Esq.,** Wiley, Rein and Fielding, December 9,2000 at *5*.

[34] *Order* at ¶ 129 (emphasis added).

[35] *Zd.* at ¶ **149.**

[36] *Id.* at ¶ 155.

[37] *Id.* at ¶ 155 ("This will continue until the largest provider's network is the dominant one, perhaps yielding the provider monopoly control of the market.").

[38] ***Powell*** *Separate Statement* at 4-5 (emphasis added).

2. There Is No Factual Basis To Conclude That AOL Is "Dominant" In IM Today.

In the more than two years since the ***Order*** was adopted, IM services have continued to rapidly develop and become more competitive. In fact, AOL's "share" of IM users has declined while its competitors' shares have grown. As a result, and contrary to the Commission's predictions, AOL today is not "dominant" in the provision of IM or any related NPD-based service. Specifically, AOL faces stiff competition from Microsoft's MSN Messenger, Yahoo! Messenger, and a number of smaller IM providers.

The ***Order*** invites AOL, when petitioning the Commission to lift the Condition, to provide evidence that it has not been a "dominant provider" of NPD-based services for four consecutive months,[39] and we do so now. Data compiled by comScore Media Metrix ("Media Metrix"), the leading Internet audience measurement service in North America,[40] show that AOL's two major competitors, Microsoft and Yahoo!, have averaged 22.2 and 19.3 percent, respectively, of the share of IM users per month over the past four months. For its part, AOL has averaged 58.5 percent share of IM users each month during this time.[41] In contrast, as recently

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39 ***Order*** at ¶ 195. In his attached Affidavit, Professor William P. Rogerson takes a longer term view. ***See*** Affidavit of Professor William P. Rogerson, attached ***("Rogerson Affidavit")***.

40 *Powell* ***Separate Statement*** at 4 ("The most objective data on the record is a study by Media Metrix, recognized as the world leader in the measurement of Internet and digital media use."). The Media Metrix data relied upon herein only track usage of AOL IM, AIM, ICQ, MSN Messenger, and Yahoo! Messenger. If comparable data for other services were included, AOL's share, however calculated, presumably would be even lower than the numbers presented below.

41 AOL's share is based upon the unduplicated number of All Locations (*i.e.*, Home, Work and University) Unique Visitors within the following three Media Metrix measurement categories: (1) AOL Proprietary Instant Message (which measures IM usage within the AOL online service); (2) AOL Instant Messenger ("AIM"); and (3) ICQ.

"Unduplicated" data ensures that an individual who uses more than one of AOL's IM offerings (*e.g.*, the IM feature of the AOL online service at home and AIM at work, both AIM and ICQ at home, AIM at home and ICQ at work, etc.) but constitutes only one entry in AOL's overall NPD, is in fact only counted once.

as June 1999, AOL's share of text-based IM was virtually 100%; that is because AOL's distinct products – AOL IM, AIM and ICQ – were the only significant IM offerings available at that time.[42] And, as explained further below, the long term trends indicate healthy competition among IM providers.

Indeed, Media Metrix data show that, in the last five months, AOL's rivals have seen continued growth in the number of Unique Visitors to their IM services: MSN Messenger's number of Unique Visitors increased from 17,640,000 in October 2002 to 19,410,000 in February 2003 (a 10 percent increase), while Yahoo! Messenger's Unique Visitors increased from 16,138,000 to 16,802,000 (a 4 percent increase). In comparison, AOL's unduplicated Unique Visitors decreased from 52,120,000 in October 2002 to 50,965,000 in February 2003 (a 2 percent decrease).

3. There Is No Legal Basis To Conclude That AOL Is "Dominant" In IM Today.

Beginning in 1980 with the *Dominant/Non-Dominant* ***First Report and Order***,[43] "dominance" in communications markets has been directly equated with market power. Market power, according to the Commission, is the ability to profitably set prices above competitive levels or to effectively lower prices to forestall entry by new competitors or eliminate existing

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The methodology employed by Media Metrix to measure IM usage has been refined since the ***Order*** was adopted, and is now specifically designed to eliminate "false positives" -- ***i.e.***, rather than counting as a Unique Visitor every user upon whose computer screen the IM client (or, in the case of the AOL service, the "Buddy List" and/or message windows) becomes the active window, it counts only those users who send or receive at least one instant message that month.

42 IM was invented by AOL in 1985 and first offered as a feature of the AOL online service in 1989. ***See exparte*** letter from Peter D. Ross, Esq. to Magalie Roman Salas, September 29,2000. AOL has been issued United States Patent 6,449,344, covering innovations developed by ICQ.

43 ***Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, First Report and Order,*** 85 F.C.C.2d 1, 21-22 ¶¶ 56-61 (1980) ("*Dominant/Non-Dominant* ***First Report and Order"***).

competitors.[44] The relevant indicia of market power (or the lack thereof) include the number and size of competing firms, the nature of barriers to entry, the availability of reasonably substitutable services, and the control of bottleneck facilities,[45] as well as elasticities of supply and demand.[46] A declining market share may also indicate the ***absence*** of market power.[47]

These "dominance" criteria were initially developed to determine which sectors of the telecommunications market were competitive and "non-dominant," and should therefore be deregulated.[48] The dominant firms at that time included AT&T and its local telephone companies, as they "control[led] access to over 80% of the nation's telephones" and thereby controlled a bottleneck facility essential to competitors.[49] In contrast, the firms that the Commission found to be non-dominant included "specialized common carriers" ("SCCs") such as MCI and Southern Pacific Communications Company (the forerunner to Sprint). SCCs were found to be non-dominant since they, unlike AT&T, "always face[d] a direct competitor that

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44 *Id.* at ¶ 56. A firm that is not constrained by competition from a sufficient number of existing and potential competitors can profitably raise price above costs -- or prevent price from falling to costs -- by either directly restraining its own output or by restraining the output of its competitors. ***See also Rogerson*** *Affidavit* at p. 12.

45 ***Id.*** at ¶¶ 57-58.

46 ***Motion*** *of AT&T Corp.* ***to be Reclassified as a Non-Dominant Carrier,*** 11 FCC Rcd 3271, 3304 ¶ 57 (1995) ("***AT&T Non-Dominance Order")*** (citing William N. Landes and Richard A. Posner, Market Power in Antitrust Cases, 94 Harv L. Rev. 937,945-52 (1981)). ***See also Rogerson*** *Affidavit* at pp. 12-13.

47 ***Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, Fourth Report and Order,*** 95 F.C.C.2d 554 n. 19 (1983).

48 ***See generally*** *Dominant/Non-Dominant* ***First Report and Order, supra*** note **43.**

49 *Id.* at ¶ ***62.***

offer[ed] a readily substitutable service."[50] Any attempt by a non-dominant firm to exercise market power would quickly be "frustrated" by its competitors?'

In 1995, the Commission applied these criteria to AT&T's motion to be classified as non-dominant in the market for interexchange carrier ("IXC") services.[52] The Commission found that AT&T was not a dominant firm with a 58.6 percent share of the IXC market[53] where supply and demand were sufficiently elastic to constrain AT&T's ability to raise prices unilaterally.[54] The fact that AT&T's market share had steadily declined from 90 percent, and that it faced competition from at least two strong competitors, confirmed that it lacked market power.[55] Applying these precedents, it is clear that AOL's IM services are not "dominant."

First, Media Metrix share data show that AOL is not dominant in IM. In the AT&T proceeding, the Commission noted that in the ten-year period from 1984 to 1994, AT&T's market share in long distance telephone service had fallen from 90 percent to 58.6 percent. The Commission found that "the decline in AT&T's market share suggests that AT&T no longer possesses market power."[56] Only two years after imposing the Condition, the Commission is faced with even more compelling facts with respect to IM. Since June 1999, when AOL served 100 percent of IM users, AOL has confronted two major new IM entrants, Yahoo! And Microsoft, as well as numerous smaller entrants. As a result, AOL has experienced a substantial

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50 *Id.* at ¶¶ 79-8 1.

51 *Id.*

52 *See generally AT&T Non-Dominance Order, supra* note 46. *See also Rogerson Affidavit* at pp. 11-12.

53 *Id.* at ¶ 40. For the last four months, AOL's share averaged 58.5% *See* also *Rogerson Affidavit* at p. 3.

54 *AT&T Non-Dominance Order* at ¶¶ 58, 63.

55 *Id.* at ¶¶ 67-72.

56 *Id.* at ¶ 67.

decline in its IM share. Its share of unduplicated all location users has fallen from 100 percent to 58.5 percent in just three and one-half years.

These numbers are significant evidence of "changed circumstances" with key implications for purposes of the Commission's analysis of this Petition." First, AOL's IM share has fallen more rapidly than did AT&T's long-distance share during the period preceding the Commission's determination that AT&T was non-dominant. Today, AOL's share in IM is approximately the same as AT&T's share in long distance when the Commission determined that AT&T was not dominant.

Second, high demand elasticity further shows that AOL is not dominant in IM. In the AT&T proceeding, the Commission found that demand for AT&T's long distance service was very price elastic. The Commission noted that there was reason to believe that many customers "will switch to or from AT&T in order to obtain price reductions . . . ."[58] The Commission also noted that 20 percent of AT&T's residential customers changed interexchange carriers at least once a year.[59] The last two years have shown that IM providers face similarly high levels of demand elasticity because nothing prevents IM users from downloading and using multiple

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57 The Commission did not state a basis for concluding that AOL was "dominant" in IM more than two years ago. *See Order* at ¶ 129. In light of the *AT&T Non-Dominance Order,* however, it would be difficult to argue that the Commission believed AOL's share of IM was *lower* than AT&T's share when it was declared non-dominant (*viz.*, 58.5%). AOL's declining share since then provides clear and convincing evidence that it is not dominant in IM today and that there is no likelihood of anti-competitive "tipping" in AOL's favor. *See Rogerson Affidavit* at pp. 10-12.

58 *See AT&T Non-Dominance Order* at ¶ 63. *See also Rogerson Affidavit* at pp. 11-12.

59 The standard economic model of market power postulates that market power is a function of a firm's (a) marginal cost and **(b)** the supply and demand elasticities that it faces. *See, e.g.,* Frank P. Darr, *Converging Media Technologies and Standing at the Federal Communications Commission,* 7 Harv. J. Law & Tec. 1, at text accompanying n.123 (Fall 1993); *see also* Thomas G. Krattenmaker, Robert H. Lande, and Steven C. Salop, *Monopoly Power and Market Power in Antitrust Law,* 76 Geo. L.J. 241, 267 (December 1987) (discussing demand elasticity in terms of the Lerner Index). Elastic demand further constrains a firm's ability to profitably price above competitive levels.

instant messenger clients, essentially without cost.[60] Over time, consumers' propensity to choose alternative providers has been demonstrated by the growth of Microsoft and Yahoo! as IM providers and the new video AIHS offerings available from them. The ability of consumers today to defeat an attempted price increase by easily shifting to established, branded, powerful rivals – such as Microsoft and Yahoo! – is no longer a theoretical possibility, but a materially changed circumstance that further confirms the lack of dominance by AOL.

Third, high supply elasticity shows that AOL is not dominant in IM. In the AT&T non-dominance proceeding, the Commission found that "AT&T's competitors have enough readily available excess capacity to constrain AT&T's pricing behavior,"[61] meaning that "supply is sufficiently elastic to constrain AT&T's unilateral pricing decisions."[62] After more than two years since imposition of the Condition, it is now clear that Microsoft and Yahoo! face no capacity constraint that would prevent them from rapidly expanding their NPDs in response to increased customer demand for their services (or reduced willingness to pay for AOL's). Nor is there any reason to believe that either of AOL's major competitors would be unable to increase their server capacity or other IM infrastructure to support such surges in demand. These conclusions are consistent with the continued growth in the number of new users of Yahoo!

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60 Any provider deciding to charge a per use fee for using its IM service likely would rapidly lose a large number of customers and find demand to be highly price elastic. It is not necessary for all or most users to coordinate a switch to a less expensive IM network in order to deter AOL from even attempting to exercise market power. The downloading and storage involved in adopting a new IM service are virtually costless, and multiple IM services can be used simultaneously. And there is no reason that adoption of a new service must be carried out simultaneously by most or all customers on different buddy lists. As a result, that price increase would be unprofitable. ***Accord Powell Separate Statement*** at 4, n.4. ***See also Rogerson Affidavit*** at p. 12.

61 *AT&T Non-Dominance* ***Order*** at ¶ 58.

62 *Id.* This criterion comports with basic economic principles. If rivals cannot increase their capacities in response to a price increase by a leading firm, then that firm has some unilateral ability to exercise market power.

Messenger and MSN Messenger, observed facts that have become clear since the ***Order*** was adopted. According to Media Metrix data, from October 2002 to February 2003, MSN Messenger's number of Unique Visitors grew by almost two million and Yahoo! Messenger's Unique Visitors grew over the same period by more than half a million. There is no evidence that suggests that either firm's resources were threatened by these increases.

Fourth, there is no evidence that AOL Time Warner's efficiency, financial strength or size would today or in the future convey upon it the ability to increase prices or reduce output in IM. In the AT&T proceedings, the Commission considered AT&T's cost structure, size, and financial resources to determine whether or not these factors gave AT&T the ability to price anticompetitively. The Commission did not find that AT&T's size or financial resources would allow it unilaterally to increase prices above competitive levels. There is no reason to believe that AOL Time Warner is in any different situation or that it is financially stronger than its largest IM rival, Microsoft. Nor docs Yahoo!, AOL's next largest rival, lack the resources necessary to compete effectively.

In summary, although the *AT&T* ***Non-Dominance*** proceeding and the current proceeding occurred at different times and involve different services, the criteria for a finding of dominance used by the Commission in its analysis of AT&T may be directly applied to AOL Time Warner today. Those criteria indicate that – due to a series of material changes – there is no legal basis today to conclude that AOL is dominant in IM, or that it threatens to become so in the future.

4. There Is No Economic Basis To Conclude That AOL Is "Dominant" In IM Today Or That IM Is Likely To "Tip" To AOL In The Future.

As set forth more fully in the attached affidavit of Professor William P. Rogerson, there is no economic basis to conclude that AOL is dominant in IM or that network effects have led or will lead IM to "tip" in AOL's favor. To the contrary, there is now "clear and convincing evidence that there are three strong and stable competitors" in IM and no "plausible reason to conclude either that AOL is dominant or that the market has 'tipped' or is in danger of 'tipping' to AOL."[63] Professor Rogerson bases his conclusion on the fact that AOL's share of IM has "continued to decline while the shares of its two competitors, Microsoft and Yahoo!, have continued to grow."[64] As Professor Rogerson points out, the evidence shows that "competition is strong and vibrant" in IM.[65]

Professor Rogerson makes two compelling arguments to support his conclusion. First, he notes that AOL's share of IM has been decreasing ever since Microsoft and Yahoo! began to compete with AOL. Professor Rogerson examines AOL's chief competitors and finds there is no reason to conclude they are weak or unstable or that their shares of IM are likely to decline. For these reasons, he concludes there is strong evidence that "the market has not 'tipped' to AOL and that it is in no danger of 'tipping' to AOL" in the future.[66]

Second, Professor Rogerson finds clear evidence of competition in IM. Specifically, he notes that competition has kept prices for these offerings at zero.[67] And he points out that AOL does not enjoy any special advantages in IM due to the size of its NPD. Indeed, Microsoft and Yahoo! each have introduced streaming video AIHS services ahead of AOL. This provides independent evidence of these competitors' viability.[68] There is furthermore no reason to believe

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63 ***Rogerson** Affidavit* at p. 3.

64 *Id.*

65 *Id.*

66 *Id.*

67 According to Professor Rogerson, a firm is capable of exercising market power if it can "increase its profits by raising price above the competitive price." *Id.* at p. 12. Professor Rogerson does not believe AOL can do this because, "along with its two competitors, [it] gives away its IM services to consumers for free." *Id.*

68 *Id.* at pp. 13-14.

that either of these competitors is capacity-constrained. Microsoft is pursuing a particularly vigorous strategy, bundling its IM offering with its monopoly operating system.[69] For all of these reasons, there is no economic basis to conclude that AOL is dominant in IM today or that IM is likely to "tip" to AOL in the future

C. AOL Does Not Control A Names And Presence Directory Whose "Network Effects" Threaten Competition.

The ***Order*** found that AOL was the largest IM provider and opined that NPDs exhibit strong network effects.[70] This led the Majority to make two predictions. First, the Majority predicted that network effects would enable AOL to enjoy an enormous advantage over actual or potential rival AIHS providers absent interoperability.[71] In other words, a "typical new user"[72] would choose AOL – the service with the largest NPD – simply because it had the largest NPD and without regard to other indicia of product quality. Second, the Majority predicted that AOL's then-''dominant'' and likely growing share of text-based IM services would confer on AOL a "first mover advantage" in streaming video AIHS.[73] Thus – simply because AOL had generated the largest NPD with its text-based IM services – AOL would be the unrivaled leader in deciding which AMS to roll out and when.

As set forth below, changed circumstances since 2000 shine an entirely new light on these predictions. Even absent interoperability, neither text-based IM nor AIHS has "tipped." Indeed, while rapidly growing their competitive offerings, Microsoft and Yahoo! have not interoperated their systems, a collaboration clearly indicated if tipping to AOL were likely.

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69 ***Id.*** at p. 13.

70 ***Order*** at ¶ 175.

71 *Id.* at ¶ 157.

72 ***See id.*** at ¶ 158.

73 *Id.* at ¶ 174.

Thus, it is plain that AOL does not have an NPD whose "network effects" confer on AOL a "first mover advantage."

1. AOL's Rivals Have Significant And Growing NPDs.

Whatever concerns existed more than two years ago about AOL's "uniquely large" NPD, there is no basis for continued concern today. Microsoft and Yahoo! have each grown their IM user base substantially.

Microsoft's growth has not been surprising. In addition to marketing its stand-alone MSN Messenger service, Microsoft has bundled both Windows Messenger (its new and backward-compatible consumer IM service) and Microsoft **.NET** Passport into Windows XP. In this manner, Microsoft has established its own IM and presence detection capabilities as the ***de facto*** standards for PC users. Published reports indicate that Windows Messenger, the streaming video AIHS-enabled IM client bundled into Windows XP, "loads and runs every time Windows is booted."[74] **A** Microsoft .NET Passport ("Passport") account, meanwhile, not only doubles as a user name for MSN Messenger, Windows Messenger,[75] and Microsoft's Hotmail email service,[76] it is also "an online service that makes it possible for you to use your e-mail address and a single password to sign in to any .NET participating Web site or service."[77] As a result, Passport's already substantial user base, which Microsoft stated in March 2002 included over 200 million

74 ProComp, "Microsoft's Expanding Monopolies: Casting a Wider .NET," May 15,2001, available at <http://www.procompetition.org>.

75 See <http://www.microsoft.com/netservices/passport/overview.asp>.

76 See <http://www.passport.net/Directory/Default.asp>.

77 "Microsoft® .NET Passport: .NET Branding," available at <http://www.passport.com/Consumer/NETBranding.asp?lc=1033>.

users,[78] and which now includes over 270 million users,[79] can be expected to enjoy continued growth.[80]

Indeed, through new PC purchases (Windows XP is the default operating system on nearly all new Windows-based PCs) and upgrades, the majority of computer users soon can be expected to be Windows XP users.[81] This will provide clear incentives – to Microsoft, obviously, but more importantly, to third-party developers as well – to incorporate Microsoft's IM and presence detection capabilities into future NPD-based services. Such an advantage will make it difficult for rival providers of such services to compete.[82] The bundling of Windows Messenger and Passport into Windows XP clearly demonstrates that Microsoft is capable of competing head-to-head with **AOL** in this evolving arena.

In addition, Yahoo! has designed its network of Internet properties so that all of its *86* million registered users[83] are potential members of its NPD. **As** Yahoo! notes, "[o]nce you

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78 '"ET Passport Overview," available at <http://www.Microsoft.com/myservices/passport/overview.asp>.

79 *See iRevolution Joins Forces With RSA Security to Provide Secure Online Authorizations to Microsoft .net Passport,* M2 Presswire Oct. 11, 2002.

80 In fact, Microsoft Chairman Bill Gates has stated that "it's our goal to have virtually everybody who uses the Internet to have one of these Passport connections." Dominic Gates, "Microsoft Could Hold Passport to Net," July 3, 2001, available at <http://www.thestandard.com/article/0,1902,27685,00.html>.

81 Indeed, in its first 12 months of sales alone, consumers purchased over **67** million copies of Windows XP as the original operating system on new PCs. *See Microsoft Announces Record First **Quarter** Revenue,* PR Newswire October 17, 2002. It can be safely assumed that this number has grown since October 2002, the last period for which data are available, and that consumer purchases of Windows XP upgrade software for existing PCs further increase the installed base of Windows XP.

82 Indeed, for these reasons, some experts predict that Microsoft's IM share will eclipse **AOL's** within the next few years. *See* Kristi Heim, "Microsoft Makes a Push Into Instant Messaging Market," *San **Jose** Mercury News,* March 7, 2003 (citing **META** Group study).

83 *See* "Yahoo! Facts & Figures," available at <http://solutions.yahoo.com/advertiser_center/research/figuresQ4.pdf>