establish a Yahoo! ID you will have access to the entire Yahoo! network. You need only do this once and your ID will work for every service in Yahoo! [including Yahoo! Messenger]."[84] Clearly, then, the number of Yahoo!'s unique users should be more than sufficient to support its continued rollout of AIHS.

2. Product Development, Not Network Effects, Will Drive Streaming Video AIHS Success.

As noted above, the Majority's merger-specific theory of harm was founded upon the belief that AOL's "uniquely large" NPD would generate "network effects" for its streaming video AIHS, such that "typical new users" would usually choose <u>only</u> AOL's **AMS** offerings Today, there is no reason to believe that network effects invariably drive the "typical new user" to choose only AOL's services.

Indeed, it is now plain that many new users choose other competing services, and both Yahoo! and Microsoft possess assets that ensure their continued ability to compete in this space. More importantly, each has demonstrated that its product and distribution channels, not the size of its underlying NPD, drives innovation and adoption.

If the size of an NPD itself was so important, Microsoft and Yahoo! today could rapidly increase their scope by establishing a combined NPD. More importantly, the fact that these already powerful competitors have the ability to do so provides substantial competitive discipline on AOL and eliminates the need for continued imposition of the Condition.

3. AOL Cannot Obtain A "First-Mover" Advantage In Streaming Video AIHS.

The Commission predicted that as a result of AOL's then "dominant" position in text-based IM, its NPD would be an essential input for competitors to develop future high-speed

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[84] "What do I need to use Yahoo! Messenger?," available at <http://help.yahoo.com/help/us/mesg/mesg-02.html>.

Internet-based services that rely on real-time delivery and interaction.[85] As such, the Commission found that, absent interoperability, AOL would have an anticompetitive "first-mover" advantage in developing and rolling out streaming video AIHS.[86] Experience now conclusively demonstrates that the possibility of AOL obtaining a "first-mover" advantage (anticompetitive or otherwise) has been eliminated.

Today, in fact, it is Microsoft and Yahoo! that have become the first movers in offering streaming video AIHS. On June 26, 2001, Yahoo! released version 5.0 of Yahoo! Messenger, which it described as "the first instant messaging service to integrate Webcam functionality and make it immediately available to consumers and businesses."[87] With Yahoo! Messenger 5.0, "people can easily set-up their Webcams to send live images while instant messaging with anyone on their Yahoo! Messenger Friends List."[88]

And on October 25, 2001, Microsoft released Windows XP, the most significant upgrade to its monopoly operating system in seven years. Windows Messenger, which "provides live, real-time videoconferencing on your computer,"[89] is bundled into Windows XP. Microsoft significantly broadened the scale of its video IM service in March 2003 by adding webcam functionality, formerly available only in its bundled Windows XP/Windows Messenger product,

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85 *Order* at ¶ 129.

86 *Id.* at ¶ 174.

87 "Yahoo! Brings Friends and Family Face-to-Face as First Instant Messenging Service to Integrate Webcam Functionality," available at <http://docs.yahoo.com/docs/pr/release790,html>.

88 *Id.* ***See also*** "What is Super Webcam?", available at <http://messenger.yahoo.com/messenger/superwebcam>(describing how, with Super Webcam, "[f]rames refresh up to 20 frames a second.").

89 "Using Windows Messenger 4.0: Videoconferencing," available at <http://www.microsoft.com/ windowsxp/pro/using/howto/communicate/videoconf.asp>.

to its free MSN Messenger service.'' Thus, to the extent that the Commission sought to ensure that AOL would have no anticompetitive first-mover advantage in streaming video AIHS, that objective has already been accomplished.[91]

4. AOL's NPD Is Not A "Barrier" To The Development Of New Ancillary NPD-Based Services.

Another indication of the changed circumstances since the Order was issued relates to the Majority's assumptions about wireless IM. The Order pointed to then-emerging wireless IM services as an area where AOL's IM "dominance" likely would generate AIHS dominance.[92] As evidence, the Majority cited to agreements between AOL and various wireless companies in which those companies agreed to make AOL's IM service available to their customers.[93] The Commission assumed that wireless carriers would choose to offer AOL's IM services exclusively because of AOL's alleged dominance and the lesser capacity of hand-held devices.[94]

90 See Jim Hu, "Microsoft Flicks On Webcam," ***Cnet** News.com* March 11,2003, available at <http://news.com.com/2102-1025-992080.html>.

91 Microsoft is innovating in a variety of ways. For example, Microsoft "hopes to deliver corporate-class communication, such as instant messaging" through Greenwich, "a real-time communications and collaboration operating system around which third-party developers and big businesses can create more sophisticated messaging, videoconferencing and Internet-based communications applications." **See** Joe Wilcox, "Microsoft's New Plans for e-Business, IM," Oct. 9, 2002, available at <http://news.com.com/2100-1001-961497.html>.

"Microsoft [also] plans to begin testing a radically new instant messaging and communications product aimed at teenagers and young adults who grew up using the Internet. The new software, called Threedegrees, creates a peer-to-peer social group in which people can chat, share photos, listen to music and meet friends. Concurrently with the test, or beta, program, Microsoft also plans to release the Windows Peer-to-Peer Update for Windows XP." Joe Wilcox, "Microsoft Aims to Tap Net Generation," Feb. 17,2003, available at <http://news.com.com/2102-1023-984816.html>.

92 *See Order* at ¶ 161.

93 *Id.* at ¶ 161.

94 Id. at ¶ 164.

In fact, however, Microsoft and Yahoo! have each entered into agreements with wireless providers to distribute their IM services. AT&T Wireless today has deals with both AIM and Yahoo! Messenger.[95] Moreover, wireless providers are not choosing AOL's software exclusively, thereby making "use of others impossible."[96] Indeed, the opposite is true. Last year, Verizon Wireless began offering AIM together with MSN Messenger to its wireless subscribers.

The growing presence of competing IM services over wireless networks further undermines notions that AOL is "dominant" and proves that "network effects" do not drive innovation and adoption.[97] There is no reason to doubt that firms like AT&T Wireless and Verizon Wireless seek to maximize their profits. Maximizing profits depends in part on making the most attractive set of features and service attributes available to customers. Offering third-party applications such as IM has proven to be one way for these carriers to boost traffic on their networks. The fact that MSN Messenger and Yahoo! Messenger are now distributed broadly over these wireless networks shows that they are considered popular applications that add value. Accordingly, the evidence from the wireless marketplace shows that AOL's NPD has not proven to be a "barrier" to the development of new advanced IM service offerings.

III. THE CONDITION IS NO LONGER "NECESSARY IN THE PUBLIC INTEREST" AND MUST BE REMOVED.

The Condition was based on predictions that instant messaging would head in a very different direction from where it has actually gone. In particular, the Majority believed that

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95 *See* **http://www.attws.com/messaging/instant.**

96 ***Order*** at ¶ **164.**

97 In addition, efforts are under way by carriers and three of the world's largest mobile telephone manufacturers (Ericsson, Motorola, and Nokia) through the "Wireless Village" initiative to expand the market for mobile NPD-based IM services. ***See*** <www.openmobilealliance.org/wirelessvillage>.

competition – both at that time and as this nascent service evolved – would be insufficient to discipline what it concluded was the dominant provider of IM.[98] Consequently, the Majority concluded that the Condition was necessary to protect competition and innovation in new video streaming NPD-based offerings.[99] But circumstances have changed. In fact, over the past two years both Microsoft and Yahoo! have grown and continue to grow relative to AOL, even without (1) access to AOL's NPD or (2) combining their own services to establish an NPD that would rival that of AOL. Indeed, they have innovated and become "first movers" for streaming video AIHS. As a result, predictions that the merger would allow AOL to dominate a single IM "platform" upon which all others depend have proven to be incorrect.

Whatever is required to succeed in delivering IM services, it is not access to AOL's NPD nor is it anything that is unique to the merger of AOL and Time Warner. In light of these developments, it would be arbitrary and capricious not to remove a merger condition that is no longer ***"necessary*** in the public interest."[100]

In light of the foregoing, the only effect of the Condition has been to hinder AOL's offering of streaming video AIHS to Internet users.[101] While this may have provided **a** head start to AOL's competitors, it surely is not consistent with the Commission's public interest

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98 ***Order*** at ¶ 188.

99 ***Id.***

100 ***Fox Television Stations,*** 280 F.3d at 1043-44 (there must be an adequate basis for concluding that regulation will further the Commission's objectives, otherwise continued regulation is not ***"necessary*** in the public interest") (emphasis supplied). Whether the Condition must be "indispensable" or merely "useful" to be preserved, it cannot be justified under either approach. ***See Fox Television Stations 11,*** 293 F.3d at 540; ***cf*** 2002 ***Biennial Regulatory Review,*** GC Docket No. 02-390, FCC 02-342, ¶ 15 (2003) (discussing different interpretations).

101 Foreclosing consumer access to these offerings does not promote any public interest goals. ***See*** *GTE/Bell Atlantic*, 16 FCC Rcd 16915 at ¶ 8.

mandate.'" Today, the Condition serves no pro-competitive purpose and is instead hindering full-blown competition. Indeed, as Professor Rogerson explains, the condition is more likely to impose social costs while generating no social benefits.[103] For these reasons, it must be removed.

In the alternative, the Commission should grant relief because it lacks the authority to keep it in place. "It is well established that an agency's power to regulate private entities must be grounded in a statutory grant of authority from Congress."[104] The Commission imposed the Condition as an exercise of its authority under Section 310(d) of the Communications Act[105]

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[102] *See Bell Atlantic Mobile Systems, Inc. and NYNEX Mobile Communications Company,* 12 FCC Rcd 22280, 22288 ¶ 16 (1997) ("[o]ur statutory duty is to protect efficient competition, not competitors."); *SBC Communications Inc., et al. v. Federal Communications Commission,* 56 F.3d 1484, 1491 (D.C. Cir. 1995) ("[t]he Commission is not at liberty . . . to subordinate the public interest to the interest of 'equalizing competition among competitors."'); *Primetime Access Rule, Report and Order,* 11 FCC Rcd 546, 555 ¶ 18 (1995) (what matters is the extent to which regulation will serve the public interest and "maximize consumer welfare," not "merely protec[t] individual competitors"); *Amendment of Parts 73 and 76 of the Commission's Rules Relating to Program Exclusivity in the Cable and Broadcast Industries, Memorandum Opinion and Order,* 4 FCC Rcd 2711, 2723 ¶ 66 (1989) (the Commission's goal is "of course, to see that the *public* interest is served, not to maintain an efficient distribution scheme that favors [certain competitors]") (emphasis added); *Evaluation of the Syndication and Financial Interest Rules, Memorandum Opinion and Order,* 73 RR 2d 1452, 1454 ¶ 39 n.52 (1993) (the Commission "seek[s] to insure that the market as a whole functions competitively" and not to redistribute profits).

See also Evaluation of the Syndication and Financial Interest Rules, Second Report and Order, 8 FCC Rcd 3282, 3302 ¶ 42 (1993) ("[a]ltering the distribution of profits among private parties is not, and never has been, a proper or desirable function of the Commission"); *Western Union Telegraph Co. v. Federal Communications Commission et al.,* 665 F.2d 1112, 1122 (D.C. Cir. 1981) (same); *Hawaiian Telephone Co. v. Federal Communications Commission,* 498 F.2d 771, 775-776 (D.C. Cir. 1974) (concluding that the Commission should protect the public interest, not individual competitors).

[103] *Rogerson Affidavit* at pp. 14-18.

[104] *Barnhart v. Peabody Coal Co.,* 123 S. Ct. 748, 763 (2003) (Scalia, J., dissenting) (internal quotations omitted); *see also ExxonMobile Gas Marketing Co. v. FERC,* 297 F.3d 1071, 1088 (D.C. Cir. 2002) ("it is *statutory aurhorization* alone that gives [the agency] the authority to regulate. . . .") (internal quotations omitted) (emphasis in original).

[105] 47 U.S.C. § 310(d).

primarily because various Time Warner entities possessed CARS (cable relay service) microwave radio licenses used to transmit signals to or from cable system headends.[106] However, the Condition exceeds the Commission's authority under Section 310(d). Specifically, Section 310(d) provides:

> "No . . . station license . . . shall be transferred . . . to any person except upon . . . [a] finding by the Commission that the public interest, convenience, and necessity will be served thereby. Any such application shall be disposed of as if the proposed transferee . . . were making application . . . for the . . . license in question. . . ."

Under the plain text of Section 310(d), the word "thereby" refers back to whether the "license. . . shall be transferred." This makes clear that the Commission may base its decision on the public-interest consequences of only the proposed license transfer, not of the broader corporate transaction that may have occasioned it. The second sentence further requires the Commission to treat the application "as if the proposed transferee or assignee were making application under section 308 for the permit or license in question," which makes clear that the only relevant factors are those that would be considered in connection with an original license application by the transferee. Because the Commission had no power to impose the Condition based on this statutory criteria, upon request for revocation it has no power to leave it in place.

Whether this argument could have been made when the Condition was first imposed is not relevant. The Commission would act arbitrarily or otherwise contrary to law if it refused to consider whether a prior action having continuing effects was issued absent statutory authority.[107] Moreover, if the Commission declines to repeal the Condition, it has in effect "re-

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[106] Time Warner and America Online, Inc. each held a small number of additional licenses. See ***Order*** at Appendix C. None of these licenses, however, are used to provide IM services.

[107] ***See American Scholastic TV Programming Found. v. FCC,*** 46 F.3d 1173, 1178 n.2 (D.C. Cir. 1995) (party with standing may challenge regulations where agency exceeded authority "regardless of statutory time limits on challenges") (internal quotations omitted); ***Public Citizen***

exercised' merger-review authority. As the D.C. Circuit has recognized, statutory time limits do not foreclose subsequent examination of a rule "where properly brought before [a] court for review *offurther Commission action applying it*."[108] In sum, a refusal to grant the petition would constitute "further Commission action applying" the Condition – and would be subject to judicial review as though entered for the first time.[109]

IV. CONCLUSION

Recognizing that its predictive judgments regarding IM could turn out to be unfounded in this dynamic and rapidly evolving environment, the Commission deliberately provided a mechanism for relieving AOL Time Warner of the restrictions imposed on its development and deployment of certain innovative IM offerings. In fact, the evolution of IM has not occurred as the Commission predicted. More than two years after imposing the restrictions, AOL's IM offerings are not "dominant." Competitors are continuing to grow rapidly and to innovate on their own. Experience shows that AOL does not control any input essential to competition and innovation in NPD-based services. The only purpose served by continuing to restrict AOL from offering video streaming AIHS is to reduce competition, thereby reducing consumer welfare. For these reasons, the IM condition is not "necessary in the public interest." With more than two years of experience against which to measure the predictions made in this case, the conclusions made in the *Order* have clearly outlived any value they might have served. Accordingly, AOL

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v. National Regulatory Comm'n, 901 F.2d 147, 152 (D.C. Cir. 1990) (claim that agency violated statute "may be raised outside **a** statutory limitations period"); *National Labor Relations **Bd. Union** v. Federal Labor Relations Auth.*, 834 F.2d 191, 196-97 (D.C. Cir. 1987) (same).

[108] *Geller v. FCC,* 610 F.2d 973,978 (D.C. Cir. 1979) (internal quotations omitted) (emphasis supplied). ***See*** *also supra* note 107.

[109] **See** *American Tel. & Tel. Co. v. FCC*, 978 F.2d 727, 734 (D.C. Cir. 1992) ("It is well established that a rule may be reviewed when it is applied in an adjudication . . .").

Time Warner respectfully requests that it be relieved of the obligations set forth in paragraphs 325-328 of the ***Order.***

Respectfully,

Steven N. Teplitz
Vice President and Associate General Counsel
AOL Time Warner Inc.
800 Connecticut Avenue, NW
Suite *200*
Washington, DC *20006*
(202)530-7883

Dated: April *2, 2003*

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
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 Wamer Inc., Transferee	)	

AFFIDAVIT OF PROFESSOR WILLIAM P. ROGERSON

My name is William P. Rogerson. I am a professor of economics at Northwestern University. In 1998-99 I served as Chief Economist at the Federal Communications Commission ("Commission"). I have published numerous academic articles on industrial organization, regulation, the economics of contracts, and telecommunications. I have served as chairman of the Department of Economics at Northwestern and **am** currently Co-Director of the Center for the Study of Industrial Organization and Director of the Program for Mathematical Methods in the Social Sciences at Northwestern. **A** copy of my cumculum vitae is attached at Exhibit 1. I submit this affidavit in support of the Petition of **AOL** Time Warner Inc. to remove a condition imposed upon it by the Commission in this proceeding.[1]

[1] ***Memorandum Opinion and Order 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, Memorandum Opinion and Order,*** 16 FCC Rcd **2400 (2001) (hereinafter *"Order")*.**

INTRODUCTION

AOL, Microsoft, and Yahoo! are the three major providers of text-based instant messaging (IM) services.[2] IM services utilize a names and presence database (NPD) to allow users of each service to detect whether other users of that service are on-line and to send short text based messages back and forth to one another in real time. The ***Order*** predicted that the next generation of NPD-based services would involve richer forms of communication including streaming video and labeled such offerings "advanced IM-based high-speed services," or **AIHS.** The condition at issue prevents **AOL** from offering streaming video **AMS** services over **AOL** Time Warner broadband facilities (the "Condition").[3] The ***Order*** also provides, however, that the Commission will remove the Condition if **AOL** Time Warner demonstrates "by clear and convincing evidence that circumstances have changed such that the public interest will no longer be served by the Condition."[4]

The Commission's rationale for imposing the Condition was based upon its concern that the presence of strong network effects in the market for instant messaging: together with its finding that **AOL** then held the vast majority of the text-based IM market (and was dominant), might cause the market to "tip" to **AOL,** resulting in **AOL** becoming a monopoly provider of instant messaging. The Commission then expressed concern that **AOL's** dominance in text-based IM could then afford the merged company an anti-competitive first mover advantage in

[2] While other providers of IM services exist, the data I analyze from comScore Media Metrix only tracks usage of these three firms. If comparable data from other services were available, **AOL's** share, however calculated, presumably would he lower than the numbers presented below.

[3] ***See Order*** at ¶¶ 191-95; 325

[4] ***See id.*** at ¶ 18. ***See also id.*** at ¶¶ 191-95

[5] In explaining why it imposed Condition as a requirement for its approval **of** the **AOL** Time Warner merger, the Commission first concluded that NPD-based services constituted a distinct market. ***Id.*** at ¶ 152. Whether NPD-based services constitute a relevant antitrust market is a question that need not be addressed in the context of determining whether the restriction on **AOL** Time Wamer should he lifted. For purposes of this analysis, I assume ***arguendo*** these services may he considered a relevant market.

streaming video **AIHS.** Even at the time of the Commission's decision, **AOL** faced two strong competitors whose market shares had been consistently growing since they began offering IM services. Nonetheless, perhaps because of the newness of the market and the inherent uncertainties associated with its decision, the Commission concluded that the danger of "tipping" was still serious enough that a condition designed to guard against possible harm to streaming video **AMS** competition was warranted.

Since the Commission adopted its ***Order,*** more than two years have passed in which we have been able to watch the market for IM services develop and mature. Based on my analysis of events that have unfolded in this period, I conclude that there is now clear and convincing evidence that there are three strong and stable competitors in the market for instant messaging. **As** a result, there is no longer any plausible reason to conclude either that **AOL** is dominant in text-based IM services or that this market has "tipped" or is in danger of "tipping" to **AOL.**

My conclusion follows from the fact that **AOL's** share of IM users has continued to decline while the shares of its two competitors, Microsoft and **Yahoo!,** have continued to grow. Based on the four most recent months for which data are available, **AOL** has an average share of ***58.5*** percent of IM users, Microsoft has an average share of 22.2 percent of IM users and **Yahoo!** has an average share of **19.3** percent of IM users. Furthermore, a variety of other developments, such as the fact that Microsoft and **Yahoo!** have already launched streaming video **AIHS** services independent of **AOL,** also support the conclusion that competition is strong and vibrant in this market.

Although the market share data do suggest that **AOL** is still a very strong competitor in this market, the Commission did not impose the Condition because **AOL** was a strong firm facing two strong and stable competitors. The Commission imposed the Condition because it believed there was a serious danger that the presence of strong network effects would nip emerging competition in the bud and make it impossible for any other firms to establish strong and stable market shares and remain as effective competitors. The Commission succinctly summed up its concerns as follows:

> The largest provider's refusal to interoperate will lead to users switching to it from the smaller providers, which will further swell the dominant provider's NPD and shrink the smaller ones'.[6]

If the concerns expressed by the Commission had turned out to be true, we would have expected the number of customers served by Microsoft and Yahoo! to cease growing and in fact begin to contract some time over the two year period since the ***Order*** was adopted. The evidence flatly contradicts this prediction. The number of customers served by both Microsoft and Yahoo! has continued to grow strongly over the entire period since the ***Order*** was adopted. In fact, although **AOL** has also continued to grow over this period, both Microsoft and Yahoo have consistently grown faster than **AOL** ***so*** that their market shares have risen and **AOL's** has fallen.

A substantial historical record now exists for **us** to assess the strength and direction of growth in competition in this market, and the evidence shows that competition is strong and growing stronger. Therefore, in my judgment, there is no longer any need for a condition designed to prevent the theoretical possibility that the market might tip to **AOL.** Moreover, where regulations such as the Condition no longer serve an evident pro-competitive purpose, they likely impose costs that are passed on to consumers in the form of reduced choice or decreased innovation in the market. For all of these reasons, **I** conclude that the Condition should be removed.

[6] *Id.* at ¶ 155

My analysis is organized as follows. Parts I and II present evidence to show that strong levels of competition exist in the IM market. I consider market share data in Part I and other evidence in Part II. Taken together, these facts establish that there is no danger of the market "tipping" to AOL, and that no condition is therefore needed to guard against this. In Part III, I explain why the Condition is likely to generate social costs even though it has no social benefits. In particular, I explain why imposing compatibility conditions on competitive network industries can be costly and create inefficiencies and distortions. Finally, I draw a brief conclusion in Part IV.

I. THE EVOLUTION OF MARKET SHARES

As set forth below, the data show that Microsoft and Yahoo! both now have substantial shares of the IM market. Furthermore, their shares have been consistently increasing while AOL's has been consistently decreasing. Accordingly, the data show that there are three strong and stable competitors in the market for instant messaging. In particular, there is **no** longer any plausible reason to conclude either that AOL is dominant or that the market is in danger of "tipping" to AOL. I explain the data and my conclusions below.

A. What the Data Say

The data **I use** to conduct my analysis of market shares are compiled by comScore Media Metrix ("Media Metrix"), the leading Internet audience measurement service in North America. Based on a sample of households, the data report the number of users of each IM service on a monthly basis for the **36** month period from March 2000 to February 2003. Beginning in October 2002, Media Metrix made some changes in the way it defined, categorized, and measured IM usage that were designed to provide more accurate measures of IM usage.'

Because of this change in definitions, I cannot construct a single consistent time series for the entire 36 month period. Rather, I have one time series for the most recent five months, October 2002 to February 2003, using the new definitions, and another time series for the previous 31 months, March 2000 to September 2002, using the old definitions. I will use the market share data from the most recent five months to determine the current level **of** market shares and to determine if there have been any short run trends in market shares over these five months. In order to determine the nature of longer run trends in market shares, I will look for trends in the previous 31 months of data.[8]

Table **1** presents the number of users and market share for each service by month over the most recent five month period from October 2002 to February 2003.9 The market share of a firm

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7 Among these changes were the following. First, Media Metrix introduced a new defmition of a Unique Visitor (*i.e.*, a user) for purposes of reporting this data beginning with October 2002. Prior to October 2002, a person was defined to use an IM service during a given month if any window associated with the IM software client became active (blue barred) on that person s computer screen. As a result, a person did not need to actually send or receive **a** single IM message during a month to be counted as an IM user in that month. Beginning in October **2002,** however, a person is defined to be a user only if the person actually sends or receives at least one IM message during that month. This change would tend to decrease the number of reported **users.** Second, Media Metrix expanded its estimate of the total number of users and began measuring users at universities whose use was formerly not measured. This change would increase the number of total reported users.

8 Beginning with October 2002, Media Metrix introduced a number of significant changes in the methodologies and definitions it used to measure IM usage which were designed to provide more accurate estimates. It appears that the change in methodologies and defmitions itself had an effect on calculated market shares. (This would occur if the changes in definitions and methodologies affected different firms differently.) If we attribute the change in market shares from September **2002** (using the old methodologies and definitions **)** to October **2002** (using the new methodologies and definitions) to the change in methodologies and definitions, it appears that the change caused AOL's market share to increase and its competitors' market shares to decrease. Since Media Metrix believes that its current methodologies and definitions provide the most accurate estimates, and I have no independent basis for questioning this, I will accept the market shares calculated using the current defmitions as providing the best estimate of the current level of market shares. I will only use the historic data to investigate the trend in market shares. Since most of the reported data is for months prior to October **2002** and since market shares prior to October **2002** use the same defmitions and methodologies, I can determined the nature of long term trends in market shares by examining the nature of trends in market shares for the period prior to October 2002. ***See supra*** n.7 and *infra* n.**11** for descriptions of some of the changes between the methodologies and definitions.

9 AOL offers three different **IM** services: AOL IM (for members of AOL), AIM (a free IM offering, separate from the AOL ISP, that allows non-AOL subscribers to communicate with AOL subscribers and other AIM **users)** and ICQ (also a free offering). In order to avoid duplicative counting, the Media Metrix data I present counts the

is calculated by dividing the firm's number of users by the sum of all three firms' users in that month.

Table 1: Unique Users by Month for Instant Messaging Services: Oct 02-Feb 03

	000's of users				Percent of Total Users		
Date	AOL	MSFT	Yahoo	Total	AOL	MSFT	Yahoo
Oct-02	52120	17640	16138	85898	60.7	20.5	18.8
Nov-02	52569	19449	16373	88391	59.5	22	18.5
Dec-02	52639	19620	17735	89994	58.5	21.8	19.7
Jan-03	51794	20350	17723	89867	57.6	22.6	19.7
Feb-03	50965	19410	16802	87177	58.5	22.3	19.3

From this table it is clear that the market share of AOL has slightly declined over this five month period. Similarly, the market shares of Microsoft and Yahoo! have slightly increased **over** the same period. Based on the average value of the four most recent months of data (November 2002 to February 2003), the market shares of the firms are: **AOL** (58.5%), Microsoft (22.2%), and Yahoo! (19.3%).[10]

In order to determine the nature of longer term trends in market shares, I will now turn to the market share data for March 2000 through September 2002, which are presented in Table 2.[11]

use of any combination of AOL, AIM, or ICQ by the same user in a month as a single use of **AOL's NPD.** This data, which eliminates duplications across AOL services, is specially prepared for AOL by Media Metrix.

10 In petitioning to remove the Condition, the Commission required **AOL** to demonstrate that it has not been dominant "for at least four (4) consecutive months." ***Order*** at ¶ 195.

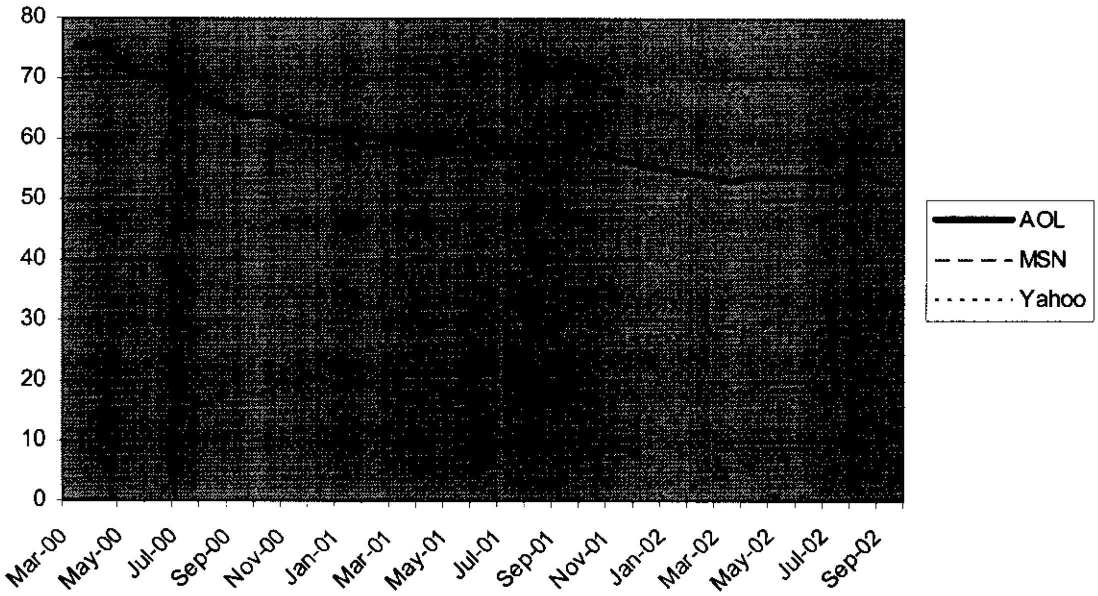
11 For the most current period of October 2002-February 2003, unduplicated data on total IM use (*i.e.*, peoples' use of their personal IM services at home, work, and/or at universities) were available and this is what is reported in Table 1. **Only** unduplicated data for home **use** are available all the way back to March of 2000, ***so*** Table 2 reports only on home use for the period March 2000-September 2002. This difference would tend to produce slightly lower reported user numbers for all three competitors in Table 2.

Table 2: Unique Users by Month for Instant Messaging Services: Mar '00-Sep '02

	000's of users				Percent of Total Users		
Date	**AOL**	**MSFT**	**Yahoo**	**Total**	**AOL**	**MSFT**	**Yahoo**
Mar-00	33355	4748	6213	44316	75.3	10.7	14
Apr-00	33732	5170	5736	44638	75.6	11.6	12.9
May-00	33915	6009	7952	47876	70.8	12.6	16.6
June-00	34779	6503	8457	49739	69.9	13.1	17
Jul-00	35223	7611	8700	51534	68.3	14.8	16.9
Aug-00	35321	8798	9371	53490	66	16.4	17.5
Sep-00	34479	9573	9541	53593	64.3	17.9	17.8
Oct-00	34774	9986	9497	54257	64.1	18.4	17.5
Nov-00	35487	11537	10564	57588	61.6	20	18.3
Dec-00	35584	12043	10240	57867	61.5	20.8	17.7
Jan-01	36816	13016	10416	60248	61.1	21.6	17.3
Feb-01	37770	13997	10795	62562	60.4	22.4	17.3
Mar-01	37599	14817	10869	63285	59.4	23.4	17.2
Apr-01	37871	16050	10788	64709	58.5	24.8	16.7
May-01	37262	16383	10711	64356	57.9	25.5	16.6
June-01	39293	16927	11327	67547	58.2	25.1	16.8
Jul-01	41487	17425	11637	70549	58.8	24.7	16.5
Aug-01	41626	18408	12026	72060	57.8	25.5	16.7
Sep-01	41670	18539	11935	72144	57.8	25.7	16.5
Oct-01	42950	19044	12616	74610	57.6	25.5	16.9
Nov-01	43927	20586	13742	78255	56.1	26.3	17.6
Dec-01	44964	22236	14004	81204	55.4	27.4	17.2
Jan-02	45433	22783	14403	82619	55	27.6	17.4
Feb-02	45362	23117	15424	83903	54.1	27.6	18.4
Mar-02	46322	25168	15583	87073	53.2	28.9	17.9
Apr-02	46381	24321	15738	86440	53.7	28.1	18.2
May-02	47595	24618	16308	88521	53.8	27.8	18.4
June-02	47773	24724	16275	88772	53.0	27.9	18.3
Jul-02	46871	25025	16619	88515	53	28.3	18.8
Aug-02	50454	25332	16553	92339	*54.6*	27.4	17.9
Sep-02	48216	25283	17658	91157	52.9	27.7	19.4

Figure 1 presents graphs of market shares over the applicable time period.

Figure 1
Market Shares of IM Providers Mar00-Sep02



Based on examining the market share figures in Table 2 and the graphs of market shares in Figure 1, it is evident that **AOL's** market share has been declining fairly consistently over the 31 month period from March 2000 through September 2002. Between March of 2000 and December of 2000, **AOL's** market share dropped by approximately **14** percentage points. Between **January** of 2001 and December of 2001 it dropped by a further ***5*** ½ percentage points. Finally, between January of 2002 and September 2002 the decrease was 2 percentage points. Over this period declines in **AOL's** market share were matched by increases in both its competitors' market shares. While no data are reported for the period before March 2000, **AOL** was the initial entrant in this market and did not face competition from Yahoo! Messenger or

MSN Messenger until mid-1999." Therefore, the market share of AOL was 100 percent in early 1999 before any entry occurred and likely declined continuously between when entry occurred and March 2000.

B. What the Data Mean

The data clearly show that AOL is still a strong competitor in this market. However, the data also clearly show that there are two additional strong competitors who have substantial market shares themselves. Furthermore, the data show that these competitors' market shares have been continuously and consistently growing at the expense of AOL's market share over the entire three and a half year period since they have entered the market. At the time the Commission adopted its ***Order*** in January of 2001, Microsoft and Yahoo! had been in the market for little over a year. Although their shares had been growing very rapidly over this period, the Commission chose to discount this evidence, perhaps because the market was still so new.

In particular, the Commission predicted that if AOL did not interoperate with its competitors, that the market would "tip" to AOL because existing customers of Yahoo! and Microsoft would choose to switch to AOL because of its larger customer base and that Yahoo! and Microsoft would therefore shrink in size.[13] The ***Order*** specifically predicted that new customers would generally prefer AOL because of its larger customer base.[14]

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[12] Yahoo! Messenger launched on June 21, 1999. See "Yahoo! Key Milestones," http:lldocs.yahoo.comiinfoiprlmilestones.htd. MSN Messenger launched roughly one month later, on July 22, 1999. See "MSN Messenger Service Reaches Over 700,000 People In First Six Days of Availability," http://www.microsoft.com/presspass/press/1999/Jul99/Sixdayspr.asp.

[13] ***Order*** at ¶ 155 ("The largest provider's refusal to interoperate will lead to users switching to it from the smaller providers, which will further swell the dominant provider's NPD and shrink the smaller ones. This will continue until the largest provider's network is the dominant one, perhaps yield the provider monopoly control of the market.").

[14] *Id.* at ¶ 158 ("Most users of IM want to he able to compose their buddy lists from, and/or engage in IM with, the largest number of other users. Therefore when choosing between rival IM services, a typical new user will place the greatest value on the service with the largest NPD (and therefore the most users) ***and will*** choose ***that service.")*** (emphasis added).

These predictions, which served as the basis of the Commission's decision to impose the Condition,[15] have been flatly contradicted by actual events. Microsoft and Yahoo! have continued to grow strongly over the past two years. In fact they have continued to grow at a greater rate than AOL so that their absolute market shares have increased. Between January of 2001, when the Commission adopted its ***Order,*** and September 2002, the market share of AOL dropped 8 percentage points while the market shares of Microsoft and Yahoo! increased, respectively, by ***6*** percentage points and 2 percentage points.

Perhaps the most significant and important finding of non-dominance that the Commission has ever made was its finding in 1995 that AT&T was no longer dominant in the market for long distance.[16] Although the economic issues at stake here are somewhat different, it is instructive to compare the level and trends in AT&T's market share at the time it was found to be non-dominant with the level and trend of **AOL's** market share today. 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% to 55.2% (as measured by revenue) and to 58.6% (as measured by minutes).[17] The Cornmission found that "the decline in AT&T's market share suggests that AT&T no longer possesses market power." The Commission also found that "AT&T faced at least two full-fledged facilities based competitors," Sprint and MCI, as well as many smaller rivals.[18] Note that AOL's current market share of

15 "The Majority essentially employs a '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." ***Powell Separate Statement*** at **4-5**.

16 ***See generally*** *In* ***the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier,*** **11 FCC** Rcd **3271** at **¶ 67 (1995).**

17 ***See id.***

18 ***See id.*** at **¶ *70*.**

58.5% is essentially the same as AT&T's market share at the time it was found to be non-dominant. Furthermore, just as for AT&T, AOL's share has been consistently declining and it also faces two strong competitors as well as smaller rivals.

II. OTHER EVIDENCE OF COMPETITION

Of course, other factors besides the level and trend in market shares can be important to help assess the level of competition in a market. In this section I will describe a number of such factors that reinforce my conclusion that competition in the market for instant messaging is healthy and that there is no danger that the market will "tip" towards AOL.

A. Competition has driven prices to zero

A reasonable definition of market power is that a firm has market power if it is able to increase its profits by raising price above the competitive price. According to this definition, it seems clear that AOL has not demonstrated any market power because AOL, along with its two competitors, makes its IM services available to consumers **for** free. I think the most natural interpretation of this fact is that consumers' demand is very elastic with respect to price and that price has therefore been competed down to zero. To put this another way, I think the fact that AOL does not raise its price above zero provides rather strong evidence that AOL perceives that it would lose a substantial fraction of its customers if it raised prices above zero. This is not consistent with the existence of market power.

B. Both competitors have already introduced streaming video AIHS services

Both Microsoft and Yahoo! have already entered the market for streaming video AMS services ahead of AOL. This, once again, provides independent evidence of their competitive viability. Yahoo! was the first to enter this market. Version 5.0 of Yahoo! Messenger, which was released in the fall of 2001, included the first instant messaging service to integrate Webcam functionality. Microsoft's IM offerings, MSN Messenger and Windows Messenger, also each provide streaming video capabilities."

C. Microsoft bundles its IM services with Windows XP

In the Petition to which this report is attached, AOL Time Warner describes Microsoft's Internet strategy that has unfolded since the ***Order*** was adopted, which includes the bundling of Microsoft Passport, Windows Messenger and Windows Media Player into its new operating system, Windows XP. The Windows operating system's dominance ensures widespread adoption of Windows XP. In its first year of sales, consumers purchased over **67** million copies of Windows XP.[20] **A** Microsoft executive has noted that during Microsoft's third quarter 2002, "Windows XP shipped on nearly 60% of all new PCs, which represents a faster penetration than any of our previous operating systems."" Therefore Microsoft can use Windows XP as **a** "platform" to encourage widespread adoption of its own IM service.

D. Both competitors have substantial non-IM related subscriber bases which they could use to increase their IM subscriber bases

Both Microsoft and Yahoo! have substantial non-IM related subscriber bases, and there is no reason to doubt they could use these subscriber relationships to further populate their own NPDs and then prompt those subscribers to activate an NPD-based service such as IM. For example, Microsoft's "Passport" service is used as a means of identification and authentication for a variety of Microsoft sites (for example, Hotmail and Microsoft Communities). Microsoft

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[19] ***See*** http://www.microsoft.com/windowsxp/pro/using/howto/communicate/videoconf.asp (Windows Messenger); Jim **Hu,** "Microsoft Flicks On Webcam," ***Cnet News.com*** March 11,2003, available at <http://news.com.cod2 102-1025-992080.html> (MSN Messenger).

[20] ***See Microsoft Announces Record First Quarter Revenue,*** PR Newswire October 17, 2002.

[21] ***See*** "Microsoft Announces Fiscal Third Quarter Results," http://www.microsoft.com/PressPass/press/2002/apr02/04-18Q02-3EarningsPR.asp (posted 4/18/02).

reported in March of 2002 that consumers have signed up for over 200 million Passport accounts" and that Passport authentications exceed 3.5 billion per month.[23] By October of 2002, consumers had signed up for over 270 million passport accounts.[24] Similarly, both access to Yahoo! Messenger and the various proprietary Yahoo! sites (Yahoo! Groups, Yahoo! Personals, Yahoo! Mail, etc.) require a Yahoo! ID, and Yahoo! has issued more than 86 million IDs.[25]

For all of these reasons, I am more certain that the market for IM has not "tipped," and, contrary to predictions made when the ***Order*** was adopted, it is not in danger of "tipping" to AOL.

III. THE COSTS OF MANDATING COMPATIBILITY IN MARKETS WITH NETWORK EFFECTS

In this section, I explain why the Condition is likely to impose social costs even though it generates no social benefits. Although the Condition itself does not require AOL to interoperate with its competitors, the intent behind the Condition, and its practical effect, is to create incentives for AOL to make its IM offerings interoperable with other IM services. I explain why imposing compatibility conditions on certain competitive network industries in some cases can be costly and create inefficiencies and distortions.

A huge variety of modem markets exhibit what economists refer to as "network effects," which simply means that consumers of a product derive more value from that product as more consumers purchase or use it. With respect to instant messaging, the source of network effects is that people value a network more to the extent that more people join the network, because this

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22 *See* ".Net Passport Overview," http://www.microsoft.com/netservices/passport/overview.asp (viewed 03/11/03).

23 *See* 'Customers Wary of Online IDs," http://news.com.com/2100-1001-892808.html (posted 4/26/02).

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

allows them to communicate with more people. The market for word-processing software provides another example. In the word processing market, the source of network effects is that people often wish to exchange files with one another and therefore find it convenient if they use the same program.

In many markets with network effects, it **is** also often possible for firms to arrange for their products to be "compatible" so that consumers using two different products can share in the network effect. For example, in the market for instant messaging, two services would be compatible if the two services interconnected so that the user of one service would be able to communicate equally well with the users of either service. In the market for word processing software, one could achieve compatibility by arranging for two programs to be **very** similar to one another and for a good translation device to be created which allowed one to easily translate files between programs.

In markets with network effects there **is** an obvious gain to be had from compatibility of products. This is simply that more positive network externalities can be created. Nonetheless, in many competitive markets which exhibit network effects it is often the case that not all firms choose to he compatible with other firms. Furthermore, government generally does NOT attempt to mandate compatibility through regulation in competitive markets. This is because at least four types of **serious** problems can occur when government attempts to mandate compatibility.

Each of these can be nicely illustrated with reference to the market for word-processing programs. Suppose, for example, that government contemplated issuing a set of standards that all word processing programs must follow in order to facilitate and enable translation between

[25] ***See* Chris Kidder,** "Yahoo! **is ready to spread spam,"** ***Florida*** **Today, April 2,2002 at 1 People.**

programs. The first problem with such a scheme is that the standards would likely constrain individual firms' design decisions. The second problem is that it would be extremely costly and time consuming to come up with a set of standards, adjudicate disputes that arose, and keep continually updating the standards as necessary. The third problem is that firms could attempt to use the regulatory process to their own advantage in order to disadvantage competitors. The fourth problem is that firms would lose much of their incentive to innovate because the process of keeping products compatible would require innovating firms in many cases to share their innovations with their competitors.

Therefore, because government recognizes that mandating compatibility can constrain design changes, is costly, can provide opportunities **for** firms to game the regulatory process, and can reduce firms' incentives to innovate, government generally does not choose to mandate compatibility in markets with network effects so long as they appear to be sufficiently competitive. In such markets individual firms, for their **own** competitive and strategic reasons, often choose not to become perfectly compatible with all other firms. However, government does not view this as a sign that regulatory intervention is automatically necessary. Rather, regulators realize that, to some extent, firms have an incentive to compete in innovation precisely because their products are incompatible and that regulation imposes many of its own costs and distortions.

Of course this is not to say that there is never any role for government to mandate or at least encourage compatibility in some cases. For example, if network effects are large enough and if one firm becomes dominant enough in a market, then the market may "tip" if the large firm refuses to make its product compatible with those of competitors and we would be left with