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December 9, 2000

Ms. Deborah Lathen
Chief, Cable Services Bureau
Federal Communications Commission
445 12th Street, S.W. --- The Portals
TW-B204
Washington, DC 20554

Re: **REDACTED: FOR PUBLIC INSPECTION**
America Online, Inc. Notice of *Ex Parte* Presentation
Applications of America Online, Inc. and Time Warner Inc.
for Transfers of Control, CS Docket No. 00-30

Dear Ms. Lathen:

This letter responds to the latest flurry of submissions by Microsoft *et al.* regarding instant messaging (“IM”). Attached to this letter are a series of charts providing additional data refuting the still-unsupported claim that IM has “tipped” to AOL. Also accompanying this submission is a letter from Professor Steven C. Salop to FCC Chief Economist Gerald Faulhaber dated December 8, 2000 (the “Salop Letter”) that answers the remarkable suggestion of Microsoft’s economist that—even in the absence of “good information regarding market shares and other relevant data”—this Commission should ignore the law and Commission precedent and instead presume the benefits of regulation over non-regulation in the field of instant messaging.

Throughout this proceeding, the argument for those seeking FCC intervention in instant messaging has been an elusive one. Microsoft *et al.* have never quite settled on just what relevant product market might be at issue, nor on what market failure could be shown to warrant unprecedented government regulation of this nascent Internet service. Why this merger would be the appropriate venue for mandating IM interoperability has remained elusive as well.

What has been quite clear, however, is that every new theory and claim advanced by Microsoft *et al.* has been predicated upon the fundamental premise that AOL controls 80-90 percent or more of all *active users* of Instant Messaging and, further, that this “market” has tipped—or is in the process of tipping—to AOL.

To this day, Microsoft *et al.* have provided no evidence that would substantiate that fundamental premise. This complete lack of supporting marketplace data remains equally true

following Microsoft's woefully delinquent confidential submission of evidence which []¹ As Professor Salop explains (and Microsoft *et al.*'s tipping theory concedes), "If IM services were tipping to AOL, then AOL's share of IM should be increasing."²

All of the data submitted in this proceeding demonstrate one unassailable fact: Microsoft's MSN Messenger and Yahoo! Messenger have been enjoying growth rates faster those that of AOL's IM services. With its competitors growing more rapidly, AOL's "market share" in IM has—by any measure—fallen significantly. Thus, this record not only fails to substantiate a claim that IM (or any relevant "market" or essential input) has "tipped" to AOL; fairly read, the record in fact permits no such finding. This is plainly true no matter which of the parties' rotating theories of competitive harm is under consideration at a given moment.

To the extent the concern has been that AOL is poised to leverage its IM position into an "unassailable dominance" of future "advanced IM" services that might depend on the combination of inputs that underlie IM today (including online user name directories and presence detection), available data confirms that this theory is not only highly speculative but plain wrong.

- First, as illustrated in the last of the attached charts, the Internet arena is populated by a wide array of companies who already today have substantial online user name directories that could be readily combined with widely available presence detection technology and any provider's IM capability. Therefore, there are a number of major potential competitors readily able to enter the marketplace should the existing participants seek, *inter alia*, to impose a price for IM service or otherwise seek to disadvantage IM users.
- Second, even if one artificially limits consideration to those already offering IM services, it still must be recognized that Microsoft and Yahoo! have online user name directories from their core lines of business that far exceed their active IM user base. *See* attached.
- Third, even if one artificially limits the analysis still further to consider only those companies' base of users who have both already downloaded IM software and whose presence is already detectable, then the Media Metrix metric of "unique visitors" would measure just that. And, as noted below and illustrated in the attached charts, these

¹ [], the record at this late date remains barren of any internal figures from Microsoft *et al.* regarding their actual user numbers. AOL submitted its internal numbers for active users of AIM, AOL's IM feature, and ICQ on July ____, 2000.

² *See* Salop Letter at 2.

numbers for Microsoft and Yahoo! have grown dramatically—at rates far faster than those of AOL’s IM services.³

- Fourth, while AOL still retains the early (but rapidly diminishing) lead in “unique visitors” it earned as the innovator in this space, AOL has no ability to keep an IM user exclusive to its online user base. To the contrary, the record demonstrates clearly that many IM users already populate the user base of multiple competing IM providers.
- Fifth, there already exist other distribution technologies – functionally substitutable for IM distribution – for the services that are posited as “advanced IM services” (namely video streaming). Today, electronic audio and video distribution is occurring via stand-alone streaming technologies (again, dominated by Microsoft’s Window Media Player), file-sharing technologies (*i.e.*, the rapid growth of Napster and the emerging growth of Gnutella), and email file attachments. Thus, the set of inputs underlying the IM application is just one of several methods by which competitors can distribute advanced video streaming or other services competitive with potential “advanced IM” services.

Thus, any notion that AOL holds (or, through this merger, could secure) an “unassailable” position in future IM extensions because of its alleged dominance in the “essential inputs” for such potential offerings is simply unsupported by the record evidence.⁴ To the contrary, it is Microsoft—having now bundled its already fast-growing IM service with its new operating system—that is poised for unchecked growth in any future IM marketplace.

³ The fact that AOL’s IM services retain a relatively larger share of the various user and usage calculations than other IM competitors is not to the contrary. As noted in the Salop Letter, until relatively recently AOL was the sole provider of IM services. Yet, “because the growth rate of MSN Messenger and Yahoo! . . . has far exceeded that of AOL, AOL’s share has been falling over time.” Salop Letter at 2.

⁴ Despite attempts by IM competitors to demonstrate some sort of nexus between the IM issues raised in this proceeding and the merger of AOL and Time Warner, there is absolutely nothing in the record that shows, or could show, that AOL’s ownership of Time Warner’s video content or broadband platform “inputs” for possible “advanced IM” services could somehow foreclose other IM providers from readily obtaining comparable inputs from competing providers. Time Warner has only a small share of video or other content in the offline world, and a miniscule share of Internet content available for any posited advanced IM service. Likewise, Time Warner’s cable systems are well within FCC ownership limits, and, of course, the FCC has found cable to face significant and growing competition from alternative broadband providers.

In addition, it should be noted that data on total minutes of IM usage—while confirming the undeniable evidence of Microsoft and Yahoo!’s rapid growth and AOL’s declining share in the IM arena—are of no direct relevance to this “input theory” of AOL TW dominance over future “advanced IM” services.⁵ Indeed, IM competitors have long claimed that “active users” is the critical indicia of AOL’s alleged market power, that it is AOL’s market share of “active users” that reaches or surpasses 80-90%, and that it is for this reason the merger of AOL TW merger poses such risk to advanced IM services.⁶ Faced with the plainly contrary evidence of active user numbers now in the record, however, Microsoft *et al.* shift their theory once again.

Now, Microsoft *et al.* submit, it is not the number of users but rather the duration and intensity of use that is the critical metric for assessing competition in the IM arena of today.⁷ This, of course, does nothing to further the “advanced IM input” theory that at least purports to have (however strained) some nexus to this merger, since that theory does not depend on current IM usage at all but on a supposed control of the inputs to existing IM services (where, as we have shown, AOL has strong existing and potential “input” competitors). Moreover, as the attached charts illustrate, the data on total usage minutes of IM services further confirm the clear trend lines: AOL’s early lead as the innovator of IM services has diminished as Microsoft and Yahoo! have introduced IM services and experienced substantially steeper rates of growth.⁸

⁵ The Media Metrix total minutes data does not, for instance, measure how long a user’s presence is being detected by its IM provider, as presence detection does not require an IM user’s window to be open and active.

⁶ See, e.g., *Notice of Ex Parte Presentation on behalf of iCast*, CS Docket No. 00-30, October 10, 2000, Testimony of Margaret Heffernan, President and CEO, iCast Before the House Subcommittee on Telecommunications, Trade, and Consumer Protection, at 3 (“alleging AOL’s control of well over 80% of the active IM users”).

Microsoft, *et al.*, now attempt to deny the significance of the Media Metrix “unique visitor” data that undermine the “tipping” claim. These parties appear to suggest that their “unique visitors” are largely customers who have downloaded and installed their IM software but activate it only in order to shut it down. The substantial growth in Microsoft and Yahoo! total minutes of IM use clearly contradict this unsupported hypothesis, as illustrated in the attached charts.

⁷ See *Notice of Ex Parte Presentation of IM Unified and AT&T*, CS Docket No. 00-30, November 22, 2000, at 2 (“The real question is duration and intensity of use.”).

⁸ [] Second, [] “network effects” cannot rationally include ICQ; ICQ is not interoperable with AIM or the AOL IM feature. Whatever calculation of
(Continued...)

As further demonstration of the absence of any “tipping” to AOL in the IM arena, the attached charts show that:

- while MSN Messenger and Yahoo! Messenger have enjoyed unprecedented growth since their inception in the middle of last year, the growth of AOL’s IM services has been largely flat;
- in order to obtain an accurate count of the total number of unique individuals in AOL’s IM user base, it is necessary to avoid “double counting” those individuals that use more than one AOL IM service—significantly reducing inflated calculations of AOL user share;
- rapid growth by MSN Messenger and Yahoo! Messenger has dramatically reduced AOL’s share of IM users among leading IM providers’ “unique visitors” from virtually 100% just last year to approximately 63% today for all its services—and only 56% for the two interoperable AOL IM services offering any conceivable network effects;
- MSN Messenger and Yahoo! Messenger also have experienced rapid growth in IM usage minutes—far outdistancing the growth rates of AOL’s IM services; and
- even if these rapidly rising competitors were not enough to allay the unfounded fear of market “tipping,” a number of other online businesses stand at the ready—with their vast online user name directories—to be effective potential competitors to AOL in any “advanced IM” businesses that might emerge.

As noted above, the accompanying letter from Professor Salop responds to the submission of Microsoft’s economist that, even though “it is extremely difficult to get good information regarding market shares and other relevant data that would allow one to predict the effects of that merger with a high degree of confidence,”⁹ the Commission should nevertheless abandon its long-standing policy by intervening in the marketplace to regulate Internet services for the first time by “imposing IM

(...Continued)

AOL/AIM minutes of use remains, it is the marked decline in AOL’s share and not its absolute size that is most striking given the shortness of time since Microsoft and Yahoo!’s entry into this arena—and it is this rapid competitor growth that is most telling of a service that has not tipped.

⁹ See Letter from Frederick R. Warren-Boulton to Magalie Roman Salas dated December 5, 2000 (the “Warren-Boulton Letter”).

interoperability conditions.”¹⁰ Far from being inconclusive, however, all of the available data precludes any finding that IM has “tipped” to AOL. As Professor Salop explains, not only do the available data show that “IM services appear to have a demand and cost structure that allows for vibrant competition from new entrants,” but the record evidence indicates that “[t]here is no reason to expect this process to reverse itself.”

Moreover, even assuming for the sake of argument that (as Microsoft contends) the data on this point is inconclusive, the potential for harm from unprecedented intervention in the Internet marketplace cannot be lost on the Commission. Clearly, as Professor Salop demonstrates, “[c]ompetition and innovation would be better served if the Commission allows the different providers of IM services to remain unregulated, free to innovate and develop new features.”¹¹ Far from being cost-free to consumers’ safe and truly instant enjoyment of IM, “[i]mposing restrictions on AOL (or any other innovator) will make innovation much more costly [and] ... will likely result in less functionality now and in the future.”¹² Indeed, imposing regulations would impose “a cost for which there is virtually no offsetting benefit.”¹³

To the contrary, Professor Salop explains that it is the cost, not the benefits, of FCC intervention here that could be great:

Microsoft is distributing its MSN Messenger bundled in Windows ME. Because of Windows’ monopoly position, Microsoft will achieve massive distribution in a very short time frame. Indeed, this tactic is analogous to a key component of the strategy that Microsoft used to overcome Netscape’s head start in web browsers and achieve dominance for Internet Explorer in a fairly short time frame, i.e., the bundling of IE with the Windows OS.

IM competition has much to fear from Microsoft’s bundling strategy. As with the IE bundling strategy, Microsoft can use the bundling of MSN Messenger with its OS to achieve a large share of users and then extinguish competition by making proprietary extensions to gain control over the industry IM standard. What would stop Microsoft

¹⁰ See Warren-Boulton Letter at 1.

¹¹ See Salop Letter at 4.

¹² Salop Letter at 3.

¹³ Salop Letter at 3.

from gaining control over IM through bundling and Commission-mandated AOL interoperability and then choosing not to allow its IM users to access other IM services once its control is complete? For example, imagine how misguided it would have been for the Commission in 1995 to force Netscape to take action to stimulate more competition by Microsoft's Internet Explorer.

Beyond just the nascent IM arena, moreover, at stake here is a fundamental marketplace assumption underlying the economics of investment and innovation in Internet services and in information services of all types. That critical premise is that the Federal Communications Commission is firmly committed to a policy of "unregulation" of the Internet and its highly dynamic and innovative businesses so central to the vitality of our economy.

For the FCC to reverse course here—not only without any reliable record evidence of market failure in these nascent (if not wholly speculative) Internet services but in the face of compelling factual evidence disproving any tipping toward AOL in IM services—would be to embrace a strikingly low standard for intrusion in the Internet arena that the Commission has heretofore proclaimed off limits to regulation. And to do so unilaterally as to AOL, at a time when Microsoft has enjoyed unprecedented growth and now has bundled its IM service with its soon-ubiquitous operating system, would be to engage in a wholly unwarranted picking of "winners and losers" in this highly fluid Internet marketplace.

Kindly direct any questions regarding this matter to the undersigned.

Respectfully submitted,

/s/ Peter D. Ross

Peter D. Ross

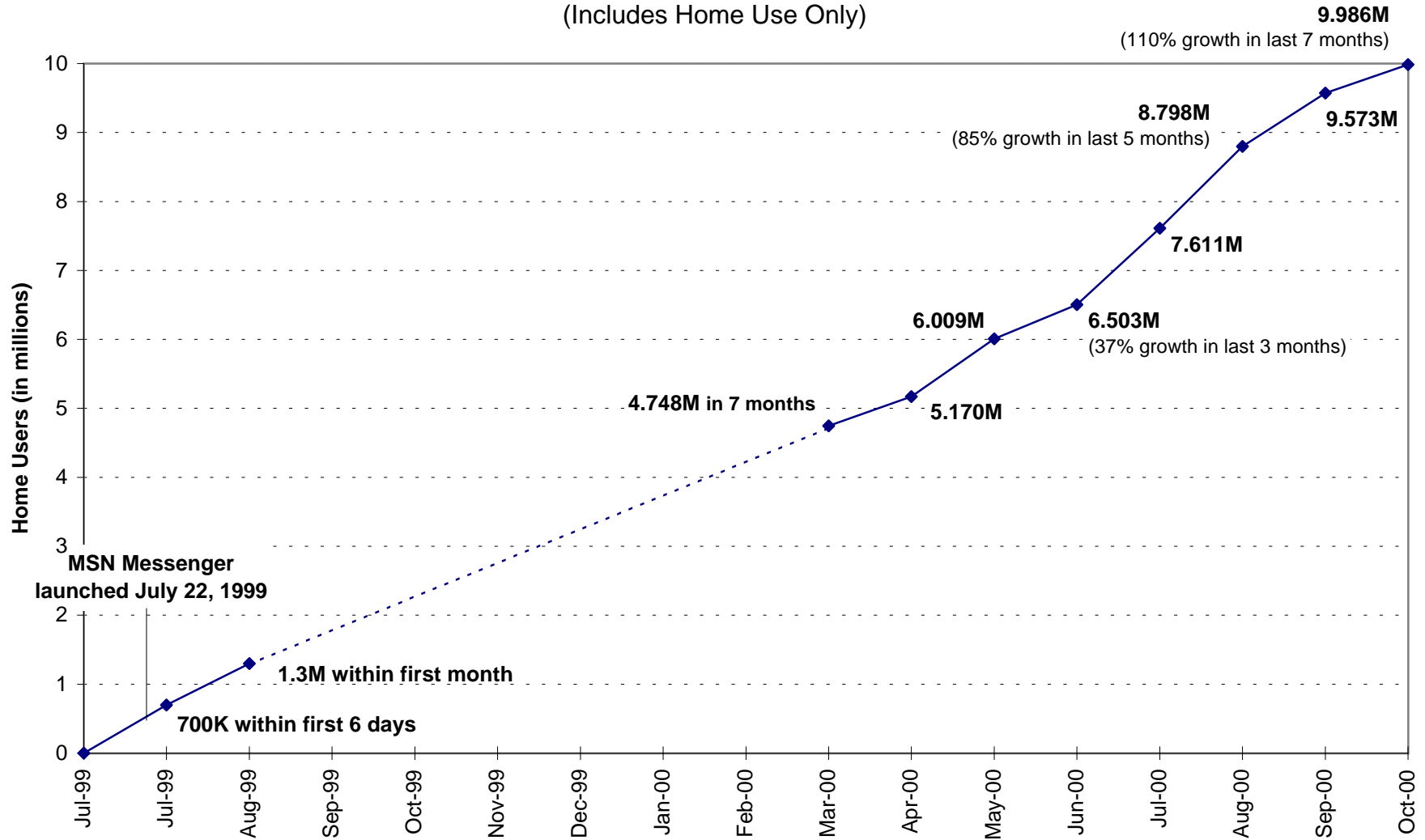
Attachments

cc: Sherille Ismail, Deputy Chief, Cable Services Bureau
Royce Dickens, Deputy Chief, Policy and Rules Division, Cable Services Bureau
Darryl Cooper, Cable Services Bureau
Robert Pepper, Chief, Office of Plans and Policy
Gerald Faulhaber, FCC Chief Economist, Office of Plans and Policy
David Farber, FCC Chief Technologist, Office of Engineering and Technology
Michelle Ellison, Deputy General Counsel, Office of General Counsel
James Bird, Senior Counsel, Office of General Counsel
Joel Rabinovitz, Office of General Counsel

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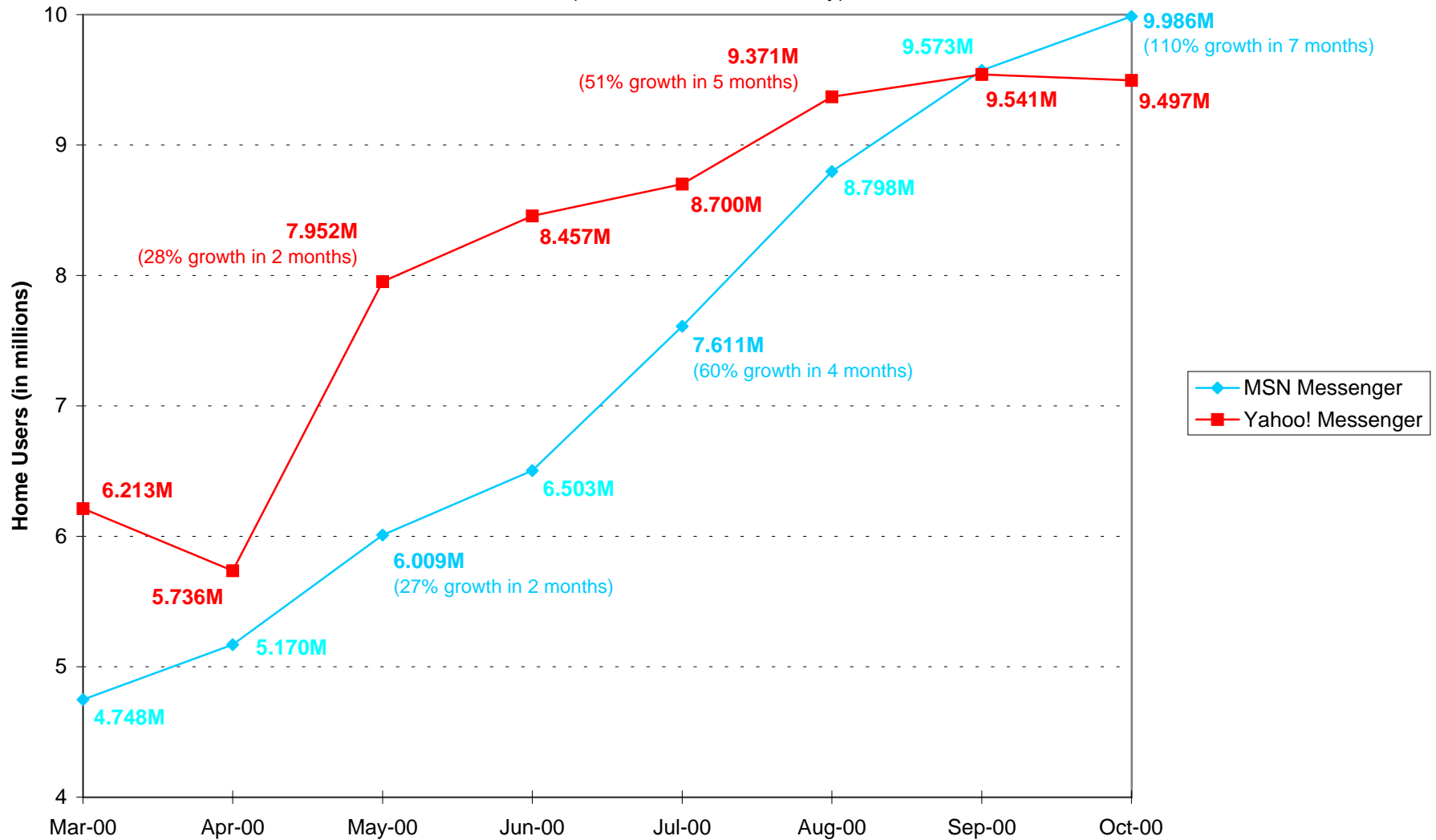
Linda Senecal, Cable Services Bureau
John Berresford, Common Carrier Bureau
International Transcription Services, Inc.

**Microsoft's MSN Messenger Has Enjoyed Unprecedented Growth
Since Its Inception in July 1999**
(Includes Home Use Only)



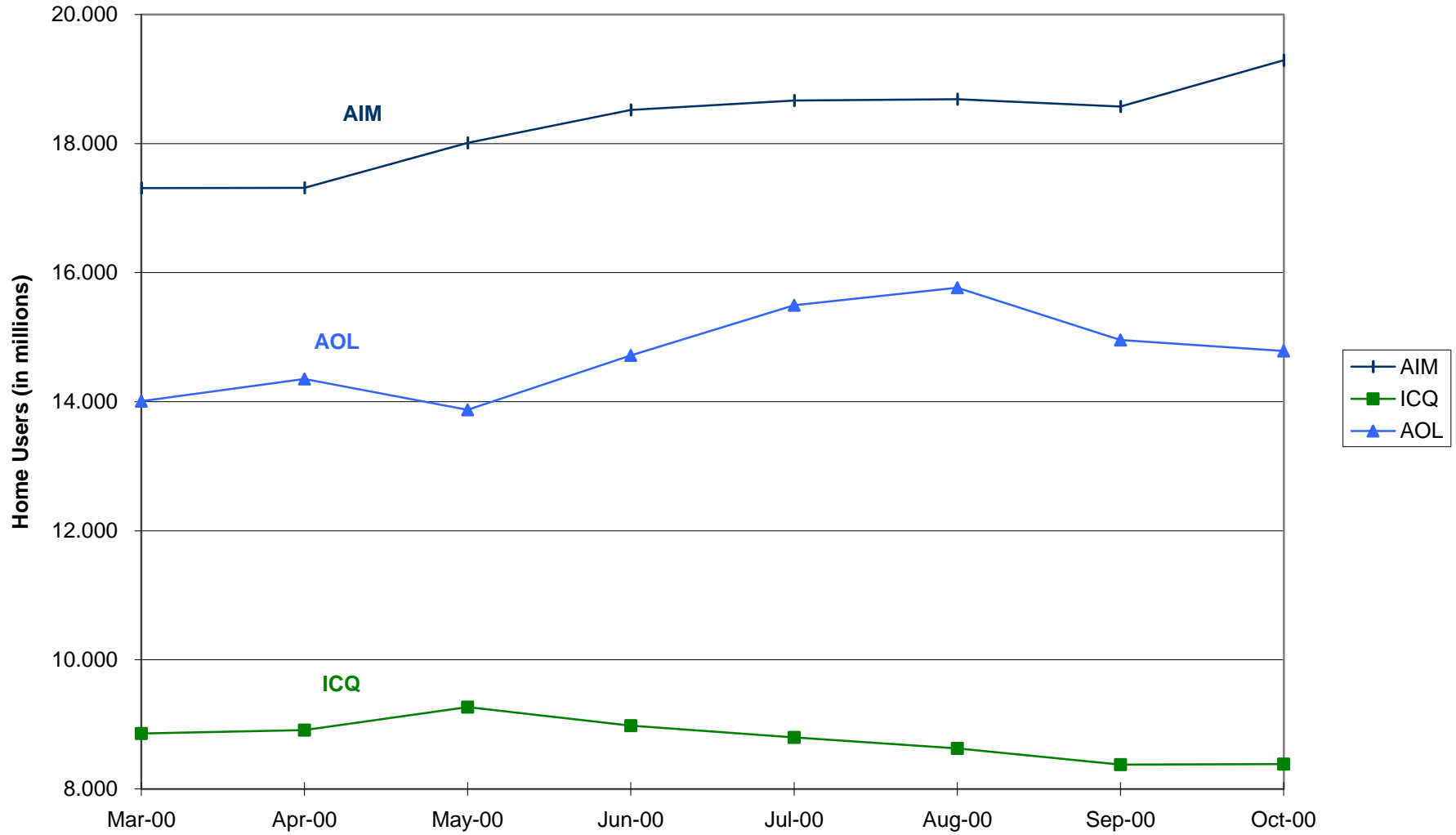
Source: Microsoft Press Releases; Media Metrix (March-October Home Only Unique Visitors)

Both Microsoft's MSN Messenger And Yahoo! Messenger Have Enjoyed Tremendous Growth (Includes Home Use Only)



Source: Media Metrix (March-October 2000 Home Only Unique Visitors)

...While AOL's IM Services Have Been Largely Flat



Source: Media Metrix (March-October 2000 Home Only Unique Visitors)

Calculating The Number Of Unique Visitors Across AOL's IM Services Requires Eliminating Double-Counting

Unduplicated Unique Visitors (in thousands)			
	March 2000	October 2000	% Change
AOL IM	14,007	14,787	5.57%
AIM	17,310	19,291	11.44%
<i>minus duplications</i>	2,885	3,682	27.63%
AOL IM/AIM Unduplicated	28,432	30,396	6.91%
<i>plus ICQ</i>	8,858	8,385	(5.34%)
<i>minus duplications</i>	3,935	4,007	1.83%
AOL IM/AIM/ICQ Unduplicated	33,355	34,774	4.25%

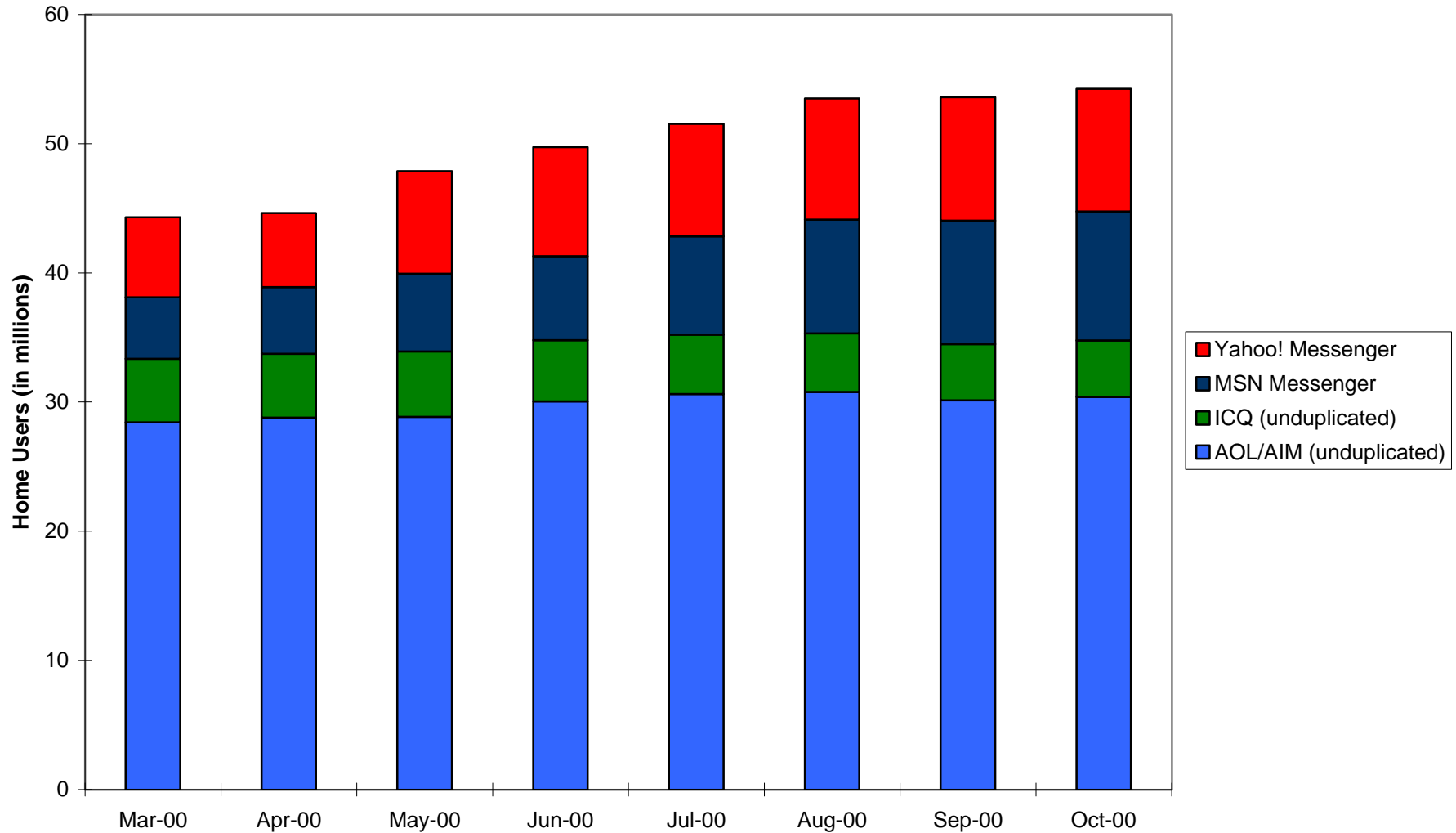
Source: Media Metrix (March, October 2000 Unique Visitors Home Only)

Media Metrix measures IM usage based upon "Unique Visitors," which it defines as "[t]he estimated number (expressed in thousands) of *different individuals* that accessed any content of a Web site or category, a channel or an application as indicated during the course of a given reporting period. All Unique Visitors are unduplicated (only counted once)."

A problem arises, however, because a significant number of consumers use two—or even all three—of AOL's IM offerings (*i.e.*, the IM feature of the AOL online service ("AOL IM"), AOL Instant Messenger ("AIM"), and ICQ). In order to obtain an accurate count of the total number of unique individuals in AOL's registered/presence-enabled user base, it is necessary to take steps to avoid "double-counting" those individuals that use more than one AOL IM service.

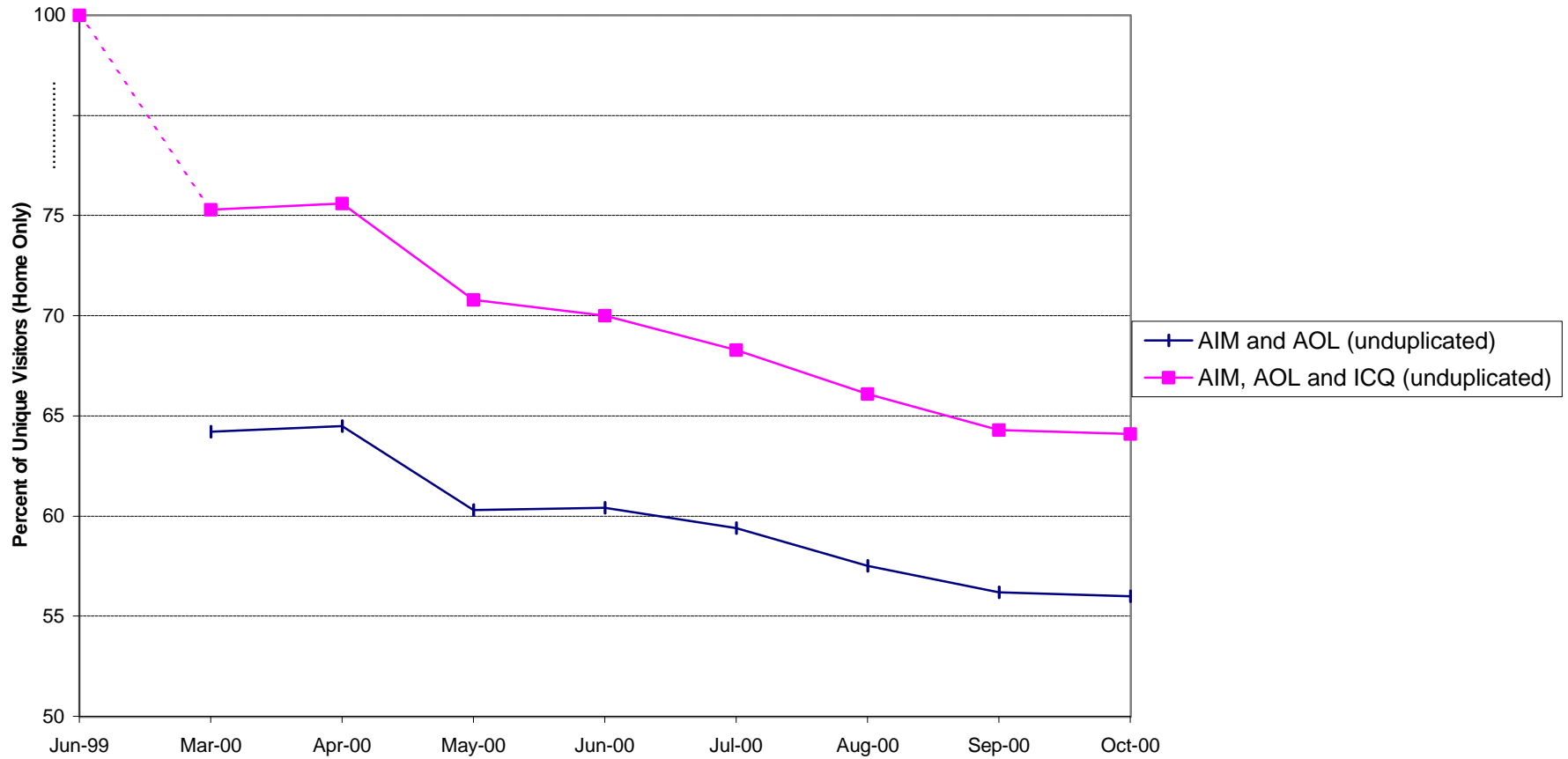
Media Metrix has calculated the number of unduplicated unique visitors (*i.e.*, minus double counts) both between AOL IM and AIM (which is the relevant user base for evaluating the impact of any "network effects" associated with combined AOL IM services) and among AOL IM, AIM, and ICQ (which is the relevant measure of the total number of unique IM users in AOL's presence-enabled user base).

**With AOL's IM Services Flat, Rapid Growth By Microsoft's MSN Messenger And Yahoo!
Messenger Has Substantially Reduced AOL's (Once 100%) Share Of Unique IM Visitors**



Source: Media Metrix (March-October 2000 Home Only Unique Visitors)

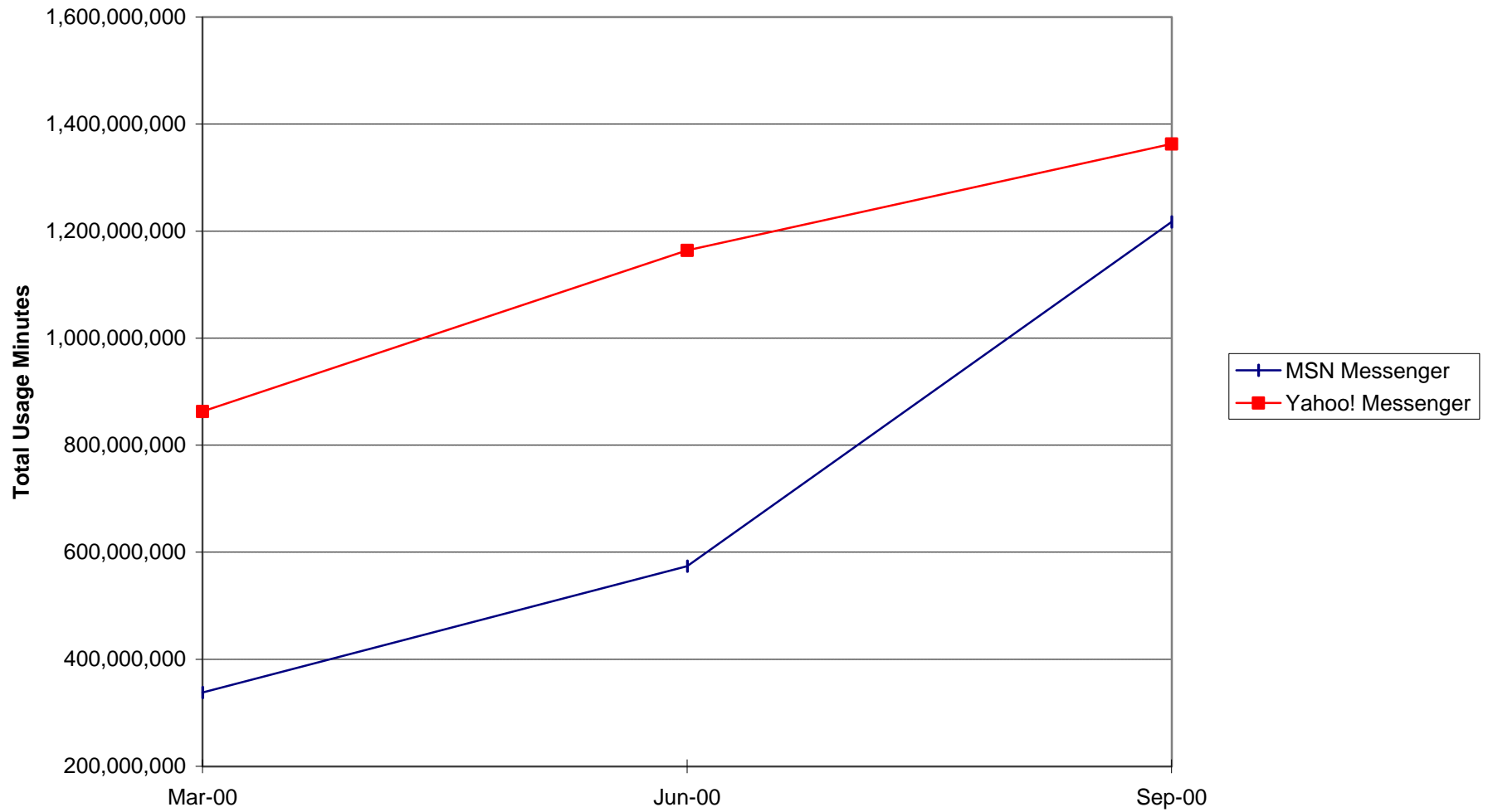
AOL's Declining Share of IM Users Among Leading IM Providers (Home Only)



Source: Media Metrix (March-October 2000 Home Only Unique Visitors)

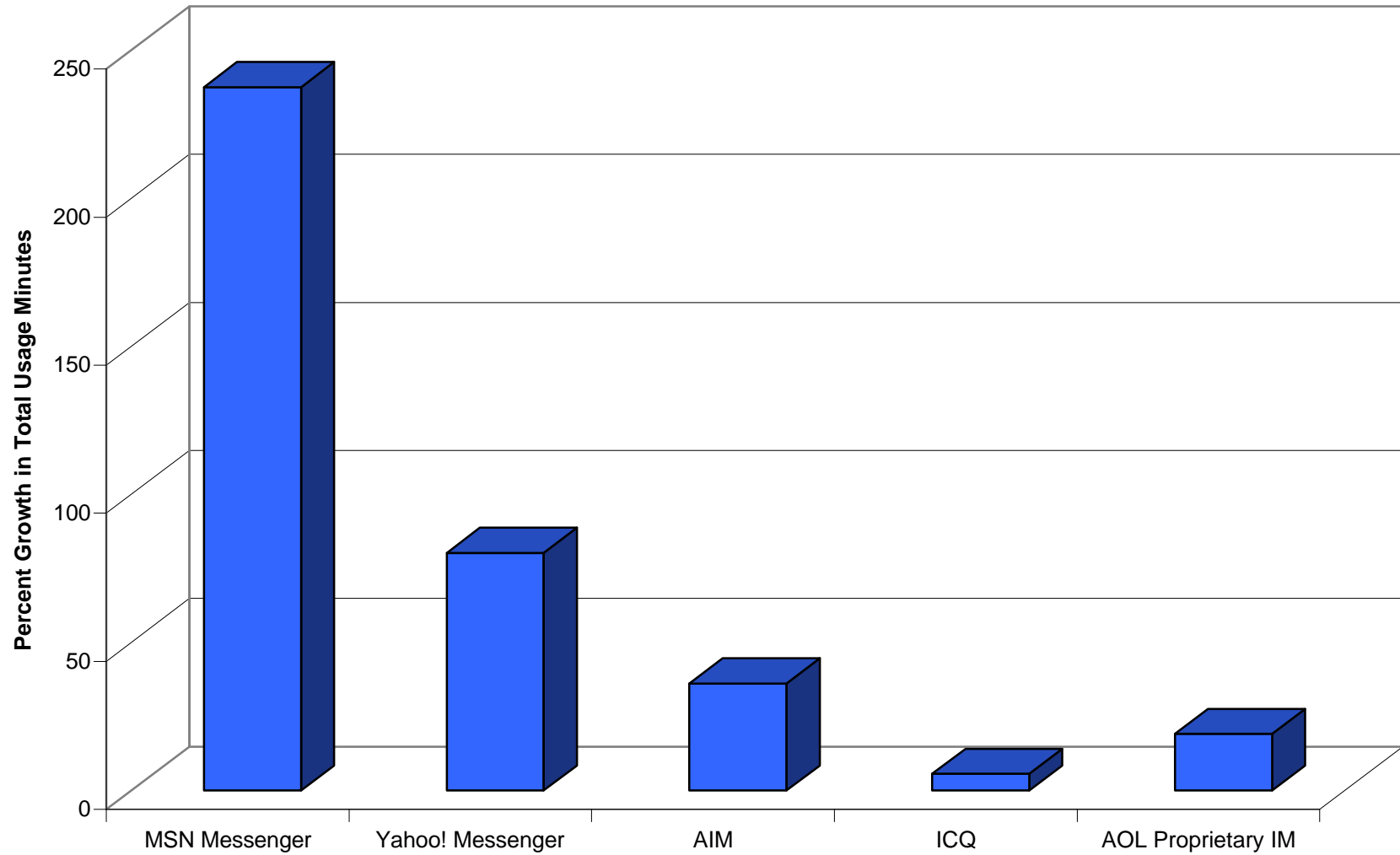
(Universe defined to include only AIM, AOL Proprietary IM, ICQ, MSN Messenger and Yahoo! Messenger;
no data available for dozens of other IM service providers)

Growth In Usage Minutes -- Up From Zero In June 1999 -- Confirms The Rapid Adoption Of Microsoft's MSN Messenger And Yahoo! Messenger



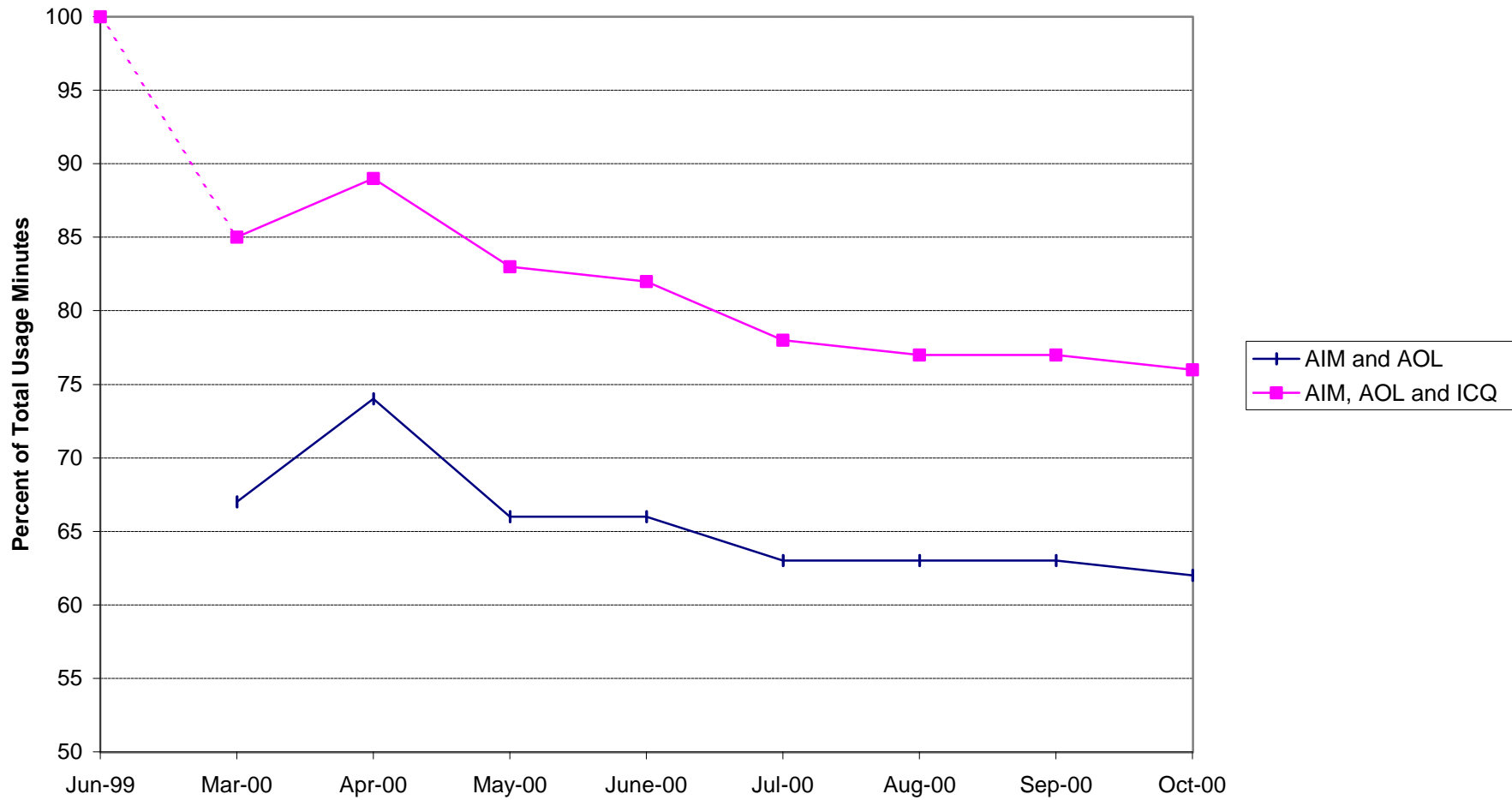
Source: Media Metrix (March-September 2000 Total Usage Minutes)

Growth in Total IM Usage Minutes Among Leading IM Providers From March to October 2000



Source: Media Metrix (March-October 2000 Home/Work Usage Minutes)

AOL's Declining Share of IM Total Usage Minutes Among Leading IM Providers



Source: Media Metrix (March-October 2000 Total Usage Minutes)
(Universe defined to include only AIM, AOL Proprietary IM, ICQ, MSN Messenger and Yahoo! Messenger;
no data available for dozens of other IM service providers)

A Wide Array of Competitors Possess Substantial Online User Name Directories

Search Engine Sites:	Registered Users	Unique U.S. Visitors in October 2000¹
Yahoo!	166 Million ²	56.5 Million
Excite	76.5 Million ³	30 Million
Lycos	61 Million ⁴	31 Million
Go Networks	27 Million ⁵	23 Million
NBCi.com	20 Million ⁶	16.5 Million

Web Content Sites:	Registered Users	Unique U.S. Visitors in October 2000
Real.com Networks	150 Million ⁷	13 Million
Shockwave.com	27 Million ⁸	5 Million (June 2000 data, last time on U.S. Media Metrix Top 50) ⁹
iVillage.com	6 Million ¹⁰	8 Million

E-Tailers:	Registered Users	Unique U.S. Visitors in October 2000
Amazon.com	25 Million ¹¹	17 Million
eBay	19 Million ¹²	16 Million
Travelocity	17 Million ¹³	7 Million
Barnesandnoble.com	6 Million ¹⁴	6 Million

Other:	Registered Users	Unique U.S. Visitors in October 2000
Microsoft - all Microsoft web sites	?	52 Million
Microsoft - Hotmail	40 Million ¹⁵	17 Million (February 2000 data, last time separately stated from other Microsoft sites on Media Metrix's Top 50) ¹⁶
Microsoft - Software	?	?
Napster	32 Million ¹⁷	6.7 Million (users of Napster software, August 2000) ¹⁸
Juno	13 Million ¹⁹	8 Million
EarthLink	4.6 Million ²⁰	9 Million

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- ¹ Unless otherwise specified all unique visitor data is from *Media Metrix Releases U.S. Top 50 Web and Digital Media Properties for October 2000*, Nov. 17, 2000, <<http://us.mediametrix.com/press/releases/20001117.jsp>>.
- ² *Yahoo! Reports Third Quarter 2000 Financial Results*, Oct. 10, 2000, <http://www.sec.gov/Archives/edgar/data/1011006/000091205700044467/a2027609zex-99_1.html>.
- ³ At Home Corporation, *United States Securities and Exchange Commission Form 10-Q for the period ended June 30, 2000*, <http://media.corporate-ir.net/media_files/NSD/ATHM/Q2FY00_10Q.pdf>.
- ⁴ *Lycos, Inc. Corporate Fact Sheet*, visited Dec. 7, 2000, <<http://www.lycos.com/info/fact.html>>.
- ⁵ *WDIG.com Financial Results*, Nov. 9, 2000, <<http://disney.go.com/investors/wdig/about/earnings/2000/2000q4a.html>>.
- ⁶ *NBCi Surpasses 20 Million Members*, May 11, 2000, <http://www.prnewswire.com/cgi-bin/micro_stories.pl?ACCT=139295&TICK=NBCI&STORY=/www/story/05-11-2000/0001215501&EDATE=May+11,+2000>.
- ⁷ Realnetworks Inc., *United States Securities and Exchange Commission Form 10-Q for the period ended September 30, 2000*, <<http://www.sec.gov/Archives/edgar/data/1046327/000089102000002002/0000891020-00-002002.txt>>.
- ⁸ *Macromedia Reports Record Revenues for Second Quarter Fiscal Year 2001*, Oct. 18, 2000, <<http://www.macromedia.com/macromedia/ir/>>.
- ⁹ *Media Metrix Releases U.S. Top 50 Web And Digital Media Properties For June 2000 & Reveals Number One Web Sites Within New Categories*, July 20, 2000, <<http://us.mediametrix.com/press/releases/20000720a.jsp>>.
- ¹⁰ *iVillage Corporate Profile*, visited Dec. 7, 2000, <http://www.corporate-ir.net/ireye/ir_size.zhtml?ticker=IVIL&script=2100>.
- ¹¹ Amazon.com Inc., *United States Securities and Exchange Commission Form 10-Q for the period ended September 30, 2000*, <<http://www.sec.gov/Archives/edgar/data/1018724/000089102000001861/0000891020-00-001861.txt>>.
- ¹² *About eBay: Company Overview*, visited Dec. 7, 2000, <<http://pages.ebay.com/community/aboutebay/overview/index.html>>.
- ¹³ *Travelocity.com and Preview Travel Close Merger*, Mar. 8, 2000, <<http://www3.travelocity.com/pressroom/pressrelease/0,1090,931|TRAVELOCITY,00.html>>.
- ¹⁴ Barnesandnoble.com Inc., *United States Securities and Exchange Commission Form 10-Q for the period ended September 30, 2000*, <<http://www.barnesandnoble.com/ir/secfilings/index.asp?userid=2UNVGWC4HR>>.
- ¹⁵ Microsoft Corporation, *United States Securities and Exchange Commission Form 10-K Annual Report for the fiscal year ended June 30, 2000*, <<http://www.microsoft.com/msft/sec/10k2000.htm>>.
- ¹⁶ *Media Metrix Releases The Top 50 Web & Digital Media Properties In The U.S., & Top Newcomers Among The Top 21,000*, Mar. 21, 2000, <<http://us.mediametrix.com/press/releases/20000321.jsp>>.
- ¹⁷ *Statement of Hank Barry, CEO Of Napster, Following Today's Oral Arguments In Front of the 9th Circuit Court of Appeals*, Oct. 2, 2000, <<http://www.napster.com/pressroom/pr/001003.html>>.
- ¹⁸ *Napster Software-Application Usage Soars 500 Percent to Nearly Seven Million U.S. Home Users, According to Media Metrix*, Oct. 5, 2000, <<http://us.mediametrix.com/press/releases/20001005.jsp>>.
- ¹⁹ *Company Information*, visited Dec. 7, 2000, <<http://www.juno.com/corp/about/>>.
- ²⁰ *Earthlink Reports Third Quarter Financial Results*, Oct. 31, 2000, <http://www.earthlink.com/about/pr/3QFinancial_results.html>.

December 9, 2000

Dr. Gerald Faulhaber
Chief Economist
Federal Communications Commission
445 12th St., SW
Washington, DC 20554

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

Dear Gerry:

We are writing this letter in response to Dr. Warren-Boulton's ex parte communication to the Commission on behalf of Microsoft, dated December 5, 2000.

We agree with Dr. Warren-Boulton on two points. First, when deciding whether or not to impose regulation on an Internet application by mandating IM interoperability, the Commission must weigh the costs and benefits of such regulation. Second, the provision of IM, like the communications market generally, is dynamic. Beyond that, however, we disagree with Dr. Warren-Boulton's analysis of IM.

Dr. Warren-Boulton's claim is that there are no data upon which to make an informed decision in this matter and therefore, the Commission should make its decision in the dark. He then states that regulating this particular use of the Internet has the benefit of preventing the provision of IM from tipping to AOL. Of course, Dr. Warren-Boulton also argues that there are no costs to imposing such regulation. Thus, he concludes that economics counsels the Commission to mandate IM interoperability without carrying out a rigorous analysis of the issue.¹

¹ Dr. Warren-Boulton cites an article co-authored by Professor Salop on judicial and policy decision making. That article does not advise decision makers to ignore relevant and available information, as Dr. Warren-Boulton seems to be doing. Nor does it counsel agencies to ignore the various distortions and other costs that regulations are generally known to cause.

We disagree. In our view, economics counsels the Commission to carefully analyze the market structure and the available data to reach an informed decision, rather than relying on the blind guesswork suggested by Dr. Warren-Boulton.

Dr. Warren-Boulton claims that “it is extremely difficult to get good information regarding market share and other relevant data that will allow one to predict the effects of that merger with a high degree of confidence.” It is surprising that that Dr. Warren-Boulton would be willing to conclude that AOL’s share of IM will cause the market to “irreversibly tip” to AOL without “good information regarding share” or how AOL’s share has changed over time. On what basis is he reaching his conclusion? More importantly, there is relevant data that has been collected by Media Metrix that has been provided to the Commission. Media Metrix is not an interested party, but rather is an independent company whose business is to sell accurate data regarding web usage to decision makers operating in these markets.

The Media Metrix data are useful in evaluating Dr. Warren-Boulton’s tipping claims. If IM services were tipping to AOL, then AOL’s share of IM should be increasing. Throughout much of the last decade, AOL was the indeed the sole provider of IM services because AOL invented the service and was quite naturally first-to-market with it. Microsoft and Yahoo! each began offering their IM services in 1999, joining a large number of other IM providers. In the short time between the introduction of their services in 1999 and today, the Media Metrix data show that Microsoft and Yahoo! have gained a substantial number of users. Thus, far from tipping, IM services appear to have a demand and cost structure that allow for vibrant competition from new entrants. Equally relevant, because the growth rate of MSN Messenger and Yahoo! (and other IM providers) has far exceeded that of AOL, AOL’s share has been falling over time.

There is no reason to expect this process to reverse itself. Microsoft is distributing its MSN Messenger bundled in Windows ME. Because of Windows’ monopoly position, Microsoft will achieve massive distribution in a very short time frame. Indeed, this tactic is analogous to a key component of the strategy that Microsoft used to overcome Netscape’s head start in web browsers and achieve dominance for Internet Explorer in a fairly short time frame, i.e., the bundling of IE with the Windows OS.

IM competition has much to fear from Microsoft’s bundling strategy. As with the IE bundling strategy, Microsoft can use the bundling of MSN Messenger with its OS to achieve a large share of users and then extinguish competition by making proprietary extensions to gain control over the industry IM standard. What would stop Microsoft from gaining control over IM through bundling and Commission-mandated AOL interoperability and then choosing not to allow its IM users to access other IM services once its control is complete? For example, imagine how misguided it would have been for the Commission in 1995 to force Netscape to take action to stimulate more competition by Microsoft’s Internet Explorer.

The cost structure facing IM users also allows the Commission to predict that there will be no tipping to AOL. Tipping typically occurs when customers must use only one of the competing

services exhibiting network externalities and they all choose the same service. In contrast, IM users do not need to select a single exclusive service. Indeed, IM users can and do rely on multiple IM programs in large part because IM programs can be downloaded and used at no charge. Thus, any two users can now communicate over IM by using a number of IM programs. This includes AOL subscribers. AOL does not prevent its subscribers from using a competing IM service. One can find out whether someone uses a particular IM service simply by sending an email. Similarly, every IM service has easy access to the users of every other IM service, including AOL subscribers. These facts imply that the extent of attainable network effects can largely be realized in the current IM environment and that tipping is unlikely to occur. Using multiple IM services is not like buying and having multiple incompatible telephones on your desk. Users of each of the multiple IM services can benefit from network effects. In addition, because of ubiquitous email, customers have virtually all of the functionality contained in IM already available to them. In particular, email allows text-based communication to anyone that also has email. While IM is faster and provides a more intrusive communication interface, there is really no difference in the basic functionality of communicating via text over the Internet.

Dr. Warren-Boulton also inexplicably asserts that regulation of IM would have no costs. This is a bold and unsupportable assertion. As Dr. Warren-Boulton concedes, the provision of IM is a dynamic process. As a result, while it is impossible to predict now exactly what new features might be invented, one can be confident that there will be some innovation in the absence of regulatory barriers. One also cannot reasonably claim that mandated interoperability will have no adverse effects on the innovation process.

Imposing restrictions on AOL (or any other innovator) will make innovation much more costly. Moreover, imposing a government-mandated interoperability on AOL's IM service will likely result in less functionality now and in the future. This is a cost for which there is virtually no offsetting benefit.

Prematurely imposing IM interoperability on AOL also will likely eliminate some of the security that AOL provides to its IM users. Just as a chain is only as strong as its weakest link, a communications system is only as secure as its least secure point of entry. By allowing anyone to interoperate with AOL's IM service, regulators will introduce many unsecured access points that would not exist if AOL and the market are allowed to take the time to develop an interoperability standard that maintains the security that AOL has developed.² In addition, part of the appeal of IM is its near real-time character. Premature government mandated interoperability may reduce performance of such systems and thus undermine the appeal of IM generally. Finally, the

² If Dr. Warren-Boulton's tipping claims were correct, one would have predicted that the "smaller" IM services, such as MSN Messenger and Yahoo! would have found a way to become interoperable among themselves to delay or reverse such tipping. In fact, the failure of those services to become interoperable suggests that advocates of FCC intervention have greatly understated the difficulty of finding a secure interoperability solution.

Commission's mandate would reduce incentives to compete by adding new differentiated features. These all represent significant potential costs of regulation.

Competition and innovation would be better served if the Commission allows the different providers of IM services to remain unregulated, free to innovate and develop new features without endangering competition or harming consumers. Rather than forcing a single IM provider to conform to a government imposed interoperability requirement, the Commission should allow all competing providers to innovate in an unfettered environment. Moreover, while IM providers search for the right interoperability standard, the Commission need not fear that the market will tip to AOL in the interim. This is the type of deregulatory competitive environment that the Act envisioned for competition and innovation to flourish. Simply put, there exists no economic reason to change that policy here and risk a significant reduction in innovation incentives in IM and a chilling effect on innovation in other Internet services.

Sincerely,

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