Open Access To Broadband Networks: A Case Study Of The AOL/Time Warner Merger

by Daniel L. Rubenfeld & Hal J. Singer

Presented by Kevin Morgan and Michael Lewis

Outline

• Introduction: the key players
• Horizontal and vertical antitrust
• Conduit and content discrimination
• The state of the market pre-merger

• Second half of the presentation
The key players

- AOL: Massive US Internet Service (content) Provider
- Time Warner: Large operator of cable systems in the US

But also:
- AT&T
- TCI
- Turner Broadcasting
- Liberty Media

AOL/Time Warner is just one case of the many vertical mergers in Media/Telecomms since the mid 90s

Horizontal and vertical antitrust

- Horizontal mergers:
  - AT&T + MediaOne = Massive Broadband ISP

- Vertical mergers:
  - AOL + Time Warner = Internet content provider
    Broadband ISP
Horizontal and vertical antitrust

- Some more relevant examples:

  "the Internet forces us to reconsider antitrust theory, recognizing that there are a variety of new ways in which firms may engage in anticompetitive behavior."

Content and Conduit discrimination

- Are two anticompetitive strategies
- Available to vertically integrated firms offering transport and portal services over broadband.

  Transport = the cable/line provider

  Portal = the ISP, broadband content, Instant Messaging, etc.

  NB this definition is quite unhelpful! Are Yahoo! and Freeserve really selling the same thing?
Content and Conduit discrimination

• Conduit discrimination
  Restrict the company’s affiliated content (portal services) when accessed via other conduits (transport services)
  Eg: make AOL Broadband only available to cable customers (not DSL)

• Content discrimination
  Restrict other people’s content when accessed via the company’s transport services; ie give better caching or greater bandwidth to AOL Time Warner content, maybe even completely block others’ content.
  Eg: give poor caching support to ESPN (owned by Disney) but good caching to CNN Sport (affiliated to Time Warner)

State of the market pre-merger

• Pre-merger AOL was actually “conduit-neutral”
  • AOL had no interests in any transport service
  • Was in its best interests to make portal services available over any broadband conduit!

• But cable companies became hostile
  • ‘Tying’ strategy forces customers to buy portal services at the same time as broadband transport
  • This starves potential entrants (to the portal market) of customers
  • Cable had the jump on other broadband conduits – it was already there!
  • Could exploit network effects in the small number of portals that existed
State of the market pre-merger

- Vertically integrated firms have the advantage
  - 2/3 of new subscribers to AT&T’s '@home' ISP were stolen from AOL
  - No point in customers paying for two portal services!
  - AOL launches campaign to make broadband access 'open' but it fails

- If you can’t beat them, join them!
  - AOL decides to buy Time Warner
  - Gives vertical advantages as well as bargaining power to use against AT&T

Part 2: Agenda

- Some Pre-Merger behaviour
- A Delineation of Markets
- Identify and qualify Ability and Incentive of Vertically Integrated Firm to Foreclose Rivals:
  - AOL-Time Warner case
    - By Content Discrimination
    - By Conduit Discrimination
Temptation to Anticompetitive Strategy

• Both AOL and Time Warner are sinners
• Pre-merger History: with Ability & Incentive for improper conduct, both succumbed:

  Time Warner:
  • Attempted to block ABC from its cable TV service
  • Imposed massive financial disincentives to non-affiliated ISPs in Texas

  AOL:
  • Made AOL IM incompatible with other IM systems, e.g. iCAST
  • Imposed ‘movement restrictions’ on Disney content

Tools to Analyze post-Merger Ability and Incentive to Foreclose Rivals

• Ability
  – Framework Riordan and Salop
    • Shows limiting factors to AOL-TW’s ability to engage in conduit or content discrimination by analyzing market reaction of other players to variation in supply and price caused by such discrimination

• Incentive
  – Game-theoretical Model Ordover, Saloney & Salop
    • Aims to quantify incentive wrt zero profit Frontier

• Cases in discriminating by conduit and content
Ability to Discriminate by Conduit

- Two questions applied to the market
  - Can downstream conduit rivals foreclosed by AOL-TW either
    - access portals/services equally cost effective to those withheld, or
    - Create their own broadband portals
  - Can consumers switch to alternative portals/service providers not foreclosed by AOL-TW
    - Availability of Substitute Broadband Portals
    - Availability of Substitute Broadband Transport Services

Availability of Substitute Broadband Portal Services

- Determine hypothetical market of non-foreclosed input suppliers
  - Equally cost effective
  - Broadband delivery requires very large economies of scale to achieve cost parity – recognised by FTC
    - Upfront costs cf. distribution costs
A broadband portal can produce content or purchase from independents
- Content needs to be diverse to retain loyalty thus content and service are linked
  - Barrier to Entry into portal market inhibits that to portal market
  - Barriers formidable to new entrants

By Analogy with Time Warner - Turner Broadcasting merger of 1997
- Entry into market is ‘slow and costly’, FTC Commissioners report
- V. large audience required to support development of new programming
- MVPDs need 40 to 60% reach of subscribers
- Based on above, risk in vertical for closure is real and substantial
- Shared inputs same scenario for broadband content
  - Plus infrastructure of servers, additional bandwidth, codecs-weakening
  - Video farms, optical metro back-bones
- Market leaders only
### Availability of Substitute Broadband Transport Services

- **Cable modems dominate (US Market)**
  - 68% at time of writing
    - Shared medium ergo traffic constraints
    - Restrictions on hosting/commerce usage
    - Uneven roll outs
- **DSL nearest rival & pricing discipline (28%)**
  - Digital loop problems: DSLAMs, reach, DSL Lite fiasco
  - Distortion by AT&T as merger stakeholder
Technologies targeted for Foreclosure

• Satellite
  – Limited consumer base
  – AOL ownership of DirecPC along DirecTV
    • A major satellite provider
    • Unlikely then as target for foreclosure

• DSL most likely target as
  – Satellite inferior substitute
  – AOL influence DirecPC pricing does not undermine its ability to discriminate

- No downstream rivals and no end users can prevent discrimination by changing to significant non-foreclosed broadband conduit:
  – Thus if AOL-TW discriminates..

Incentives Model

– Conduit Discrimination
  • Costly in loss of revenue from content over foreclosed platforms
  • Increase tho’ in perceived value over cable
  • So, cable broadband provider will do so if gain from additional access revenues exceeds loss from narrower distribution

• Church and Gandal Model of 6 params
  – Content Discrimination
    • E.g., insulate Spinner and Time Warner’s music portfolio from competition
Incentives for Post-Merger Conduit Discrimination

Incentives for Post-Merger Content Discrimination

- Discrimination against rival content providers seeking to reach AOL’s customers
- Two questions:
  - Can upstream rivals reach a sufficient no. of customers through alternative conduits
  - Would foreclosure reduce the operations scale of an upstream rival to below MVS or increase marginal costs

- Availability of Alternative Broadband Customers
- Minimum Viable Scale and MC of Broadband content
Implications for Conditions on AOL-TW Market behaviour

• Partial to complete content and conduit discrimination considered profitable
  – Cite AT&T connexion
• MoU drafted between Time Warner & AOL on Open Access business practices

FTC Decrees

• Conduit Discrimination: Open Access Condition
  – no delays, non discriminatory in AOL/Time Warner for unaffiliated ISPs equal access to the combined company’s cable modem platform
• Effect: This should promote investment in the broadband portal market by giving new entrants certain access to the merged company’s cable customer
Consent

- **Content Discrimination : Consent Decree**
- states provisions
  - Earthlink & content to be offered as priority choice to consumers prior to AOL-TW offering

- **Effect**: Customers seeking access to foreclosed content will not have to switch to another transport conduit that suffers
- from a lower rate of market penetration