AOL-Microsoft Talks Ended by a Growing Rivalry

By JOHN MARKOFF

The collapse of talks between Microsoft and AOL Time Warner this weekend was rooted in Microsoft’s strategy of making its new operating system the tool to provide a wide range of tightly integrated services directly to computer users, an area AOL has dominated for years.

The dispute, over how their software would be combined, shows how rivalry in the computer industry has shifted from individual pieces of software, like Web browsers, to control over whole systems that govern how consumers use computers.

The breakdown in the companies’ alliance complicates Microsoft’s future in two ways: Just as Microsoft awaits an appeals court decision about breaking the company into two parts, the breakup raises the prospect of new antitrust challenges concerning Microsoft’s new operating system, Windows XP. And it creates a risk that opposition from AOL and its 30 million users will hinder introduction of Windows XP this fall.

In Windows XP, Microsoft is trying to closely link its programs to a range of consumer activities, including financial services, shopping and entertainment, via the Internet. Its new, more encompassing strategy gives AOL’s latest version, which already performs most of the same tasks in an integrated fashion, its most direct competition yet.
For that reason, the collision may have been inevitable, according to industry executives. With its "Net" Internet strategy, Microsoft is increasingly moving into markets that are crucial to AOL. consequence, industry analysts warned, may be the fracturing of the computer industry at a time it can least afford it.

"This is an industry that is already in decline, and there is a chance that it could be sent reeling into depression," said David Readerman, a managing partner at Thomas Weisel & Partners in San Francisco. "Is this just about C.E.O. egos? It seems the greater good, not only for the industry but Microsoft, would be broad consumer enthusiasm for Windows XP."

Annual sales in the United States personal computer industry are projected to decline for the first time in memory, he said, and the Windows XP operating system, set to go on sale in October, has been one of the few bright spots that might lead consumers to upgrade their computers.

Until now, Microsoft has presented computer users with the parts that performed critical computer tasks: the dominant Windows operating system, on which programs — including AOL — run; the network that connects users to the Internet; the Internet Explorer browser, which enables the user to reach sites on the Web; and the Windows media player, which permits them to use audio and video software.

But AOL has presented users with many of these same services as a package, with far fewer installation problems, in an environment that has attracted 30 million users.

Now Microsoft is developing a new system called Hailstorm that will link a wide range of services, from financial to entertainment, in a way that critics assert will leave no room for competitors such as AOL.

Still, squabbles over the control of standards have long been a hallmark of high-technology industry, and the failure of the talks between Microsoft and AOL was viewed as part of that tradition.

"I’m surprised that the talks got this far," said Richard A. Shaffer, founder of Technologic Partners computer industry publishing and conference firm. "Having several instant messaging and digital media player standards accomplishes nothing for the consumer. The problem is that everyone wants to be the standard."

Over the weekend, the companies disagreed about why the talks had foundered. AOL officials said they thought all of the issues had been resolved with the exception of the role of RealNetworks’ RealPlayer, a competitor to Microsoft’s Windows Media Player.

Microsoft executives angrily disputed this, saying there were still a range of unsolved issues on the table when Jim Allchin, the head of Microsoft’s operating system business, and Ray Oglethorpe, president of AOL’s online unit, agreed to end the talks in a phone call on Saturday.

Will Poole, vice president of Microsoft’s digital media division and one of the company’s negotiators, said that AOL threatened to sue Microsoft on antitrust grounds in the absence of an agreement. "AOL asked much, offered little and told us they wanted to sue us over XP," he said. "AOL
propose a win-win deal. They proposed an I-win-now-you-lose-later deal."

Accounts of how the talks progressed and then broke down suggest that, at the least, Microsoft become vulnerable to accusations from AOL and other competitors that its behavior has change since last year’s bitter antitrust trial. That trial concentrated on Microsoft’s decision to bundle its Internet Explorer Web browser with its Windows operating system, which already dominates the market. A federal court decided that this action amounted to an attempt to extend market domin ways that harmed Netscape, the rival browser, and recommended Microsoft’s breakup.

Several executives of rival companies say that Microsoft was repeating the pattern by trying to RealPlayer from Windows XP, an accusation that Microsoft strongly challenges. But then, AOL Warner has been accused of being a multimedia bully itself.

As AOL officials described it over the weekend, the talks came close to a successful conclusion Friday. AOL negotiators thought they were within reach of a deal in which they would agree no Microsoft, and Microsoft would agree to include AOL’s software in Windows XP.

During the week, as the negotiations proceeded, AOL executives said that Microsoft began rais objections to adding RealPlayer to the AOL software that would be included as part of Window RealNetworks, which is negotiating a closer alliance with AOL Time Warner, which owns AOL ahead of Microsoft in striking agreements with record companies to put their music online.

AOL officials said they thought they had solved several of the legal issues Microsoft had raised later in the week, the AOL officials said, they heard another Microsoft objection: the RealPlayer software that AOL planned to provide would not run correctly with Windows XP.

In several proposals last week, AOL executives said, Microsoft asked that the company provide 5.0 version of AOL software, which does not include RealPlayer, rather than the current 6.0 ver Microsoft executives disputed the AOL account and said they merely tried to persuade AOL to dis its exclusive relationship with RealNetworks and give consumers a choice of digital media play

The companies are also at odds over making their instant messaging systems compatible.

Several analysts said that the breakup of the talks showed AOL’s growing confidence in compe with Microsoft’s MSN Internet service. With more than 5 million customers, MSN is a distant s to AOL.

Even with a deal, the AOL program might have been buried two mouse clicks deeper than it is now and therefore be more difficult for Windows XP users to find.

Microsoft might allow hardware manufacturers to include an AOL icon in a "start" menu that w up from the lower left-hand corner of the screen in Windows XP.

AOL executives said they no longer needed Microsoft to provide it with visibility, because they advertise heavily, distribute their software widely on compact discs and have computer makers use their software on new machines.

But AOL executives are widely reported to have intensely debated the seriousness of the threat Windows XP and Microsoft’s new Hailstorm Internet strategy. Some Hailstorm features are vie some industry experts and rival executives as a way to lock customers into Microsoft’s product: services.

Earlier this year, AOL planned to sell an AOL personal computer that would be based on the riv Linux operating system. Several people familiar with the program said it was scaled back after chief executive, Robert Pittman, decided not to confront Microsoft so directly.
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