6. AOL/Time-Warner

This merger was conspicuous for many reasons. First it was large; second, it was contentious; third, it had a historical context; fourth, it raised the timeless issues of Coasian transactions costs. The theories that must be considered in searching for an explanation for the merger include: managerial entrenchment, monopoly, and synergy.

Historical Context:

Time-Warner was itself a creation of merger between Time, Inc., and Warner Brothers Communications in 1989. This merger was a defensive move by the management of Time to fend off a hostile takeover by Paramount Communications. Paramount had made an offer of a 70 percent premium for Time. Time's management turned this down and sought out a merger with Warner in order to stop Paramount. Paramount did not have the borrowing power to purchased a merged Time-Warner. Paramount sued but its legal bid to annul the merger failed.[1] Based on the ex-ante evidence of managerial performance, popular reports, and ex-post stock price performance, Time's management was terrible and the Time-Warner merger was merely a way for them to avoid getting the axe.

The AOL/T-W merger might be considered in the same light. Possibly the merger could be a vehicle to finally get rid of the T-W managers. Alternatively, AOL might be copying the master.

Monopoly:

The AOL/T-W merger was hotly contested by the FTC with intervening comments by Microsoft and others. The concerns expressed were essentially that the merger would create a new enterprise that would be dominant in a new market. This objection is the old "market foreclosure" argument that the antitrust authorities have long appealed to in vertical mergers. The ol' favorite in this line of reasoning is the Ford Motor Co. attempted acquisition of Autolite.

It is important to recognize that the AOL/T-W merger is vertical. The two companies did not line up together in any market. The business lines of the two companies are:

Time-Warner

—Movies, books, TV programming, etc. (called content)

—Cable TV (this is physical delivery via coax wires); serves 20% of households.[2]

AOL

—dial-up internet access (ISP); serves 28m households

—Netscape, instant messager, ICQ[3]

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[1] The court initiated what is called the *business judgement rule*, which says that to the extent that management acts in a way that exercises business judgement, the court will not step in. In this case the court said that Time was making a decision about the managerial direction of the firm, a business judgement. The court said that had Time merely put itself on the block, it would be forced to accept the highest bid. Ironically, several years later, Paramount itself was caught by this same rule. Having announced that it was "for sale" Viacom, managed by a bitter rival of the Paramount CEO, made an offer. Paramount tried to avoid the takeover but could not.

[2] Reports vary: Time Warner was the nations second largest cable television distributor and one of the leading cable television network providers. Time Warner's cable operation potentially serviced approximately 33.5 million homes, or about 20% of the U.S cable television households. Time Warner or its subsidiaries owned several networks including but not limited to HBO, Cinemax, CNN, TNT, TBS, Superstation, Turner Classic Movies, and the Cartoon Network.

The specific FTC concerns were potential anticompetitive effects in three markets:

1) broadband (as opposed to dial-up) ISP
2) residential broadband Internet transport services, or last mile access
3) the market for interactive television (“ITV”) services.

On the face of it, these complaints seem unfounded, much like the Ford case of years gone by. In regard to the first charge, AOL has some dial-up subscribers. Dial-up internet access is fast becoming obsolete. Hence, AOL wants to serve its customers by offering them high-speed access. If this is anticompetitive, then so is Mom and apple pie. AOL can develop its own delivery system or go buy the infrastructure from someone else. It is arguably cheaper to buy it. The logic of the FTC is that if AOL develops its own system of high-speed delivery, then T-W would use its potential delivery system in competition. The problem with this argument is that AOL has to get it somewhere and wherever it gets it the same argument could be applied.

The second argument fails as well. AOL has no last mile access. If T-W does, it has it without regard to the merger. Possibly the FTC by means of the merger review was trying to get back at T-W for prior behavior. At all events, the last-mile argument is very weak because there is a good bit of competition in the last mile today. Coax cable competes with phone lines and with satellite service.[4]

Finally, the last argument is about a market that does exist. At all events, T-W does not come close to having a monopoly in television programming.

The complaints of competitors were more telling, both because they showed what was the likely effect of the merger and why it the antitrust action against was protection of competitor rather than protection of competition (i.e., consumers).

Synergy:

The main fear of competitor to the merger was that an AOL/T-W company would link content to high-speed internet access and thus would supply a superior product. Presumably, T-W has the content in its programming and has the delivery mechanism via the potential for coax cable to be h/s ISP. AOL has a customer base of internet users.

The interesting thing about AOL is that its customers are currently offered "content" as part of their IS. AOL started out as a kind of dial-up bulletin board before there really was an internet. It was in competition with CompuServe and others. It now owns CompuServe and the other are gone. As the internet has grown, the proprietary content provided by AOL has shrunk as a percent. Nonetheless, there is every reason to believe that proprietary services on the internet will be an important part of its future.

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[3] AOL operated both CompuServe and America Online that together provide access for 27.8 million members. AOL also owned a significant number of Internet related products such as AOL Instant Messenger, ICQ, MapQuest, AOL.com and Netcape.com, the Netscape Navigator and Communicator and several others.

[4] The quality of high-speed ISP deliver over these various media varies widely with the infrastructure of the system. In some places, the last-mile phone lines are fiber; other places they are copper. In Clemson our cable does not offer h/s isp, but they have it in Greenville. We have DSL from two different providers in the immediate downtown Clemson area. Satellite offers high speed internet downloads. However, currently uploads must go via another medium. No doubt, technology will offer advances in the future that will make the last-mile even more competitive.

Currently there are many services that are proprietary, that is, not free. The WSJ on the internet is subscription based. Financial services usually are linked to your brokerage account, but even so, there are independent services that require a subscription. High quality search engines are proprietary.

In the future we can expect that movies, music, and literature delivered over the internet will be subscription based. The Napster case will probably be decided against Napster, and while there will always be renegade pirate sites for music and video, these will be frequently by only those with low time cost. Whenever such a site becomes popular, it will be busted. As a consequence, the average household will subscribe to a service, much like a souped up AOL that bundles proprietary internet content.

While this all seems reasonable, the exact dimensions are currently unknown. This is a market that currently doesn't exist. How does anyone know what features that will be valuable and which not. Possibly, this bundled service provider will need to link h/s isp with the bundle, possibly not.

Transactions Costs:

The question that is posed from a transactions costs perspective is, Why merge? That is, why not simply contract between content suppliers and ISPs. Arguably there are potentially both hold up and pricing problems that make merger the more efficient alternative, even admitting that a company the size of AOL/T-W will certainly be plagued with shirking problems.

In a contractual setting, T-W would be providing content and also providing IS connection. AOL would manage the bundling of content and the marketing of the IS. AOL concern would be that T-W would start its own competitive service (as Microsoft did to IBM with DOS). Moreover, even if AOL had an exclusive contract, it would have to worry about shortfalls on quality. On the other hand, T-W would fear that AOL would search for alternative content suppliers, and of course some alternative suppliers would be efficient because of holes in the content coverage of T-W. All told, an exhaustive contract covering all contingencies would be complex, suggesting that merger cum shirking looks attractive.

While the hold-up issues seem apparent, there are pricing concerns as well. As we stand in the present looking to this new market it is far from clear how valuable any component of the deal will be. How much are AOL's current subscribers worth? How much should T-W be paid for its stock of old movies, music, books, etc.? Who knows how these will fit into a proprietary bundle of internet access.

In an historical context, the AOL/T-W merger bears a similarity to the block booking that used to occur between movie production companies and theater chains. This contractual relation is generally considered today to have been quite efficient but it was stopped by government intervention.