AOL Returns To Its Roots

Abstract: AOL Time Warner’s new strategy for its America Online business is to focus on content, not access.

By Lydia Leong and Patti Reali

Recommendations

- Portals must craft a compelling, high-value set of applications and content that will retain and attract customers of all access modalities, and that will be especially compelling for broadband users who pay higher monthly rates.

- Portals should leverage content ownership and content partnerships to match what consumers demand — and what they are willing to pay for — sports, music and games.

- Cable ISPs should keep close tabs on the content strategy being pursued by AOL Time Warner, and be proactive about defining and offering targeted broadband content and applications with high revenue-sharing potential in conjunction with content provider partners.
AOL's Strategy Announcement

On 4 December 2002, AOL Time Warner gave an analyst presentation detailing its plans for revitalizing its America Online division. Both tactical and strategic moves were discussed, and several alliances between America Online (AOL) and the Time Warner media properties were announced.

The key message from the presentation is that AOL is reiterating its position as a provider of content, not access. AOL explicitly classified itself as a "value-added interactive services company," not an ISP. This represents an important step in the process of integrating AOL into Time Warner and makes it clear that Time Warner's media strategy will dominate the merged company.

Figure 1 shows broadband penetration of U.S. online households by access mode.

Figure 1
Penetration of U.S. Online Households by Access Mode in June 2002

Gartner Dataquest Perspective

Gartner Dataquest believes that AOL’s new strategy is not a fundamental strategic change for the company, but rather, a refocusing on the core strategy of the business.
While this is a positive move, AOL Time Warner also must articulate its strategy regarding the migration of more than 33 million AOL subscribers from dial-up to broadband services. While AOL is a firmly established player in the narrowband market, it has not yet established itself as a dominant player in the broadband content and services market. It is questionable whether or not AOL will be able to execute its strategy in time to establish itself as the broadband leader, which would help turn around its financial fortunes.

A Brief History of AOL

AOL began as Quantum Computer Services in 1985, operating an online service provider (OSP) called QuantumLink, which was a competitor of OSPs such as CompuServe and Genie. OSPs charged subscribers a monthly fee, as well as per-hour charges for time spent connected to the service. OSPs provided community features, chat features, games, files for download and proprietary content; it was to the provider's advantage to make the service as "sticky" as possible so that users would spend more time online and thus pay more money each month. QuantumLink differentiated itself by providing a friendly, easy-to-use, and graphically oriented interface specifically for Commodore 64 owners. It also ventured into more experimental territory with real-time interactive communities such as Habitat, an online multiplayer game that could be considered the precursor to today's The Sims Online.

In 1989, Quantum Computer Services became America Online and focused on providing family-friendly, easy-to-use OSP services to a wide variety of home computer users. In 1994, however, the rise of consumer ISPs such as Netcom, and the growth of the World Wide Web, began to threaten the livelihood of OSPs. ISPs could provide flat-rate access to the Internet and a rapidly growing body of content, as well as community like features via mechanisms such as IRC and USENET News. The free massive global Internet sharply lowered the value proposition of the online services and bulletin board services (BBSs).

Realizing that it would lose subscribers to ISPs unless it offered Internet access of its own and, more importantly, concerned by Microsoft's plans to offer Internet access with its MSN online service, AOL moved to stem the bleeding. At the beginning of 1995, AOL bought ANS, a commercial ISP, and used it to offer Internet access to its users until AOL cut a deal with WorldCom in late 1997, whereupon AOL exited the network business. However, the service remained a pay-by-the-hour service until the end of 1996 when AOL moved to flat-rate pricing in reaction to Microsoft's announcement of flat-rate pricing for MSN.

Once AOL moved to flat rate pricing and became more cost-competitive with ISPs, AOL was extraordinarily successful in signing up subscribers, thanks to its easy-to-use interface. Most subscribers came online for Internet access, but AOL was also extremely successful at keeping subscribers within its own content properties, thanks to AOL's aggressive acquisition of successful Web destinations. AOL gained significant revenue from advertising and e-commerce partnerships, based on eyeballs
(both subscriber and nonsubscriber) driven to those destinations. AOL also was able to derive additional revenue from selling premium services to subscribers. Furthermore, AOL was moderately successful in getting subscribers of other ISPs to pay for content-only, "bring your own access" subscriptions to AOL.

**AOL Has Never Seen Itself As a Real ISP**

There are several key points that must be kept in mind when considering AOL’s strategy:

- AOL did not intend to become an ISP. AOL became a provider of Internet access because it had to offer Internet access to preserve and grow the base of subscribers to its proprietary content. It merged with Time Warner to expand its portfolio of proprietary content.

- AOL has a long history of offering compelling content to an online audience. It has always emphasized its own content. It has always seen itself as a new media company, not a network access company.

- AOL was originally a content aggregator, not a content creator. AOL was good at taking content from other sources, presenting it in an appealing manner and supplementing it with features that worked well in an online environment. AOL merged with Time Warner to have access to unique original content — both newly created and that which people were historically willing to pay for — rather than having to depend on content created by other companies.

- AOL has historically viewed Microsoft as its most threatening competitor. As with AOL, Microsoft has a holistic view of the consumer, wanting to provide a spectrum of services that are independent of access method.

- The merger of AOL with Time Warner originally touted the strength of the merged entity in both content and access. However, AOL Time Warner has never really been able to realize the potential of Time Warner Entertainment L.P., or Time Warner Cable’s (TWC’s) broadband networks, in a manner that made sense for either AOL’s content or Time Warner Cable’s pipes.

For a number of years, AOL emphasized its subscriber growth as one of its key metrics. Subscriber growth drove all the other AOL services, creating more Internet-enabled eyeballs for AOL content. Now, AOL is turning its focus to member satisfaction, trying to increase the revenue potential of its existing subscribers. Given the near-saturated nature of AOL’s core market in North America, subscriber retention will be increasingly critical for AOL.

AOL is once again focusing on how it can use its media properties to bring value to its subscribers. Previously, when Internet access became the primary value proposition for AOL subscribers, AOL allowed itself to create too much distance between its subscription business and its advertising-supported, free-to-all Internet users media properties. It prided itself on the fact that AOL subscribers spent most of their online time within AOL-owned properties and AOL partner properties, but did
not significantly differentiate the features available to AOL subscribers vs. non-AOL-subscribers. Consequently, these features were not as effective as they could have been in attracting subscribers to AOL, or preventing existing subscribers from switching to other ISPs, especially once AOL began to lag other ISPs in broadband deployment. Furthermore, as long as those media properties were supported by revenue from advertising impressions, it was reasonable to make them available to all; now that advertising revenue has fallen drastically, AOL must find new ways to derive revenue from those properties.

More importantly, AOL is de-emphasizing its access business. AOL wants subscribers to its content. It doesn’t particularly care how the subscribers get access to that content. AOL is in the access business because it’s a convenient way to lock in content subscribers. While it is best for AOL, from a branding and ownership perspective, to acquire subscribers that receive both content and access through AOL, content-only subscriptions still represent an excellent source of revenue.

**AOL As Content Provider**

AOL has historically been a threatening competitor to local exchange carriers (LECs) and cable companies. It seems, however, that AOL may be moderating its tone, taking more of a partnership approach to future dealings with these last-mile network providers. AOL does want to own the customer, but it seems to be stepping back from its belief that it needs to own the customer’s network connection. This decision is likely driven by AOL’s difficulties in the broadband market, where asking a consumer to pay for both broadband access and an AOL content subscription has been a serious pricing problem.

AOL has fought the pricing battle from a regulatory standpoint, but it appears that marketplace dynamics will be more significant. AOL’s most attractive products, from a pricing standpoint, will likely be those in which it is the content partner in a revenue-sharing deal with a last-mile network provider, in a structure similar to SBC’s partnership with Yahoo. For more affluent users who can afford to pay for a broadband connection and a separate content subscription, AOL must create unique proprietary content offerings that justify the cost of that subscription.

AOL is beginning to leverage the Time Warner media properties for content that subscribers will pay for. Unique content will be created for the AOL service, but there will also be additional content that is available to AOL users for free but which general Internet users must pay for. For instance, CNN presently offers an online video clips service that anyone can subscribe to; AOL subscribers do not need to pay for access to these videos. This is an attractive business model, as it enables the company to derive media revenue from any Internet user, while still providing content with a tangible value to AOL subscribers. Indeed, having such content visible to the general Internet population will help promote the AOL content subscription service because for heavy users of these media properties, an AOL subscription is likely to be more cost-effective than paying for a bunch of separate premium access services.
AOL’s advertising revenue is sharply down, making it far more dependent on content subscriptions, premium services revenue and revenue gained through e-commerce. AOL is exiting the merchandise business, which required AOL to maintain inventories, in favor of concentrating on making AOL a shopping destination that obtains its revenue from commissions. It also plans to enter new lines of business, such as creating a liquidation marketplace. However, the key to its commerce business will be targeted promotions and integration of commerce into AOL. Subscribers will receive special benefits and offers, thus creating greater value in an AOL subscription.

The AOL Broadband Struggle

Gartner Dataquest believes that users will be slow to accept paying a significant premium for exclusive services. In the narrowband market, where AOL is only marginally more expensive than a typical ISP, the slight premium is easy to justify. In the broadband market, where a subscriber could easily be paying $50 a month for his or her connection, justifying an additional $14.95 for an AOL content subscription could be far more challenging. While AOL is successfully increasing the stickiness of its service offerings, Gartner Dataquest believes that the service provider is in for more hard times as it proves out this service model.

AOL has already demonstrated difficulty with this add-on content model. TWC systems offer Road Runner as its high-speed broadband data service, but these systems also permit customers to subscribe to any ISP, a result of the Justice Department’s merger approval provisions. However, receiving AOL over a TWC connection is typically $10 more than any other ISP over that TWC connection, including Road Runner and Earthlink. Given the already high basic cost of the broadband connection, the result is cost-prohibitive except for the most loyal subscribers and those with means to pay for it. As a result, AOL has been less than successful in attracting or migrating subscribers over to its broadband service.

AOL has proclaimed its desire to sell its service to users on a stand-alone basis, regardless of whose connectivity they use, but based on Gartner Dataquest’s mid-year 2002 survey of consumers, we do not believe that the market is ready for this business model. AOL wants users to pay on a regular basis for access to one site that serves all their content needs; users want to pay on an ad hoc basis when they are compelled to buy content, whether it’s music, video downloads or Time Magazine news and analysis.

AOL says that it wants to use the cable TV service model of different levels of services at corresponding price points, including those that bring their own access. Gartner Dataquest believes that one of the key reasons many dial-up users haven’t migrated to broadband is the unwillingness or inability of those users to pay the $40 to $50 per month for always-on, higher-speed connectivity. Casual dial-up users that primarily utilize the Internet for e-mail and information/research purposes may not see the value in paying double for a little more speed and a little less hassle. In
mature broadband markets, where penetration of cable and DSL are approaching 35 percent or more, a lower price will be the key motivator in converting dial-up subscribers to broadband, content notwithstanding.

The current multi-tier service rollouts by other cable operators makes AOL Time Warner's challenges clear. AT&T Broadband (now Comcast) launched its UltraLink service, allowing users to surf the Internet at speeds up to 3 Mbps, for $79.95 per month; the high price is an attempt to capture revenue from power users. Going up market, however, has not been as successful as going down market. Charter Communications has been offering multi-tiered service since mid-2001. Of new subscribers to its Charter Pipeline service, more than half are at the lowest tier of service, which starts at 256 Kbps for $29.95 per month, and scales to 1.5 Mbps for $49.95 per month. Charter's lowest-price tier is closest to AOL's dial-up price of $23.95 per month; most cable data service providers charge an average of $40 per month.

The market for broadband access subscriptions is expected to continue to grow in terms of total numbers. Gartner Dataquest forecasts that by 2006, more than 50 percent of U.S. households with PCs will have a broadband connection. Technology advances and more sophisticated provisioning systems are increasing the likelihood that many new subscribers will be coming in at the lowest tier of service, at a price point only slightly greater than dial-up. AOL will have to put together an incredibly compelling package to ask users to pay an extra $15 or more a month for features and content.

Table 1 shows the penetration of online households in the United States.

Table 1
U.S. Online Households

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<th>Total</th>
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<tr>
<td>Online Households</td>
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<td>Online Penetration of Households (%)</td>
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Source: Gartner Dataquest (January 2003)

AOL Faces Many Challenges

Gartner Dataquest is skeptical that AOL can turn its fortunes around in two quarters, based on locking users into a sliding scale of exclusive content packages, with or without access. We also wonder if the flip side of this strategy will mean that much of the vast portfolio of Time Warner content — CNN, Time Magazine, Sports Illustrated, People, Fortune and other magazines, plus music and video — will become fee only. These two strategies would mean that what AOL expects to achieve a major change in consumer behavior. Indeed, this may impact its own subscriber base the most, as it moves to decouple content from conduit.
Gartner Dataquest believes that AOL Time Warner’s move is poorly timed. Business models for broadband-enabled content are in their infancy. Broadband access subscriptions are just starting to enter the early majority stage. Usage patterns and income demographics may be working against the likelihood of dial-up users opting to pay substantially more for broadband access. In this time of economic difficulty, consumers are looking to save more money, not spend more money.

AOL Time Warner is moving in the right strategic direction, by emphasizing content over access. AOL’s tactical execution will need to be flawless, however, and even then, the market may present insurmountable challenges for the specific underpinnings of its current business plans.

**Key Issue**

How will the roles of public network operators, service providers and content producers change the current and future value chains?