Antitrust Chronicle

AUGUST · VOLUME 2 · SUMMER 2018

RETHINKING VERTICAL MERGERS

CPI COMPETITION POLICY INTERNATIONAL

TABLE OF CONTENTS

03 **Letter from the Editor**

04 **Summaries**

06 **What's Next?**
Announcements

07 **Kabuki Dances or Rube Goldberg Machines? Vertical Analyses of Media Mergers**
By Cristina Caffarra, Gregory S. Crawford & Helen Weeds

15 **The District Court's *AT&T/Time Warner* Decision: Insights into the Law of Vertical Integration**
By Christopher S. Yoo

21 **Vertical Mergers and the MFN Thicket in Television**
By Erik Hovenkamp & Neel U. Sukhatme

29 **An Algorithm for Analysis of Vertical Concerns**
By Malcolm B. Coate

34 **Input Foreclosure in Telecoms/Media Vertical Mergers: The *MEO/GMC* Case**
By Alípio Codinha, Mariana Costa, Marta Ribeiro & Pedro Marques

39 **The Rediscovery of Vertical Merger Enforcement?**
By Paul Johnson & Anthony Gamble

45 **Implications of the *AT&T/Time Warner* Decision for Vertical Integration and Media Business Models in the Age of Digitization**
By Kalpana Tyagi

Editorial Team

CEO & Founder
David S. Evans

Editor in Chief
Elisa V. Mariscal

Managing Director
Raúl Escalante

Managing Editor, CPI Projects
Elisa Ramundo

Managing Editor, The Antitrust Chronicle
Sam Sadden

Senior Editor
Nancy Hoch

Latin America Editor
Jan Roth

Junior Editor
Jeff Boyd

Editorial Advisory Board

Rosa Abrantes-Metz
Stern School of Business

Kent Bernard
Fordham School of Law

Rachel Brandenburger
Oxford University

Dennis W. Carlton
Booth School of Business

Adrian Emch
Hogan Lovells

Kyriakos Fountoukakos
Herbert Smith

Jay Himes
Labaton Sucharow

James Killick
White & Case

Stephen Kinsella
Sidley Austin

Ioannis Lianos
University College London

Robert O'Donoghue
Brick Court Chambers

Aaron Panner
Kellogg, Huber, Hansen

Vanessa Yanhua Zhang
Renmin University

LETTER FROM THE EDITOR

Dear Readers,

The August 2018 CPI Antitrust Chronicle features articles on a topic that has been all over the news recently: vertical mergers. The recent District Court decision in the *AT&T/Time Warner* merger has opened a Pandora's Box of antitrust discussions. This seems understandable seeing that the case is the first government action to block a vertical merger in the U.S. in over forty years.

Indeed, as one of this month's authors notes, the *AT&T/Time Warner* decision was one of the most eagerly anticipated antitrust decisions in recent years. Was this just a one-off case or is the Justice Department signaling its intention to adopt a more aggressive posture towards vertical integration?

Do we need to rethink the analysis of vertical integration? Some argue that the processes and procedures of competition authorities need to evolve. Especially in the age of mergers between cable and satellite TV service providers globally. What about in other sectors?

Looking down the road, the October Chronicle will feature articles from speakers at the 13th CRESSE Conference recently held in Crete, Greece. CPI had the opportunity to participate at the conference which featured keynote addresses by Herbert Hovenkamp, David S. Evans, Eleanor Fox, Dennis Carlton, and John Vickers.

We are also pleased to announce CPI's inaugural annual conference on **"Challenges to Antitrust in a changing economy"** that will take place on November 9, 2018 at Harvard Law School. This event, co-organized with CCIA, aims to generate an open and cutting-edge debate on competition law and economics in the tech industry. Confirmed speakers include: Bruce Kobayashi, William Kovacic, Einer Elhauge, Hal Varian, Diana Moss, Nancy Rose, Julie Brill, Greg Ip, Jonathan Baker, Rob Atkinson, and Michael Mandel, among others. Read the full program and register free online at the event registration site, here.

Lastly, please take the opportunity to visit the CPI website and listen to our selection of Chronicle articles in audio form. This is a convenient way for our readers to keep up with our recent and past articles on the go, in the gym, or at the beach.

As always, thank you to our great panel of authors.

Sincerely,

CPI Team

SUMMARIES

07

Kabuki Dances or Rube Goldberg Machines? Vertical Analyses of Media Mergers

By Cristina Caffarra, Gregory S. Crawford & Helen Weeds

In his recent opinion in the *AT&T/Time Warner* merger, Judge Richard Leon described the bargaining models presented by the government as a "Kabuki Dance" and a "Rube Goldberg Machine." We summarize key considerations in recent vertical media mergers in the U.S. and EU and show how *AT&T/TW* deviated from these in important ways: in failing to consider that the integrated entity might foreclose over-the-top video providers in its role as ISP, in its ready grant of efficiency claims, and in its evisceration of the use of bargaining models in vertical merger analysis. We conclude that bargaining models should be "released on appeal" as a useful framework for analysis in these cases.

15

The District Court's *AT&T/Time Warner* Decision: Insights into the Law of Vertical Integration

By Christopher S. Yoo

The U.S. District Court's opinion unconditionally approving AT&T's acquisition of Time Warner is often mistakenly regarded as the mere application of settled law to a particular case. A close reading of the decision yields insights in five areas: (1) what constitutes must-have content; (2) the importance of focusing exclusively on merger-specific harms; (3) the importance of showing both the ability and the incentive to harm competition; (4) the increasing importance of empirical analysis; and (5) the problems with dual-agency review. As such, analysis of the District Court opinion will continue to provide key lessons even if it is superseded on appeal.

21

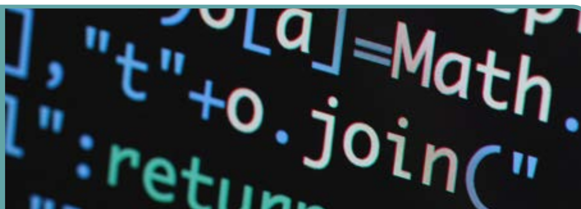
Vertical Mergers and the MFN Thicket in Television

By Erik Hovenkamp & Neel U. Sukhatme

Increasingly, cable and satellite TV services (known as "MVPDs") seek to acquire upstream programming creators, as illustrated by AT&T's recent merger with Time-Warner. At the same time, the pay-TV industry is rife with most-favored nation ("MFN") agreements, which can sharply constrict the competitive process. The most problematic variety, so-called "unconditional" MFNs, raise serious antitrust concerns, as they may forestall effective entry by new streaming-based platforms; penalize procompetitive deviations from the *status quo*; and facilitate *de facto* coordination among integrated MVPDs.

While vertical mergers in the industry have received significant antitrust attention, the MFN concerns are interrelated. Problematic MFNs may naturally induce a double marginalization problem, even if the parties are otherwise capable of contracting around it. This creates a strong motivation for integration, but it also raises a question as to whether a merger is the only way to avoid double marginalization. Further, MFNs might compel a problematic form of reciprocal dealing that generates *de facto* price fixing between integrated rivals. Consequently, the industry's trend toward integration may trigger other kinds of anticompetitive conduct.

29



An Algorithm for Analysis of Vertical Concerns

By Malcolm B. Coate

Vertical analysis may play an important role in antitrust policy for Internet-related markets. As anticompetitive effects are horizontal in nature, this paper proposes a three-step review process, first focusing on the core competitive effect, then the potential for exclusion and finally balancing of efficiencies and anticompetitive effects. Two illustrations are offered, one for the *Microsoft* litigation and the other for the consummated *Facebook/Instagram* merger. The *Microsoft* discussion highlights the complications of vertical analysis, and posits an expected value standard for anticompetitive effects. For mergers comparable to *Facebook/Instagram*, consummated transactions may be anticompetitive even with a comprehensive efficiency review.

SUMMARIES

34

Input Foreclosure in Telecoms/Media Vertical Mergers: The *MEO/GMC* Case

By Alípio Codinha, Mariana Costa, Marta Ribeiro & Pedro Marques

This article explores part of the competitive assessment performed by the Portuguese Competition Authority on the proposed merger between MEO, a telecoms firm, and GMC, a media & contents company operating in Portugal. We used the same analytical roadmap of the *Comcast/NBCU* and *Liberty Global/Corelio/W&W/De Vijver* Media transactions to assess anticompetitive impacts from possible input foreclosure strategies, but used a consumer survey to quantify more precisely subscriber switching and departure rates. The results of the survey were critical to conclude that, post-merger, GMC would have an increased ability and incentive to engage in input foreclosure strategies which would result in significant hampering of competitive pressures in the provision of retail pay-TV services in Portugal.

39

The Rediscovery of Vertical Merger Enforcement?

By Paul Johnson & Anthony Gamble

Vertical transactions were for a long time a neglected area of merger control. However, with recent changes in the economy and economic theory, competition authorities are rediscovering vertical merger enforcement. This article examines the European Commission's approach to vertical mergers and the academic and policy debate relating to vertical merger control. It then offers practical suggestions for competition authorities grappling with these issues.

45

Implications of the *AT&T/Time Warner* Decision for Vertical Integration and Media Business Models in the Age of Digitization

By Kalpana Tyagi

Technological convergence has had a substantial impact on the way content is generated, distributed and consumed. This in turn has prompted substantial business model innovation and a “wave of creative destruction” in the converged telecoms and media sector. Using inter-disciplinary insights from competition policy and business strategy, particularly business model innovation, this article critically interprets the implications of the unconditional clearance of the *AT&T/Time Warner* merger. Following the emergence of “digital, big-data driven” business models, this articles calls for a continued case-by-case assessment of vertical integration in the converged telecoms sector.

WHAT'S NEXT?

Our September 2018 Antitrust Chronicle will focus on recent developments in **Platform Competition and Antitrust**.

ANNOUNCEMENTS

CPI wants to hear from our subscribers. In the remaining months of 2018, we will be reaching out to members of our community for your feedback and ideas. Let us know what you want (or don't want) to see, at: antitrustchronicle@competitionpolicyinternational.com.

CPI ANTITRUST CHRONICLE OCTOBER 2018 & NOVEMBER 2018

Our October 2018 Chronicle will feature articles from speakers at the **CRESSE Conference** which took place in Crete this summer.

The November 2018 Chronicle will focus on issues related to **Due Process and Antitrust**.

Contributions to the Antitrust Chronicle are about 2,500 – 4,000 words long. They should be lightly cited and not be written as long law-review articles with many in-depth footnotes. As with all CPI publications, articles for the CPI Antitrust Chronicle should be written clearly and with the reader always in mind.

Interested authors should send their contributions to Sam Sadden (ssadden@competitionpolicyinternational.com) with the subject line "Antitrust Chronicle," a short bio and picture(s) of the author(s).

The CPI Editorial Team will evaluate all submissions and will publish the best papers. Authors can submit papers in any topic related to competition and regulation, however, priority will be given to articles addressing the abovementioned topics. Co-authors are always welcome.

KABUKI DANCES OR RUBE GOLDBERG MACHINES? VERTICAL ANALYSES OF MEDIA MERGERS

BY CRISTINA CAFFARRA, GREGORY S. CRAWFORD & HELEN WEEDS[1]

1 Cristina Caffarra, Charles River Associates; Gregory S. Crawford, University of Zurich; Helen Weeds, Imperial College Business School.

I. THE VERDICT

"[A] historic defeat for the Justice department" is how the Wall Street Journal described the June 2018 dismissal by Judge Leon of the U.S. Department of Justice's ("DOJ's") attempt to prevent AT&T and Time Warner's proposed "blockbuster" vertical merger. The verdict had been eagerly awaited not just because of the unusual circumstance of a vertical merger being challenged at trial – but also because much of the substantive disagreement during the trial was (equally unusually) centered on the bargaining model that is now the routine go-to tool in both the U.S. and Europe to assess vertical mergers, especially in media markets. As proclaimed in a GCR headline during the proceedings, "Bargaining theory hangs over AT&T/Time Warner."

The outcome was not surprising for anyone who had closely followed the trial but was nonetheless disappointing for its treatment of bargaining analysis – something that economists broadly agree is the right way to think about these deals. In both trial comments and his published opinion, Judge Leon described negotiations between programmers and distributors as a "Kabuki Dance" in which the two sides threaten blackouts even though both know that neither wants that (at least not permanently). Referring to the complexity of the government expert's model of such negotiations as a "Rube Goldberg [machine]," he concluded that "in fairness to Mr. Goldberg, at least his contraptions would normally move a pea from one side of the room to the other."

Judge Leon states (twice) in the judgment that "antitrust theory and speculation cannot trump facts." This is undoubtedly true, but did he *have* all of the facts? While the trial was lengthy, and traversed reams of evidence, some important facts seem to have been missing from the mix that might have mattered to the final view: the potential for the merged entity to foreclose rival over-the-top ("OTT") operators like Netflix and Amazon, questions around the legitimacy of the parties' claimed efficiency benefits, and empirical evidence on the extent to which vertically-integrated firms internalize the impact of their decisions on their sister division's profits. Now that the judgment has been appealed, perhaps some of these facts will find their way into the record.

Most importantly, while it is perhaps reasonable to conclude that bargaining models were not reliable and credible as applied in *AT&T/Time Warner*, in our view they were unfairly convicted in general. *Thus possibly a Kabuki Dance, but never a Rube Goldberg machine*. Such models should be "released on appeal" as a useful framework for analysis in vertical media mergers.

II. A COMPARATIVE VIEW: RECENT VERTICAL MEDIA MERGERS IN THE U.S. AND EU

We start with a quick summary of key considerations in recent vertical media mergers in the U.S. and the EU.[2] We then focus in the subsequent section on multiple notable puzzles of the *AT&T/Time Warner* case: which arguments were run and – surprisingly – *not* run, which arguments gained traction and which did not, and where the judgment appears to leave us for now (at least until the appeal is heard).

Vertical mergers are known to allow important efficiencies to be realized. While several can be proposed, including investment, contracting, and bargaining efficiencies, the one most consistently claimed as quantifiable is the "elimination of double marginalization" ("EDM"). This captures the idea that in many media markets, particularly in the U.S., contracts between programmers and distributors consist of a per-subscriber fee for access to that programming (e.g., in 2016 pay-TV distributors in the U.S. were expected to pay ESPN an average of $7.21 per subscriber per month to include it in one of their bundles). A typical claim in these mergers is that merging allows the combined entity to pass programming at its true marginal cost (essentially zero), eliminating one of the two (profit) margins in the vertical supply chain and resulting in lower prices to consumers.

Competition concerns tend to arise in these deals due to the joint ownership of significant programming assets (rights to valuable programs and/or channels) and significant distribution assets (a pay-TV and/or broadband platform). Two distinct forms of (full or partial) foreclosure concerns can be raised. *Input foreclosure* occurs when the merged entity refuses or worsens the terms of supply of its programming to rival distributors (e.g., an integrated *AT&T/Time Warner* increases the affiliate fees it demands for TNT from Charter). *Customer foreclosure* occurs when rival programmers are denied, or discriminated against in the granting of, access to the integrated distributor's pay-TV and/or broadband platform (e.g., an integrated *Comcast/NBCU* refuses to carry Bloomberg TV, or carries it but places it in an unattractive channel position).

2 As background, pay-TV distributors – or, in the U.S., multi-channel video program distributors ("MVPDs") – deliver programming to end-consumers via cable, fiber-optic, direct-to-home ("DTH") satellite or terrestrial (airwave) platforms, as well as IPTV, in which programming is streamed over Internet Protocol ("IP") networks by the customer's Internet service provider ("ISP"). The last 10 years have seen a dramatic growth of OTT video providers (e.g., Netflix, Amazon) – also referred to in the U.S. as online video distributors ("OVDs") – whose services are streamed over the open Internet to any consumer via their broadband connection. The OTT operator requires access to the customer's broadband connection but is not the ISP; often, the ISP may also provide pay-TV services.

Analysis of vertical media mergers in the U.S. and EU has focused on four key considerations: (1) input foreclosure (full or partial) of integrated programming to rival distributors (both traditional pay-TV distributors and OTT operators); (2) customer foreclosure of rival channels to the integrated operator's pay-TV platform; (3) customer foreclosure of OTT providers' access to the integrated operator's broadband platform (i.e., in the latter's role as an ISP); and (4) efficiencies due to EDM. Before turning to the recent *AT&T/Time Warner* judgment, we briefly sketch how these issues played out in three previous media mergers: *Comcast/NBCU* in 2011 (U.S.), *Liberty Global/Ziggo* in 2014/2018 (Netherlands), and *Liberty Global/De Vijver Media* ("DVM") in 2015 (Belgium).

A. Comcast/NBC Universal (US 2011)

The attempt to bring together Comcast, the largest cable distributor in the U.S., and NBC Universal ("NBCU"), a major U.S. programming provider, was reviewed by both the DOJ and the Federal Communications Commission ("FCC") and cleared subject to conditions.

The regulators raised full and partial input foreclosure concerns over the supply of NBC's programming to both traditional and OTT rivals. As well as carrying out a vertical analysis of the profitability of fully withholding programming from rival distributors, the FCC examined partial foreclosure concerns using a model of carriage negotiations based on Nash bargaining – the same model as later used in *AT&T/Time Warner* – to predict increases in licensing fees for NBCU programming.

The estimated price increases were considered not to be offset by any vertical efficiencies from EDM, which were dismissed by the FCC. The parties put forward empirical estimates of price effects from previous instances of vertical integration and disintegration, but this evidence was rejected by the FCC as unreliable. Meanwhile the DOJ dismissed vertical efficiencies by concluding that the industry largely solved the double marginalization problem by using more sophisticated, non-linear pricing schemes than the per-subscriber fees underpinning simple models of EDM.

Customer foreclosure of rival programming from Comcast's cable platforms was also a concern. In particular, rival channels might be placed in package tiers having fewer subscribers or excluded from "local neighborhoods" of channels sharing a common focus, thus shifting viewing and advertising revenues from the rival channels to those of NBCU. Finally, there were concerns that Comcast would discriminate against OTT providers in its role as ISP.

Conditions were imposed including a "baseball-style" arbitration procedure to protect rival MVPDs and OTT providers from input foreclosure.[3] "Net neutrality" requirements were also imposed to ensure that, in its role as an ISP, Comcast would provide non-discriminatory treatment to all OTT providers comparable to its own OTT service, Fancast Xfinity.

B. Liberty Global/Ziggo (EU 2014, 2018)

This merger of two, non-overlapping cable operators in the Netherlands, Liberty Global's UPC and Ziggo, had vertical aspects due to the parties' programming interests, particularly UPC's pay-TV channels Film1 and Sport1. The European Commission's ("EC's") vertical concerns included full and partial input foreclosure of Film1 to competing pay TV distributors. It also raised concerns that the merged entity would restrict OTT operators' access to third-party content by using the increased bargaining power of its combined cable operations to impose terms in carriage contracts with programmers restricting those providers from supplying their content via OTT.

The EC assessed input foreclosure using a vertical analysis of upstream and downstream margins and also considered a model supplied by the parties evaluating the merged entities' incentives to raise rivals' costs. Concerns were resolved by Liberty's commitment to divest Film1 to a third party (the channel was subsequently sold to Sony) and to terminate clauses restricting OTT supply in existing contracts (and not include such clauses in the future).

While the parties claimed the transaction would eliminate double marginalization between Film1 and Ziggo, the EC was dismissive of this. Pointing to minimum quantity mechanisms in carriage contracts which can align the interests of the upstream and downstream firms, the EC concluded it was "unlikely that any further vertical contracting efficiency can be realized post-merger" (Decision ¶240).

---

3 In baseball-style arbitration the parties submit final offers and the arbiter chooses one of the two, selecting the one that "best reflects the fair market value of the programming at issue" (FCC, *Comcast Corporation and NBC Universal, MB Docket 10-56*, January 2011).

The EC also raised customer foreclosure concerns about OTT operators' access to the parties' broadband platform. Highlighting the parties' role as ISPs providing Internet access to 43 percent of Dutch broadband customers, it pointed to various technical means by which delivery of OTT services to these customers could be inhibited. This was remedied with an undertaking to maintain sufficient interconnection capacity.

C. Liberty Global/De Vijver Media (EU 2015)

This was a purely vertical transaction bringing together Belgian cable operator Telenet, owned by Liberty Global, and media company De Vijver Media ("DVM"), provider of two popular Dutch-language FTA channels in Flanders, Vier and Vijf. The EC considered the channels to be important inputs for TV distributors, and Telenet to have a dominant position in TV retailing.

Concerns were raised over both full and partial input foreclosure. Comparing critical switching rates with survey results on the likely degree of subscriber switching, the EC concluded that there would be a strong incentive to withhold Vier and Vijf from rival distributors. Using a Nash bargaining model similar to that employed in *Comcast/NBCU*, it also found that there would be a strong incentive for partial input foreclosure (also referred to as "raising rivals' costs"). There was no discussion of offsetting efficiency gains from EDM as "the Notifying Parties [had] not made any claims that the Transaction would lead to vertical efficiencies" (Decision ¶499). The EC further determined that input foreclosure of OTT providers was also likely. To overcome concerns the parties reached agreement on licensing terms with several distributors during the investigation and gave formal undertakings to license Vier and Vijf to competing distributors on FRAND terms.

The EC also considered a full customer foreclosure strategy of channels targeting similar audiences to Vier and Vijf but concluded that it would not be profitable. Focusing instead on partial customer foreclosure, especially via electronic program guide ("EPG") positioning, the EC found that this could confer part of the benefit of full foreclosure with limited costs. It therefore required the parties to amend carriage agreements with potential target channels to prevent unilateral reductions in license fees and changes in the channels' EPG positions.

D. AT&T/Time Warner (U.S. 2018)

The combination of Time Warner's video programming and AT&T's distribution assets, specifically its U-verse IPTV service and the DirecTV DTH satellite platform, was challenged by the DOJ and proceeded to trial at the District Court in Washington, D.C.

The government's case focused almost entirely on the risk of partial input foreclosure of Time Warner's programming from rival distributors (both MVPDs and OTT operators, though no discussion of the latter appeared in the judge's opinion). In support of its claim that the merger would represent a significant lessening of competition, the government's economic expert Carl Shapiro presented a bargaining model similar to that developed by the FCC in *Comcast/NBCU*.

In his published opinion, Judge Leon rejected not only the inputs into the bargaining model, but also two key principles underlying such an approach. First, he considered that payoffs from a permanent "blackout" of programming (a key ingredient of the assessment of negotiated outcomes) were irrelevant as such events were "a vanishingly rare occurrence."[4] Second, he rejected the notion ("the economist's assumption," as he put it at trial) that a vertically-integrated firm would consider its *entire* profit when negotiating carriage decisions with rival distributors, rather than that of each of its business units separately, in favor of testimony from executives claiming that ownership of a distributor plays no role in affiliate fee negotiations. Nonetheless, he accepted the parties' claim of consumer price reductions from EDM (also accepted by the government's economic expert), although this involves consideration of the firm's profit as a whole. Judge Leon also accepted empirical estimates of (the absence of) price responses to historical integration/disintegration events presented by the parties' economic expert, Dennis Carlton.

Breaking tradition with past practice, no customer foreclosure concerns were brought forward by the DOJ, whether for channels rival to Time Warner's or for OTT providers concerned about obtaining access to the merged entity's broadband platform. Thus, having rejected the government's position that the price impact of partial input foreclosure would outweigh efficiencies from EDM, Judge Leon denied the request to block the merger.

E. At a Glance

The issues addressed by regulators in the four vertical media mergers are set out at a glance in Figure 1 below. As is apparent, *AT&T/Time Warner* is distinct from the other recent mergers not only in the scope of the foreclosure concerns pursued by the DOJ but in the ultimate decisions on their relevance taken by the court. We discuss what we consider to be the most important of these differences in the rest of this note.

4 A permanent "blackout" is the permanent failure to reach agreement between the integrated programmer and a rival distributor.

Figure 1: Concerns raised by regulators in recent vertical media mergers in the U.S. and EU

	Input foreclosure of programming to MVPDs/OTTs	Customer foreclosure of channels' access to MVPDs	Customer foreclosure of OTTs' access to ISPs	Elimination of double marginalization
Comcast/NBCU (US 2011)	✓	✓	✓	Rejected by DOJ
LG/Ziggo (EU 2014, 2018)	✓	✓	✓	Rejected by EC
LG/DVM (EU 2015)	✓	✓	✕	Not claimed
AT&T/TW (US 2018)	✓	✕	✕	Accepted

III. "ONE OF THESE THINGS IS NOT LIKE THE OTHERS"

The assessment of *AT&T/Time Warner* deviates from previous analyses of vertical media mergers in the U.S. and EU in at least three important ways. First, puzzlingly, the U.S. government chose not to push as a major concern customer foreclosure of OTT providers' access to ISP networks. Second, and again puzzling, the government readily granted the parties' claims of efficiencies from EDM. Finally, Judge Leon's evisceration of the use of bargaining models in vertical merger analysis is something that needs to be reflected on.

A. No Concern about Foreclosure of OTT Providers' Access to ISP Networks

One of the biggest surprises in *AT&T/Time Warner* was the government's decision not to address potential foreclosure concerns related to actions the integrated firm could take to disadvantage OTT providers in its role as ISP provider. As shown in Figure 1 above, such concerns were addressed in both the *Comcast/NBCU* and *Liberty Global/Ziggo* mergers.

This is particularly surprising given the lack of competition in U.S. broadband markets. According to the FCC, as of the end of 2016, 74 percent of households had access to two or fewer providers of services at the superfast broadband speeds required for high-quality and reliable video services (25 Mbps).[5] This simply confirms what everybody already knows: that the vast majority of U.S. households wanting high-speed broadband access can go to one of two places, their local cable or telecoms incumbent. By contrast, regulated access to broadband lines promoted by the EC ensures that in most EU countries there are multiple providers of superfast broadband services available to most households. For example, in the UK it is reported that around 95 percent of premises have access to superfast broadband (>24Mbps), with BT reaching almost 90 percent of premises.[6] Since BT's network is used by two large competitors, and a number of smaller ones, in addition to BT itself, it seems likely that close to 90 percent of UK premises have access to at least three providers of superfast broadband and, when Virgin Media's cable broadband network is also taken into account, that around half are served by at least four superfast providers.

Similar concerns arise with mobile Internet. According to the FCC, AT&T is one of the two leading U.S. wireless telecommunications providers, with a 2016 market share of 32.4 percent. Together with Verizon, the other leading national wireless provider, AT&T is leading investments in next-generation 5G mobile internet technology, suggesting that such concerns will only grow with time.

In such settings, it is reasonable to be concerned that the merged entity may disadvantage OTT providers by, *inter alia*, charging higher interconnection fees, degrading transmission of OTT content, introducing data caps or usage-based pricing that make it more expensive for consumers to access OTT content, negotiating exclusive deals with third-party programmers, and/or making their own programming less available to

5 FCC, Internet Access Services: Status as of December 31, 2016 (released 02/18), Figure 4. *Available at* https://www.fcc.gov/internet-access-services-reports.

6 Department for Digital, Culture, Media and Sport, "Future telecoms Infrastructure Review: Call for Evidence," December 19, 2017; https://labs.thinkbroadband.com/local/ (as of August 2018).

OTT providers. As described in Rogerson (2018), each of these issues was analyzed in depth in the 2014 proposed *Comcast/Time Warner Cable* merger, which was determined by both the FCC and DOJ to pose significant competitive harms (and was subsequently withdrawn by Comcast).[7] Similarly, in *Comcast/NBCU* the FCC imposed conditions ensuring equal treatment to that of the integrated operator's OTT offerings to mitigate such concerns. In *Liberty/Ziggo*, too, the EC considered similar concerns and imposed conditions to ensure adequate interconnection capacity.

Yet, for *AT&T/Time Warner, potential foreclosure of OTT video providers' access to the integrated entity's ISP service didn't even make it into the case*. As noted by Nilay Patel in *The Verge*, "Judge Leon says Netflix and Hulu … are major competitors to AT&T and Time Warner, but both the government and the judge fail to note that all of them depend heavily on open access to AT&T's network to reach consumers." We can only ask, "Why not?"

B. Efficiency Gains were Readily Granted

Another significant departure of *AT&T/Time Warner* from past precedent was its ready granting of efficiency gains from EDM. In such cases efficiency gains – even the more quantifiable kinds like EDM – tend to be resisted by regulators.

In its concluding statements in *Comcast/NBCU* in 2011, the DOJ wrote that the merged entity,

> is unlikely to achieve substantial savings from the elimination of double marginalization. Documents, data, and testimony obtained from Defendants and third parties demonstrate that much, if not all, of any potential double marginalization is reduced, if not completely eliminated, through the course of contract negotiations between programmers and distributors over quantity and penetration discounts, tiering requirements, and other explicit and verifiable conditions.

In the same case, the FCC concluded that efficiency gains from EDM arise only when the additional customers attracted to the integrated firm by lower prices could not also obtain its content from a rival distributor, as the payment of per-subscriber fees by such distributors introduces an opportunity cost equivalent to the per-subscriber fee paid by the integrated firm prior to the merger. The EC similarly dismissed efficiency gains from EDM in *Liberty/Ziggo* on grounds that contracts had minimum quantity requirements which already eliminated double marginalization pre-merger.

In his opinion, Judge Leon wrote that he was persuaded by evidence presented at trial by the parties' economic expert, Dennis Carlton, purportedly finding that previous episodes of vertical integration in the industry had not been associated with higher prices for integrated content to rival distributors. Interestingly, the FCC reached the opposite conclusion when it analyzed the data underlying similar evidence presented by the parties in *Comcast/NBCU*. In any case, interpretation of this evidence is questionable: it would have been surprising if evidence of price increases *had* been found. With long-term contracts in place, price increases would be delayed and might not yet show up in the data. Moreover, the conditions placed on parties in previous mergers specifically forbade price increases to rivals (at least for the duration of the undertakings, a period that overlapped with some of the data being analyzed).

What is particularly surprising about the DOJ's challenge of this empirical evidence, however, is its failure to mention "the dog that *didn't* bark." Dennis Carlton in his trial testimony claimed that efficiency savings from EDM would be expected to be realized at once, immediately lowering prices charged by the integrating firm. If such an effect occurs, *shouldn't that also have been evident in the data from previous vertical mergers and divestments?* And if that evidence were not present, should that not have cast doubt on one of the parties' key benefits claimed from the merger?

IV. BARGAINING MODELS: KABUKI DANCES OR RUBE GOLDBERG MACHINES?

The most striking departure of the *AT&T/Time Warner* judgment from previous cases is the wholesale dismissal of bargaining theory as a useful framework for quantifying the consequences of partial input foreclosure (i.e., raising rivals' costs), both in general and in this specific case.

Judge Leon objected to two key maintained assumptions in the government's case. First, he rejected the idea that the merged entity would internalize the impact of its programming division's negotiations with rival distributors on the profits of its distribution division – in other words, that the merged entity would act in a "joined-up way" with the two divisions able to work out the licensing strategy that maximized group profit (the "profit internalization" issue). Second, he dismissed the notion that a reasonable threat point in a bargaining framework is that of a permanent blackout, even though this may not often occur in practice, if at all.

7 Rogerson, William P. (2018). "Economic Theories of Harm Raised by the Proposed Comcast/TWC Transaction (2015)," in The Antitrust Revolution, 7th edition, edited by John E. Kwoka, Jr. and Lawrence J. White, Oxford University Press, New York.

A. On Profit Internalization

In the context of bargaining, the judgment entirely dismissed the notion that programming and distribution divisions within a single firm operate in a "joined-up way" to maximize firm profit. This view was based almost exclusively on testimony by executives to the effect that "this is not how things work" and that each division fends for itself. We find the acceptance of this position surprising. As noted by the government's expert, Carl Shapiro, not only is joint profit maximization a maintained assumption throughout economics and finance, *it is also the assumption that you are making if you are willing to grant efficiency gains due to the elimination of double marginalization.* Put another way, if one accepts that there is an efficiency in the vertical chain arising from programming becoming available to the distribution division *at cost,* it is inconsistent to argue that the integrated firm's programming division will be oblivious to benefits to other parts of the group and will maximize only its divisional profit when negotiating distribution agreements with rivals.

It is also surprising that the government did not introduce to trial direct empirical evidence on this point contained in an academic paper recently published by one of us with three academic co-authors.[8] To address the core question in a vertical merger – is it likely to be welfare-enhancing or welfare-reducing? – the paper builds a comprehensive model of the U.S. pay-TV industry, incorporating a souped-up version of the bargaining model used in *Comcast/NBCU, Liberty/DVM*, and *AT&T/Time Warner*. Focusing on the carriage of U.S. Regional Sports Networks ("RSNs") between 2000 and 2010, the paper finds that *if* there are indeed efficiency gains via EDM, then vertical integration of the networks studied increases consumer welfare by approximately 15 percent on average. But, hidden in this average: when full foreclosure and/or significant instances of raising rivals' costs occur, welfare losses from unavailable or more expensive access to channels can wipe out these efficiency gains (and would be welfare-reducing in the absence of efficiency gains).[9]

Most salient for *AT&T/Time Warner*, the paper also *estimates directly the strength of internalization by integrated firms*, finding that an integrated distributor internalizes 79 cents of each dollar of profit realized by its affiliated programmer when making pricing, carriage, and internal-to-the-firm bargaining decisions. Similarly, it finds that the integrated firm's programming division fully (indeed perhaps more than fully) takes into account the benefits to its distribution division when a rival is denied access to its programming. In other words, the paper finds empirical support for the idea that integrated firms internalize the profits of their constituent divisions. It is very surprising that this evidence was not presented at trial.

B. On the Appropriate Threat Point in Bargaining Models Applied to Vertical Media Mergers

Judge Leon also dismissed the idea that a channel's total blackout is an important element in a carriage negotiation with a distributor. But this begs the question: does that mean one should throw out bargaining models altogether, or just apply them in a better way? The judge did the former; we would argue for the latter.

The essence of bargaining models underlying the analysis of partial input foreclosure is simple: if A and B are negotiating over the price of a transaction and A's outcome in the case of no agreement gets better (what's called their "no agreement profit" or "threat point"), would we not expect A to get a better outcome in that agreement? Allowing for profit internalization between divisions of an integrated firm, a vertical merger increases the integrated programmer's threat point because failure to reach an agreement with a rival distributor induces some customers of that distributor's customers unhappy with the lack of access to the negotiated programming may switch to the integrated firm's distribution division. This means the integrated programming division is better off in such a negotiation. Simple.

But what is the right threat point to use? In the academic work summarized above, the authors – like the DOJ – used threat points based on permanent blackouts when considering integrated firms' incentives to foreclose. Judge Leon in *AT&T/Time Warner* declared this to be not right, as in practice permanent blackouts had not occurred for Time Warner content. While we are not convinced – there have been permanent blackouts for high-value sports networks in both Philadelphia and San Diego, which were used as evidence in the academic work cited above – if Judge Leon's point is accepted, this raises the question of what should be used instead.

---

8 Gregory S. Crawford, Robin S. Lee, Michael D. Whinston & Ali Yurukoglu (2018), "The Welfare Effects of Vertical Integration in Multichannel Television Markets," *Econometrica*, volume 86, Issue 3 (May, 2018), pp. 891-954.

9 The paper's results also highlight the importance of effective Program Access Rules: in their absence full foreclosure would occur for 4 out of 26 RSNs and prices in the other 22 cases would be 18 percent higher on average. It furthermore provides guidance for competition regulators about conditions when adverse welfare effects are likely: when the integrated distributor has a large footprint, when it has higher profit margins than rivals, when there is a smaller market expansion effect from serving the rival (e.g., lower ad rates and fewer complete non-subscribers), and when there is higher substitutability between the integrated and rival distributors.

Short-term losses from temporary blackouts might be considered a more reasonable threat point. While this may have been more convincing to Judge Leon, it is likely that such a model would have suggested a smaller increase in negotiated prices, as fewer subscribers switch in response to a temporary blackout than a permanent one, making it less likely that this detriment would outweigh the claimed efficiencies from EDM. Another possibility is threat points that worsen with the time since disagreement, which might give rise to a larger merger detriment.[10] While these are open issues for both academics and practitioners, they are not so insurmountable as to throw out the baby with the bath water.

V. RETOOLING THE BOX

Vertical merger analysis is a mainstay of media mergers around the world. Yet a major vertical deal had not been tried in front of a judge in the U.S. for over 40 years – and the judgment in *AT&T/Time Warner* is puzzling. It is surprising that the likely real issue in the case, potential customer foreclosure of OTT providers from the merged entity's broadband network, was completely unaddressed by both sides. It is surprising that efficiencies were so readily accepted, and by the DOJ as well as Judge Leon: there are both theoretical and empirical reasons why reduced double marginalization may not take place in vertical media mergers. It is surprising that bargaining models – however poorly argued and clunkily applied to the case – were so comprehensively jettisoned even as a general economic framework. The analogy with a Kabuki Dance may be fair, but *never* a Rube Goldberg machine.

It is therefore *un*surprising that the DOJ appealed the decision, focusing particularly on this point.[11] The toolbox for the enforcement of vertical mergers needs to be revamped and validated. But bargaining models should be "released on appeal" as a useful framework for analysis in these cases.

10 Our thanks to Mike Whinston and Robin Lee for this suggestion.

11 Johnson (2018), "Justice Department gives glimpse of appeal argument in AT&T-Time Warner Case," *Variety*, July 18, 2018 quotes the DOJ filing, claiming that their case "based on well-accepted and non-controversial economic principles of bargaining, but the district court effectively discarded those principles and their logical implication that the merged firm will raise prices to rivals."

THE DISTRICT COURT'S *AT&T/TIME WARNER* DECISION: INSIGHTS INTO THE LAW OF VERTICAL INTEGRATION

BY CHRISTOPHER S. YOO[1]

1 John H. Chestnut Professor of Law, Communication and Computer & Information Science and Founding Director of the Center for Technology, Innovation and Competition, University of Pennsylvania.

I. INTRODUCTION

Arising out of the first government action to block a vertical merger in over forty years, the District Court's opinion regarding the fate of AT&T's acquisition of Time Warner represented one of the most eagerly anticipated antitrust decisions in quite some time. Not because the law was unsettled. Quite the contrary, the law on vertical integration is widely regarded as being relatively clear, at least by legal standards. The bigger question was whether by opting to proceed with the case, the Justice Department was signaling its intention to adopt a more aggressive posture towards vertical integration. And in the U.S. system, such a change in enforcement policy can only be effective if sanctioned by the courts.

Those hoping for a major sea change in the law of vertical integration must have been sadly disappointed. Although I found some personal gratification from the fact that the first major law review article that I authored as a law professor was the first source cited in the main body of the opinion (p. 7),[2] at first blush, the decision appeared to turn on case-specific assessments of the credibility of testimony offered by competitors and expert witnesses that would appear to have few implications for future cases.

Closer inspection reveals that the District Court's opinion does more than that. Its careful restatement of the law confirms and reinforces key aspects of the law. In addition, the detailed application of the law to the facts of the case yields new insights that did not exist before.

II. THE NATURE OF MUST-HAVE CONTENT

One of the most interesting aspects of the District Court's decision was its rejection of claims that the merged firm would harm competition by making it harder for other cable companies, satellite companies such as DirecTV and the DISH Network, and other providers of multichannel video (defined in the statute as Multichannel Video Programming Distributors or "MVPDs") to obtain access to must-have content. The District Court correctly concluded that in order to state a plausible claim on this basis, the content must truly be essential to an MVPD's survival; it is not enough that the content is simply very popular.

As an initial matter, it is hard to see Time Warner's programming as essential. The alleged must-have nature of Time Warner content is undercut by the factual record in the case, which showed that the DISH Network suffered only negligible losses when CNN went dark during the 2014 midterm elections (p. 77), DISH Sling has succeeded despite not having content that many regard as must-have (such as CBS and Showtime), testimony from Charter and DISH acknowledging that Time Warner content was not essential, and the inability to back up their bare assertions with any analysis led the Court to discount competitor claims of essentiality (pp. 75-78).

A review of Time Warner's flagship channels reveals that each faces significant competition that raises serious questions about their status as must-have. Although the testimony placed CNN in second place among cable news channels (p. 31), recent media reports indicate that CNN has since slipped to third place and is facing increasingly intense competition at a time when the number of people relying on television as their primary source of news is declining. Time Warner's general interest channels, such as TBS and TNT, face vigorous competition from similar networks transmitting old movies and off-network syndication, such as USA (which outranks TBS in number of viewers), Nickelodeon, and Lifetime, and the inputs necessary to create are readily available on the open market.[3] Finally, the District Court found that Time Warner's premium movie channels, such as HBO and Cinemax, have never reached more than 30 percent of available households, have long faced vigorous competition from channels such as Showtime, Starz, and Epix, and are increasingly facing competition from new over-the-top ("OTT") video providers (which the District Court calls "virtual MVPDs") such as Netflix, Hulu and Amazon Prime (pp. 23, 34 n.10, 35, 167).

The ready availability of substitutes for each of these types of programming renders claims of essentiality untenable. Instead, the District Court correctly concluded that must-have programming is a marketing phrase used by virtually every cable channel to convince others that its content is popular (p. 77). As such, the District Court's opinion is likely to make both litigants and courts more careful about casual attempts to characterize content as must-have.

2 All in-text page references are to the slip opinion in *United States v. AT&T Inc.*, Civil Case No. 17-5211 (RJL) (D.D.C. June 12, 2018), *available at* https://ecf.dcd.uscourts.gov/cgi-bin/show_public_doc?2017cv2511-146.

3 Christopher S. Yoo, *Vertical Integration and Media Regulation in the New Economy,* 19 Yale J. on Reg. 171, 230 (2002).

III. THE FOCUS OF MERGER-SPECIFIC HARMS

Even if content were so popular with consumers as to become essential for an MVPD's success, the courts have long recognized that turning popularity into a source of antitrust liability risks having the perverse effect of penalizing firms that were too successful in satisfying their consumers. Such a result would run afoul of *Alcoa's* hoary maxim, "The successful competitor, having been urged to compete, must not be turned upon when [it] wins."[4] Moreover, as the Supreme Court recognized in *Trinko*, the desire to become so popular as to become dominant "is not only not unlawful; it is an important element of the free-market system" so long as it is the result of "'growth or development as a consequence of a superior product, business acumen, or historic accident.'" Indeed, "The opportunity to charge monopoly prices—at least for a short period—is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth."[5] In other words, popularity may be the result of competition on the merits, which is precisely what the antitrust laws are designed to promote, not deter.

Simply put, unless accompanied by some anticompetitive practice, successful product, process, and business model innovations that place one party in a superior bargaining position are something to be celebrated, not penalized. This risk of dampening procompetitive activity is one of the major reasons why the courts rejected Philip Areeda and Donald Turner's proposal to impose antitrust liability on "no-fault monopoly."[6]

Thus, even if Time Warner's channels were truly must-have content, that fact would not by itself provide a basis for blocking the merger. Indeed, the District Court repeatedly recognized that whatever special appeal that Time Warner's channels have would exist regardless of whether the merger were permitted to go through or not (p. 78). That is another way of saying that the mere fact that particular content may be essential does not raise merger-specific harms that justify antirust intervention. Blocking the merger would require some finding that vertical integration somehow enhanced the merged company's ability to exploit the bargaining leverage provided by must-have content.

The District Court did spend considerable time evaluating and ultimately rejecting the claim that the merged company would refuse to license Time Warner content to other MVPDs. The opinion acknowledged that content blackouts are bad not just for MVPDs, but also for cable networks, whose profitability depends on their ability to secure wide distribution. On balance, the District Court found that the merged company would not find it profitable to deny any MVPD access to Time Warner content (pp. 72, 156, 160). Indeed, the government's expert conceded as much, a fact that the District Court saw fit to point out on six separate occasions (pp. 72, 82, 97, 117, 152, 165 n.57).

This dynamic underscores the extent to which that cable networks and MVPDs are channel partners whose interests are both partially cooperative and partially adversarial. Every link in a vertical chain of production shares a common interest in maximizing the value of the entire chain. Once the surplus has been maximized, all actors in the chain have the inherently adversarial incentive to claim as much of that surplus as possible. As an abstract matter, the iteration should allow the long-run benefits from maximizing overall value to dominate the short-run benefits of claiming more of the surplus. But some industries fall into the unfortunate trap of permitting the short-run adversarial interests to dominate the long-run cooperative interests. This is particularly unfortunate because in almost all cases, the parties are eventually able to agree on a deal. Indeed, the District Court found that Time Warner has always been able to reach agreement with MVPDs eventually and that there has never been a long-term blackout of Time Warner content (p. 72). The District Court also found that the 2011 vertical merger between Comcast and NBC Universal did not lead to any attempts at foreclosure (p. 106).

Faced with the impossibility of supporting a claim that the merged company would cut other MVPDs off from access to Time Warner content, the government took a different tack. It argued that the merged company would gain increased bargaining leverage from the fact that some of the subscribers who dropped an MVPD because of the lack of Time Warner content would migrate to DirecTV. Losses in viewership resulting from the deadlock would be partially offset by increased revenue from new DirecTV subscribers diverted from the other MVPD. This increased leverage would allow Time Warner to strike a deal at a higher price (p. 73).

It is hard for antitrust courts to identify what constitutes an improper exercise of bargaining power. As the District Court noted, both sides should expect these negotiations to be tough and for both sides to threaten to impose a blackout (pp. 71-72, 157). Indeed, deadlock is a not uncommon feature of any arm's length negotiation. The District Court found unconvincing competitors' generic statements of enhanced bargaining power that were not backed by any economic analysis to justify those bare assertions (pp. 83, 94-96). Any supposed increase in bargaining power is further limited by consumers' increasing propensity to cut the traditional pay television cord altogether and to subscribe to

4 *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 430 (2d Cir. 1945).

5 *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP,* 540 U.S. 398, 407 (2004) (quoting *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966)).

6 3 Phillip Areeda & Donald F. Turner, Antitrust Law 63-67 (1978).

OTTs like Netflix (pp. 23, 138). The claims of enhanced bargaining power were further undercut by testimony from rivals stating that they did not believe that the merger would increase Time Warner's bargaining leverage (p. 93). Indeed, as the District Court noted, no actor conceded that it would feel compelled to agree to any possible price increases demanded by the merged company (p. 98).

Such speculative assertions that the vertical integration would lead to an increase in price do not constitute proof of a likelihood of a substantial lessening of competition. Such an assessment is further complicated by the fact that successful competition on the merits can also increase a company's bargaining power. Imposing antitrust liability on this basis risks dampening the incentives for firms to create those improvements or simply protecting the merged company's "rivals from any and all competitive pressures they would experience should the merger go through" (p. 92).

IV. THE NEED TO SHOW BOTH THE ABILITY AND THE INCENTIVE TO HARM COMPETITION

Another key implication of the District Court's decision results from its emphasis that an antitrust violation requires a showing of both the ability and the incentive to engage in anticompetitive activity. Both showings are necessary, although neither by itself is sufficient.

Consider the District Court's discussion of the potential impact of preventing competing MVPDs from obtaining access to Time Warner programming. The District Court recognized that the merged company had the ability to do so, but found that it would find any such course of action to be unprofitable. As the opinion noted, "evidence indicating defendant's recognition that it could be possible [to withhold content from its MVPD rivals] is a far cry from evidence that the merged company is likely to do so" (p. 90). Simply put, showing that the merged company has the *ability* to foreclose their competitors says nothing about their *incentive* to do so. Both showings are necessary to state a plausible case of consumer harm (p. 83).

The District Court came to the same conclusion with respect to the claim that the merged company would unilaterally foreclose OTTs. Although the merged company might have the ability to withhold content (or alternatively force OTTs to take more content than they would like), it was likely to find such practices inconsistent with its business strategy to promote wider availability of content over wireless devices (pp. 153-57). With respect to the possibility of tacit collusion with Comcast to harm OTTs, the government's expert asserted that the possibility existed, but conceded that he had no way to assess how likely it was to occur (p. 159). The District Court again found no credible proof that the merged company would have the incentive to reduce distribution of Time Warner programming (p. 160). If anything, the merged company had the incentive to encourage OTTs rather than to quash them (pp. 161-63). And even if it did withhold Time Warner content, the fact that many OTTs have been able to survive without other programming properties generally regarded as must-have raises questions about whether such content blackouts will have the effect predicted by the government (pp. 75-77, 151 n.52). Indeed, OTTs are thriving despite the fact that no OTT carries every channel that most people regard as must-have programming.

The District Court drew the same conclusion with respect to the government's third theory of liability, which argued that the merged company might withhold HBO-based promotions from rivals. The District Court found that the merged company's heavy dependence on HBO-based promotions suggested that it lacked any incentive to engage in this type of behavior (pp. 166-67). In addition, the absence of any proof that customers leaving other MVPDs would subscribe to DirecTV raised serious questions about the merged company's ability to pursue this strategy. Indeed, the District Court concluded that such customers were just as likely to forego subscribing to an MVPD altogether and simply sign up for Netflix (pp. 167-68). The opinion thus concluded that the merged company would possess neither the incentive nor the ability to use withholding HBO-based promotions to harm competition (p. 169).

All of these analyses reinforce the importance of evaluating whether a firm has both the ability and the incentive to engage in the allegedly anticompetitive conduct. All too often, the presence of a large, dominant firm is considered enough to tempt imposing antitrust liability without sufficient inquiry into whether the practice being challenged would actually be profitable. Fortunately, the economic incentives facing large companies tend to align with the maximization of consumer welfare in the vast majority of cases.

V. THE INCREASING IMPORTANCE OF EMPIRICAL ANALYSIS

One of the most striking aspects of the District Court's opinion is the emphasis it places on empirical analysis. With respect to industry testimony, the District Court disregarded simple statements of opinion offered by competitors because they were not backed up by any economic analysis (pp. 92-94). Clearly, the District Court regarded some empirical foundation as a necessary precondition for testimony to carry any weight.

The importance of empirical analysis is even more apparent in the opinion's discussion of the expert testimony offered by both sides. The District Court recognized (and the government's witness conceded) that event studies were superior to model-based approaches (p. 100). Event studies of three recent vertical mergers in the cable industry (News Corp.'s 2003 acquisition and 2008 divestiture of DirecTV, Time Warner's 2009 spinoff of its cable assets, and Comcast's 2009 acquisition of NBC Universal) conducted by the defendant's witness found no statistically significant evidence of price increases for programming and found some evidence that prices had decreased and that the industry had become even more competitive since those transactions (pp. 101-02). These findings are consistent with the findings of a recent survey of the peer-reviewed empirical literature on vertical integration co-authored by a scholar who would later serve as FTC Chief Economist during the Obama Administration.[7] This survey found that, aside from a few isolated studies, the weight of the evidence indicates that "under most circumstances, profit-maximizing vertical-integration decisions are efficient, not just from firms' but also from the consumers' points of view," a conclusion that the researchers did not have in mind when they began their review of the evidence.[8] Somewhat surprisingly, the government's expert did not conduct his own analysis of this evidence (p. 100).

For testimony based on economic models, the District Court's opinion makes crystal clear that the parameters going into such models must have a strong empirical foundation (pp. 118-45) and must take into account real-world institutional features, such as long-term contracts, that can limit the merged company's ability to raise prices (pp. 146-48, 163-64). Once these are taken into account, the empirical evidence indicated that consumer prices might actually go down (p. 147).

The District Court's skepticism of the government expert's model is an apt illustration of the distinction between *exemplifying theory* and *generalizing theory* drawn by MIT economist Franklin Fisher.[9] Generalizing theory proceeds from fairly general assumptions to establish broad propositions that apply under a wide range of circumstances. Exemplifying theory, in contrast, employs specialized assumptions to show what can happen under particular circumstances and produce results that are quite sensitive to small changes in assumptions. As such, the proper role of exemplifying theory is to advance possibility theorems demonstrating that certain outcomes can exist, under appropriate circumstances, of course. Without a solid empirical foundation showing how likely those preconditions are to be met, exemplifying theory only identifies what *can* happen without shedding much light on the likelihood that the predicted possibility theory might actually come true.[10]

The District Court's desire for a strong empirical basis for the parameters used as inputs into the theoretical model is understandable. Theorems come in the form of "if *P*, then *Q*." Such models can be very good at demonstrating that certain outcomes are possible. Indeed, theoretical models proved invaluable to rebutting calls by the Chicago School to make vertical integration and vertical restraints *per se* legal by showing the existence of circumstances under which vertical integration could harm consumers. As the District Court carefully explained, however, antitrust liability depends on probabilities; mere possibilities are insufficient (pp. 83, 90). Thus, such a model's ability to explain the likelihood of *Q* depends entirely on how likely *P* is true as a factual matter.

The highly stylized nature of most modern theoretical models makes careful study of the empirical basis of parameters particularly important. For example, Michael Whinston's influential model of how tying can induce foreclosure depends on a very specific relationship between the size of the outside market and the minimum efficient scale of the tied product, arguing that tying can leave stand-alone producers with too little volume to compete as cost-effective producers. The relevant ranges for these parameters are quite exacting. If the outside market is larger than the minimum efficient scale for the tied product, the model fails to yield foreclosure. In addition, Whinston acknowledges that his model does not consider whether tying might give rise to efficiencies even though the necessary conditions for his model are the ones under which the elimination of double marginalization would yield significant welfare benefits,[11] which in the case of *AT&T/Time Warner* was recognized by the government's expert to be in excess of $350 million (pp. 57, 66-67, 109). Like the model offered by the government's expert in the *AT&T/*

7 Francine Lafontaine & Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence,* 45 J. Econ. Lit. 629 (2007).

8 *Id.* at 680.

9 The discussion that follows is based on Christopher S. Yoo, *Network Neutrality, Consumers, and Innovation,* 2008 U. Chi. Legal F. 179, 249-56.

10 Franklin M. Fisher, *Games Economists Play: A Noncooperative View,* 20 RAND J. Econ. 113, 117-18 (1989).

11 Michael D. Whinston, *Tying, Foreclosure, and Exclusion,* 80 Am. Econ. Rev. 837 (1990).

Time Warner case, Whinston's model represents a classic example of exemplifying theory in that both employ stylized assumptions that are quite sensitive to small changes in parameters (pp. 138-39, 147). In both cases, any proper assessment of the economic desirability of a vertical practice depends on sound parameterization on the model's inputs and assessment of the potential efficiencies.

VI. THE PROBLEMS WITH DUAL-AGENCY REVIEW

A final striking feature of this case, the difference between this merger review process and that of Comcast's acquisition of NBC Universal, is the absence of extensive conditions on the merger. Although the District Court approved the *AT&T/Time Warner* merger without conditions, the order approving the *Comcast/NBC Universal* merger contained many restrictive provisions. It required *Comcast/NBCU* to license content to OTT competitors and refrain from retaliating against any channel that licensed its content to a competing MVPD. The merged company had to surrender its management rights to OTT competitor Hulu. Lastly, the merger clearance required *Comcast/NBCU* to comply with the Federal Communications Commission's ("FCC's") 2010 Open Internet Order until 2018 even though the courts struck down that order in 2014 for exceeding the agency's authority. The merger review process thus allowed the FCC to impose a restriction on *Comcast/NBCU* that fell outside of its statutory authority.[12]

The FCC's Order clearing the merger was even more onerous, requiring *Comcast/NBCU* to comply with over one hundred merger conditions that spanned twenty-six pages. These included commitments to expand Spanish-language programming; expand local news, local public affairs, and other public interest programming; enter into cooperative agreements with locally focused non-profit news organizations; increase children's programming; develop an on-demand platform for public access, educational, and governmental content; add 1,500 miles to its broadband network; upgrade service in at least six rural communities; provide 600 courtesy broadband account locations in schools, libraries and other community institutions in underserved areas; and create a Broadband Opportunity Plan to promote broadband adoption in low-income homes. In addition, the Order included agreements between *Comcast/NBC Universal* and the Independent Film & Television Alliance to allocate $6 million per year for four years to fund independent productions and agreements with leaders of Asian American, African American, and Hispanic organizations that included commitments on governance, supplier, workforce, and program diversity by creating Diversity Advisory Councils, adding a Hispanic member to Comcast's Board of Directors, and other measures.

While many of these conditions have laudable intentions, none of them even plausibly addressed harms created by the merger. Instead, they are the product of the fact that the *Comcast/NBCU* merger required the transfer of licenses issued by the FCC, in contrast to the *AT&T/Time Warner* merger, which did not. This subjected *Comcast/NBCU* to the FCC merger review process, which applies a public interest standard that includes factors that go beyond those applied by antitrust law and that places the burden of proof on the merging parties to show benefits instead of on the government to show harm. Moreover, in contrast to Justice Department merger review, FCC review is not subject to any statutory time limits, and FCC's self-imposed regulatory guidelines are routinely tolled and extended. The lack of a statutory deadline and the placement of the burden of proof on the merging parties have the effect of forcing the merging parties to offer supposedly voluntary commitments until the FCC is satisfied. To the extent that the conditions are styled as voluntary commitments, they are immune from judicial review.[13]

The contrast between the two mergers provides an eloquent illustration of the problems with dual agency review. Not only is much of the review duplicative; the nature of the FCC review process is characterized by longer delays and enables the agency to impose a wide range of conditions unrelated to the merger that sometimes exceed the agency's authority. Rather than pursue general regulatory requirements that would address a problem with respect to the entire industry, merger conditions impose a one-off restriction that affects only a single actor simply because it had a merger pending and is typically insulated from judicial scrutiny.

VII. CONCLUSION

In the end, the District Court's opinion did more than resolve the case in a factbound way. A close reading reveals that it confirms certain key understandings of the law of vertical integration. Moreover, its application of that law to the facts of the case extended aspects of the law in ways that provide new insights into the scope of the law. Although the District Court decision will likely soon be superseded by the decision of the Court of Appeals, reading it still yields many worthwhile insights upon which practitioners may continue to draw for years to come.

---

12 For other similar examples, see Christopher S. Yoo, *Merger Review by the Federal Communications Commission: Comcast-NBC Universal,* 45 Rev. Indus. Org. 295, 311-12, 314 (2014).

13 *Id.* at 298-99, 311-13.

VERTICAL MERGERS AND THE MFN THICKET IN TELEVISION

BY ERIK HOVENKAMP & NEEL U. SUKHATME[1]

1 Erik Hovenkamp is a Postdoctoral Fellow, Harvard Law School, Project on the Foundations of Private Law; Visiting Fellow, Yale Law School, Information Society Project. Neel U. Sukhatme is Associate Professor, Georgetown University Law Center; Affiliated Faculty, Georgetown McCourt School of Public Policy. We are grateful to Bill Rogerson and Steve Salop for helpful comments.

I. INTRODUCTION

Recently, a number of cable and satellite TV service providers, known as "MVPDs,"[2] have sought to combine with upstream programmers. In 2011, Comcast obtained approval to acquire NBC Universal,[3] and it is now seeking to acquire Sky PLC, a major European programmer.[4] More recently, AT&T (which also owns DirecTV) successfully defended against the government's challenge of its proposed acquisition of Time-Warner,[5] which retains many valuable programming properties, including HBO, Warner Brothers, and Turner Broadcasting. These vertical mergers are occurring against a backdrop of emergent downstream competition, as consumers are increasingly opting for new streaming-based platforms. These "over-the-top" ("OTT") distributors include video-on-demand services like Netflix, as well as "virtual" MVPDs like YouTube TV or Sling TV, which stream the same live TV content as cable or satellite providers.

At the same time, the pay-TV industry is rife with "most-favored nation" ("MFN") agreements.[6] Both programmers and MVPDs increasingly insist upon such arrangements in their dealings with one another. Indeed, there are allegedly even "MFNs on MFNs."[7] This MFN glut has been criticized as undermining competition throughout the industry.[8] One prominent claim is such MFNs forestall the "cord-cutting" movement by preventing effective entry by emerging OTT competitors.[9]

MFNs can take many different forms and may have either pro- or anticompetitive effects.[10] Conventionally, an MFN gives its holder a promise of "equal access" to the transaction terms offered (by the MFN grantor) to third parties. A typical example involves a large buyer who requires an MFN ensuring that it gets a better unit price than smaller buyers. This can help to facilitate quantity discounting over an extended period, while avoiding the need to stipulate all future prices at the outset. Many such arrangements are benign or procompetitive. However, MFNs might also injure competition, such as by excluding smaller competitors or by facilitating coordination among rivals.[11] For instance, an "MFN-plus" requires the grantor to give *strictly worse* terms to third parties, which raises the costs of the MFN holder's rivals.

In the pay-TV industry, MVPDs have increasingly employed an atypical arrangement known as an "unconditional MFN."[12] These agreements may pose significant competition policy concerns, though they have received relatively little attention in the antitrust literature.[13] An unconditional MFN permits the MVPD to "cherry pick" from a programmer's dealings with third parties, taking for itself any distinct benefit provided to a third-party distributor without having to further assume whatever countervailing obligation the third party incurred to secure that benefit.[14]

---

2 "MVPD" stands for "multichannel video programming distributor."

3 *United States v. Comcast Corp. et al.*, 1:11-cv-00106 (D.D.C. 2011).

4 Shalini Ramachandran, *Comcast Drops Bid for Fox Assets, Will Focus on Pursuit of Sky*, Wall St. J. (July 19, 2018), www.wsj.com/articles/comcast-drops-bid-for-fox-assets-will-pursue-sky-1532004447.

5 *United States v. AT&T, Inc.*, __ F. Supp. 3d __, 2018 WL 2930849, (D.D.C. 2018). Note, however, that the government recently filed a notice of appeal.

6 In general, an MFN agreement specifies that one party, A, must give the other party, B, a deal no worse than A offers to some or all third parties with whom A also deals. See, e.g., Steven C. Salop & Fiona Scott Morton, *Developing an Administrable MFN Enforcement Policy,* 27 Antitrust 15 (2013).

7 *See* Initial Comments of INSP, LLC, at 24., No. 16-41 (F.C.C. Feb. 26, 2016), www.fcc.gov/ecfs/filing/10126013185310 [hereinafter INSP Comments I].

8 *See, e.g.,* Shalini Ramachandran, *'Favored Nations' Fight for Online Digital Rights,* Wall St. J. (June 14, 2012), https://on.wsj.com/2uOSSvF.

9 *Id.*

10 *See, e.g.,* Jonathan B. Baker & Judith A. Chevalier, *The Competitive Consequences of Most-Favored-Nations Provisions,* 27 Antitrust 20 (2013).

11 *Id. See also* C. Scott Hemphill & Tim Wu, *Parallel Exclusion*, 122 Yale L. J. 1182, 1208-09 (2013).

12 *See* In the Matter of Promoting the Availability of Diverse and Independent Sources of Video Programming, 31 FCC Rcd. 11352, 2016 WL 5636964 (Sept. 29, 2016) [hereinafter Proposed MFN Rulemaking]. This FCC rulemaking proposal, which would have prohibited unconditional MFNs, was not put into effect.

13 One paper on Comcast's (since-abandoned) bid to acquire TWC discusses unconditional MFNs in a footnote. *See* William P. Rogerson, *Economic Theories of Harm Raised by the Proposed* Comcast/TWC *Transaction, in* The Antitrust Revolution: Economics, Competition, and Policy, at n. 107 (7th Ed., John E. Kwoka, Jr. & Lawrence J. White, eds., 2018).

14 *See* Section III, *infra*.

For example, suppose a programmer offers a lower license fee to a third-party OTT distributor, but only because this MVPD is taking just one network, whereas the MFN holder is licensing three.[15] The MFN holder may then claim that lower price while continuing to distribute all three networks. By contrast, if the MFN were conditional, the MFN holder could only claim the better price if the third party had similarly obtained the rights for the same three networks. For this reason, unconditional MFNs are often described as applying "term-by-term," even when there is an obvious *quid pro quo* or interdependence among different terms.[16] As clarified below, these MFNs may deter any deviations from the standard content packages and price ranges offered by the major incumbent distributors.

While vertical mergers in the industry have received widespread attention recently, the MFN concerns are interrelated. Problematic MFNs, particularly (but not exclusively) unconditional ones, may naturally induce a double marginalization problem,[17] even if the relevant firms are otherwise capable of contracting around it. This creates a strong motivation for integration, but it also raises a question whether a merger is the only way to reduce double marginalization. Further, MFNs may compel a problematic form of reciprocal dealing that facilitates *de facto* coordination between integrated rivals. Thus, as a result of problematic MFNs, the industry's trend toward integration may trigger seemingly-unrelated forms of anticompetitive conduct.

A further problem is that the MFNs discussed here are subject to strict confidentiality agreements.[18] This prevents programmers from specifying precisely which firms are doing what. As such, scholarly inquiries, including ours, necessarily face significant information limitations. For instance, we have no ability to say what particular kinds of MFNs might bind the programmers involved in prior or prospective vertical merger cases. In light of these information constraints, we emphasize this is an area in need of further investigation by the antitrust agencies.

II. EFFICIENCY CONSIDERATIONS

Almost all vertical mergers can have potential procompetitive effects, the most robust of which is elimination of double marginalization ("EDM"). The double marginalization problem occurs whenever the unit price of the upstream good includes a markup (such as a royalty). An upstream markup increases a downstream firm's marginal cost, causing it to raise its price. If both the upstream and downstream firms are monopolies, the final price is higher than if the firms were integrated. This is because an integrated firm would internalize only the true costs of joint-production, not inter-firm transfers. The result is that EDM enhances both profits and consumer welfare.[19]

Vertical mergers, however, might also elicit countervailing anticompetitive effects. For example, in vertically related oligopoly markets, the merged firm might exclude rivals or raise their costs, the incentive for which arises only as a result of vertical integration.[20] Moreover, strategic considerations might diminish or eliminate the merged firm's incentive to lower the downstream price in accordance with EDM. For example, by stealing sales from downstream rivals, a downstream price cut may in turn lead to foregone upstream sales.[21] This opportunity cost can discourage the merged firm from lowering its downstream price after the merger.

EDM is not necessarily merger-specific. Circumstances permitting, it can alternatively be achieved by contract. The conical example is a two-part tariff with the variable (per-unit) price component equal to upstream marginal cost and the fixed price being the source of upstream profits.[22] If upstream marginal costs are essentially zero, as occurs with a nonrivalrous upstream good like programming, then the deal could simply rely on fixed fees alone, rather than imposing marginal fees per unit of distributor output.[23]

---

15 Some OTT distributors offer "skinny bundles" that include fewer networks.

16 *See, e.g.,* Updated Comments of INSP, LLC, No. 16-41, at 18 (F.C.C. March 30, 2016) [hereinafter INSP Comments II], www.fcc.gov/ecfs/filing/60001533407.

17 See the next section for discussion of the double marginalization problem.

18 *See, e.g.,* Comments of Altitude Sports & Entertainment, Outdoor Channel, Sportsman Channel and World Fishing Network at 2, No. 16-41 (F.C.C. Mar 30, 2016), www.fcc.gov/ecfs/filing/60001533198 [hereinafter KSE Comments]. The comments note that programmers are also subject to non-disparagement provisions.

19 Joseph J. Spengler, *Vertical Integration and Antitrust Policy*, 58 J. Pol. Econ. 347 (1950); Michael H. Riordan, *Competitive Effects of Vertical Integration, in* Handbook of Antitrust Economics 145 (2008).

20 *See, e.g.*, Michael A. Salinger, *Vertical Mergers and Market Foreclosure,* 103 Q.J. Econ. 345 (1988).

21 *See, e.g.,* Steven C. Salop, *Invigorating Vertical Merger Enforcement,* 127 Yale L.J. 1962, 1970-71 (2018).

22 With this tariff, there is no per-unit markup acting like a downstream marginal cost.

23 These marginal fees are usually applied to the number of per MVPD subscribers per month.

III. VERTICAL MERGERS AND EDM IN PAY-TV

Vertical mergers between MVPDs and programmers have a few distinguishing characteristics that bear on the efficiency analysis. First, the relevant programming content is nonrivalrous: once created, it is effectively costless to expand the volume of output, which is unlimited. There is thus no inherent reason why one platform's delivery of such content should interfere with rival platforms' ability to do the same. Second, the value consumers get from such content typically does not depend on what platform they use to access it. Third, because the content is usually subject to copyright protection, the rightsholder is the only party who can supply it; there are no perfect substitutes.

In mergers targeting important physical assets, such as complex production machinery, there might by cost-reducing "synergies" that result from integration of the two firms' technologies. But the assets at the heart of vertical media acquisitions are intellectual properties, not physical assets. Programming content is encoded in standard digital files, and all MVPDs already specialize in distributing content in this form. Thus, absent a double marginalization problem, nonexclusive licensing agreements would seem sufficient to provide an MVPD with everything it needs to conduct its business — but not the right to exclude rivals.

In the absence of production-based efficiencies, EDM would seem to be the most broadly-plausible efficiency in MVPD-programmer mergers.[24] However, it is still important to ask whether it is merger-specific.[25] In fact, there is some evidence that fixed fee licensing of programming is often commercially practicable, at least when it is not frustrated by MFNs. For example, Netflix uses fixed fees for most of its licensing agreements.[26] More generally, even programmers who license mainly to MVPDs often use fixed fees when licensing with on-demand streaming services.[27] Finally, economic intuition suggests that, where transaction costs are substantially outweighed by transaction *value*, as they are in the cable industry, then the parties are willing to work harder to overcome the demand-uncertainty that is often hypothesized to preclude contract-based EDM.[28]

IV. MFNS AND DOUBLE MARGINALIZATION

If EDM cannot be feasibly achieved by contract, this may be due to MFNs, not nebulous "bargaining frictions." To explore this possibility, we begin with a discussion of the relevant MFN agreements. We then explain how they may naturally induce a double marginalization problem.

A. The MFN Thicket

MFNs are now pervasive in the pay-TV industry. A serious concern is that MFNs may "discourage discounting and other innovative arrangements" in the distribution of upstream content.[29] The most problematic arrangements — unconditional MFNs — may adversely distort the competitive process generally. Many independent programmers allege they are now regularly required to accept such MFNs.[30] To ensure compliance, the parties may rely on "MFN audits" conducted by third party accountants.[31] Smaller programmers will tend to be bound by the largest number of such MFNs, since they have inferior bargaining power in most transactions. And, for the opposite reason, relatively large MVPDs will tend to hold the most unconditional MFNs.

24 In the *AT&T/Time-Warner* case, AT&T advocated other efficiencies, namely developing "a national platform for targeted video advertising" or the creation of "innovative video features." We will not discuss those theories, except to say we are skeptical that they are merger-specific.

25 The DOJ apparently conceded that EDM was merger-specific in the *AT&T/Time-Warner* case.

26 In its webpage for "Top Investor Questions," Netflix notes that "[w]e generally license content for a fixed fee and a defined time period." The webpage is *available at* https://ir.netflix.com/top-investor-questions#fcq-1.

27 *See, e.g.¸* Viacom Inc., Form 10-K, at 51 (Nov. 16, 2017), https://bit.ly/2JBX7QP (noting that Viacom uses fixed fees when licensing to on-demand OTT services).

28 *See, e.g.,* Frank Mathewson & Ralph Winter, *Tying as a Response to Demand Uncertainty,* 28 RAND J. Econ. 566 (1997).

29 *See* Steven C. Salop, *The AT&T/Time Warner Merger Case: What Happened and What is Next,* Medium (June 29, 2018), https://bit.ly/2JExdvF.

30 *See, e.g.,* Comments of TheBlaze, Inc., No. 16-41 (F.C.C. March 30, 2016), https://ecfsapi.fcc.gov/file/60001566056.pdf.

31 *See* KSE Comments, *supra* note 18, at n. 4. Note that these audits, if undertaken between integrated competitors, may necessarily facilitate price information sharing. The just-cited comment notes that less restrictive MFN agreements permit the programmer to "self-certify" compliance, but that this option is increasingly unavailable.

As defined by the FCC, an unconditional MFN "entitles an MVPD to contractual rights or benefits that [the programmer] has offered or granted to [a second MVPD], without obligating [the MFN holder] to accept any terms and conditions that are integrally related, logically linked, or directly tied to the grant of such rights or benefits in the [the second MVPD's] agreement."[32] In other words, the MFN holder can pick and choose, term by term, any benefits afforded to other distributors, without assuming whatever obligation those distributors incurred to secure that benefit.

For example, suppose a programmer and a larger MVPD agree that the programmer's content will appear in this MVPD's premium tier (which has low penetration), for which the latter will pay 50 cents per subscriber. Further, the programmer and a smaller MVPD agree this content will go in this MVPD's basic and most penetrative tier, and in exchange the programmer agrees to a discounted rate of 25 cents. If the larger MVPD has a conditional MFN, then it cannot claim the lower 25-cent rate without also shifting the programmer's content to its own high-penetration tier. But if the MFN is unconditional, then it can claim the lower fee without any corresponding re-tiering obligation.[33]

The benefit claimed by the MFN holder, and the obligation it can forego, can take many different forms, even within a single MFN agreement. As one programmer writes:

> [these MFNs] now cover virtually every material economic and non-economic term of a distribution agreement… Economic terms include prices, discounts, launch support, and revenue splits; and non-economic terms cover tier placement, packaging, technology rights, and alternative platform distribution. Modern MFNs are also cross-platform, covering not only programmers' terms with other MVPDs, but with OTT distributors as well.[34]

If each contract creates a new constraint that binds across other contracts, then programmers are discouraged from entering into different kinds of agreements with different MVPDs. In other words, MFNs might not just preclude a programmer from offering a smaller buyer a better price for the same content; they might deter the programmer from entering into arrangements that differ in *any* material way from its deal with the MFN holder, even if they do not provide the other buyer with better bang for the buck. This is because any benefit afforded in a deal with a smaller MVPD will be captured by its larger distributors, even if all other terms are different. The result may be that "a network's *worst* terms from any deal become its only terms in all contracts with *all* MVPDs."[35]

Consequently, MFNs can force conformity across distribution agreements. This preserves the *status quo*, preventing innovative new distribution or packaging arrangements that might be well-suited to virtual MVPDs or other emerging platforms. Exacerbating the problem, some programmers have alleged that, whereas MFNs historically applied only to third-party MVPDs of equal or lesser size as the MFN holder, in some cases they now apply to all other distributors, regardless of size.[36]

B. MFNs and Double Marginalization

The transactional conformity created by unconditional MFNs may further induce a double marginalization problem, even if the firms could otherwise contract around it. To illustrate this, we first consider how MFNs prevent firms from achieving EDM in the context of hypothetical pricing involving two-part tariffs. We then show the argument applies more generally, meaning that other contract-based EDM approaches are similarly foregone. We finally explain how more traditional conditional MFNs might also contribute to double marginalization.

Suppose a programmer would like to charge each MVPD a two-part tariff. Such a tariff is characterized by a pair (p, F), where p is a variable (per-unit) price and F is a fixed fee. Thus, an MVPD pays a total amount of $pQ + F$, where Q is MVPD output (the number of subscribers). Assume for simplicity that a programmer wishes to license to two MVPDs, A and B, where B is larger than A. As noted earlier, if the marginal cost of licensing is effectively zero, double marginalization is eliminated by agreeing on pure fixed fee licensing (i.e., $p = 0$). Then the programmer could enter into two agreements with fixed fees F_A^* and F_B^* for MVPDs A and B, where $F_A^* < F_B^*$. And the MVPDs produce some output levels Q_A^* and Q_B^*, where $Q_A^* < Q_B^*$.

32 Proposed MFN Rulemaking, *supra* note 12, at 11.

33 This example is paraphrased from TheBlaze Comments, *supra* note 30, at 5. *See* KSE Comments, *supra* note 18, at 3.

34 INSP Comments I, *supra* note 7, at 17.

35 *Id*. at 18.

36 *See* KSE Comments, *supra* note 18, at 3.

These contracts would achieve EDM. But now consider how unconditional MFNs would forestall that result. When B sees that A is paying a lower fixed fee, B will claim that lower fee for itself, notwithstanding that the lower fee was predicated on the lower volume of distribution supplied by A. This may easily be a prohibitively costly concession for the programmer. In that case, pure fixed fee licensing won't happen, but only because the MFNs deter it.

One might posit that there is at least a partial solution: charge a common two-part tariff ($\tilde{p}, \tilde{F}$), with both price components being positive, to both MVPDs. This does provide conformity as to the two price components, and the inclusion of a positive fixed fee defrays some amount of double marginalization. However, this necessarily leaves the smaller MVPD A with a higher average price. Specifically, the average price ("AP") comparison is:

$$AP_A = \frac{\tilde{F}}{Q_A(\tilde{p})} + \tilde{p} > \frac{\tilde{F}}{Q_B(\tilde{p})} + \tilde{p} = AP_B$$

Here, $Q_A(\tilde{p})$ denotes firm A's output in the resulting equilibrium, and similarly for $Q_B(\tilde{p})$, where the latter is strictly greater at any level of the variable price.[37] These output measures depend (inversely) on $\tilde{p}$ due to double marginalization. This hypothetical tariff would thus leave smaller MVPDs at a systematic cost disadvantage, diminishing their interest in carrying the programmer's content. It is clear that there is exactly one way to avoid an asymmetry in the average price: pure variable pricing ($\tilde{F} = 0$). And because the programmer is not using a fixed fee as a profit-supplement under this approach, it will set the variable price higher.

The programmer thus faces a Catch-22. On one hand, it could rely on pure variable pricing so that it can deal with all MVPDs, but this generates the maximal amount of double marginalization. On the other hand, it could rely on a (nondiscriminatory) two-part tariff to partially alleviate double marginalization, but this diminishes the number of MVPDs it can hope to deal with. To illustrate the latter point, suppose that there are many MVPDs with whom the programmer wants to deal, and which vary in size. Then, due to the fixed fee — which is set at a high enough level to get acceptable value from the largest MVPDs — there is some range of relatively small MVPDs that will not accept the tariff, because the average price would be prohibitively high. An independent programmer wants to deal with as many MVPDs as possible, and thus it likely prefers to rely on pure variable pricing to ensure it can transact with all interested distributors.

This analysis applies more generally, as other contractual means of achieving EDM may similarly unravel. For instance, two-part tariff contracts are very similar to an agreement that involves no fixed fee, but rather specifies a minimum quantity and a variable price. This is an alternative way of achieving EDM, provided that the quantity minimum is large enough to force the buyer to make more sales than it otherwise would, given the variable price.[38] The MVPD would make more money if it could violate the output floor by raising price, which is what it would otherwise do as a result of having to pay the margin-distorting variable fee. Thus, the larger MVPD B can benefit by claiming the lower output minimum assigned to the smaller MVPD A.[39] And it is not obligated to further take A's variable price (although it might want that, too).

Another way a programmer and MVPD can mitigate (but not necessarily eliminate) double marginalization is to adjust the division of advertising revenues. The programmer could offer an MVPD a lower variable price in exchange for a larger share of said revenues. But if another MVPD has an unconditional MFN, it could claim that lower price without conceding any portion of its own revenue share. The programmers' comments highlight this kind of penalty on discounting to smaller or "skinnier" distributors as one of the major problems caused by unconditional MFNs.[40]

Conditional MFNs might also generate a double marginalization problem. For example, suppose again that the programmer relies on two-part tariffs, with both components being positive. A smaller MVPD might get a lower fixed fee but also a higher variable price. The relevant condition might simply be that a larger MVPD cannot get the lower fixed fee without the larger variable price. But if the difference in the fee size is sufficiently large, this may be profitable for the larger MVPD on balance. (However, the MFN could preclude this if there were an additional condition on the maximal output level.) Preferring to avoid that possibility, the programmer might just rely on pure variable pricing with everyone.

37 Note that $Q_A^* \equiv Q_A(0) > Q_A(\tilde{p})$ for all $\tilde{p} > 0$ (and similarly for B), which reflects that the MVPD internalizes the variable price as a marginal cost.

38 Specifically, imagine that A's quantity minimum is set to be Q_A^* and the variable price is set to the level satisfying $p_A Q_A^* = F_A^*$. Then firm A is committed to make an expenditure of at least this amount, and thus does not internalize P_A as a marginal cost until its output exceeds Q_A^*. But that won't happen, since Q_A^* is already A's optimal output when it is not double marginalized. This arrangement is equivalent to the pure fixed fee arrangement considered above.

39 By taking A's output minimum (which will be lower than B's), B's expenditure commitment falls from $p_B Q_B^*$ to $p_B Q_A^*$ (see the preceding footnote).

40 *See, e.g.,* INSP Comments II, *supra* note 16, at 21-22 (noting that "[t]he result was that the one remaining distributor and its subscribers did not get the benefit of the lower rate, and the network did not get the benefit of broader distribution to millions of additional viewers.").

So-called MFN-plus arrangements, discussed earlier, may further exacerbate double marginalization. In particular, an MFN-plus may be applied to the variable price level, thereby forcing other MVPDs' marginal costs upward. This is effectively an agreement designed to increase double marginalization for rivals.

C. Relationship to Vertical Merger Concerns

To the extent that MFNs distort prices upward, this alone may be sufficient to attack them on antitrust grounds. But the double marginalization effects may also bear on considerations of vertical mergers between programmers and MVPDs. If widespread MFNs lead many or most programmers to rely on variable prices, the cumulative effect may be substantial double marginalization throughout the industry. That, in turn, creates a stronger impetus for vertical integration, as this may provide some relief in the form of EDM. But, if the double marginalization problem is caused by one of the defendant's unconditional MFN commitments, then EDM may not be merger-specific.[41] Instead, it may be the parties' MFN commitments that are preventing them from contracting around a double markup.

There is an important caveat, however. Proposed mergers that garner antitrust scrutiny will tend to involve major players in the industry. And a major programmer is less likely to accept an unconditional MFN, since it has significant bargaining power. If the programmer is not bound by any unconditional MFNs, then we cannot blame such agreements for the double marginalization arising *between these defendants*.

But this cuts in both directions: if there are no MFNs requiring or inducing the defendant-programmer to charge variable fees to the defendant-MVPD, then the defendants cannot argue that EDM is merger-specific due to the industry's MFN glut. That MFNs might be causing double marginalization in other parties' dealings does not imply that the same result is occurring between the defendants. On the contrary, if the defendant-MVPD is one of the industry's largest, it may be the source — not the victim — of the most restrictive MFNs. In such cases, it is still possible that the defendants could contract around double marginalization.

Further, that the defendant-programmer is not bound by an unconditional MFN does not rule out the possibility that other kinds of MFNs are forcing double marginalization within the defendants' dealings. As noted above, conditional MFNs may also do so. And even a large programmer may have accepted some such arrangements with the largest MVPDs. For instance, the programmer might have an MFN-plus with a very large third-party MVPD such that the programmer must charge everyone, including the would-be acquiror, a higher variable price than that paid by the MFN holder. Then, at the very least, some amount of double marginalization between the defendants is caused by one of the parties' MFN commitments. The point is that, in order to assess the likelihood that EDM is merger-specific, it is necessary to look at the details of the defendants' MFN agreements.

There is also a broader sense in which MFNs are relevant, which does not bear on whether EDM is merger-specific within a given case. Widespread, restrictive MFNs can substantially constrict the competitive process, preventing any procompetitive deviations from the *status quo*. This suggests that vertical mergers should not be contemplated as occurring within an ordinary free market; any interrelated MFN concerns should also be accounted for. Further, if antitrust enforcers took a more proactive approach in challenging anticompetitive MFNs, this might help to allay some of the concerns imputed to vertical mergers. The next section reinforces the latter point.

V. MFNS AND CROSS-LICENSING

MFNs may also induce anticompetitive effects in cross-licensing between vertically-integrated rivals. When rival MVPDs acquire important upstream programmers, their relationship is no longer purely horizontal. There are also countervailing vertical relationships, with each firm's upstream division licensing to the other firm's downstream division. Steve Salop recently observed this creates the opportunity for a problematic form of reciprocal dealing in which the integrated rivals raise each other's margins in parallel.[42] But, unlike a one-way license fee arrangement, here each firm's licensing costs are offset by countervailing licensing receipts. The firms can thus enjoy the benefit of higher prices without the profit losses that usually accrue from increased marginal costs.

41 The defendants might argue that it is reasonably necessary to enter into such MFNs. But if the MFNs are probably anticompetitive in their own right, this argument is not very compelling.

42 Salop, *supra* note 21, at 1977-78.

In the literature on patent agreements between product market rivals, this kind of arrangement has long been recognized as a mechanism for achieving *de facto* downstream price-fixing without requiring an express price-fixing agreement.[43] As in that context, the integrated MVPDs can earn larger profits by charging each other artificially high variable fees, which enlarges the downstream price effect. And, importantly, countervailing license fees are not necessary for the firms to reach a mutually-satisfactory agreement; they can "net out" the countervailing fees such that only one firm (or neither) is paying per-unit fees to the other.[44] This would alleviate the reciprocal dealing concern, while still allowing the firms to account for a possible asymmetry in the programming value being exchanged.

MFNs exacerbate the reciprocal dealing concerns. When one or both integrated rivals have MFN obligations to third party MVPDs, the worry is not simply that such rivals *could* engage in this problematic form of reciprocal dealing. Rather, they may feel contractually *compelled* to do so. To illustrate, call the integrated firms A and B, and a third party MVPD C. Further, suppose that B's upstream content is more valuable than A's, so that cross-licensing between these firms normally would require A to pay a net fee to B. Then, suppose further that C holds an MFN stipulating that B's upstream division cannot charge lower fees to anyone else than it charges to C. Then, from B's perspective, it *must* charge a countervailing fee to A. But that means the firms cannot net out their fee obligations so as to avoid the reciprocal dealing concern.

It may be that even a conditional MFN would lead to this result, since cross-licensing between A and B may consist in separate one-way licensing agreements. In that case, the rights licensed from A to B would ostensibly not be a condition on the fee charged by B to A. Then a conditional MFN would preclude B from setting a discounted fee to A in light of the content it receives. The same would apply to A's fee if it has also entered into an MFN with C.

As this illustrates, MFN obligations held by integrated rivals may essentially require such rivals to strike agreements that raise serious antitrust concerns. And such concerns are wholly separate from those attending vertical integration itself. Indeed, the relevant restraints are horizontal in the reciprocal dealing agreement.[45] Hence, MFNs might enlarge the broader competitive effects of vertical mergers.

VI. CONCLUSION

Vertical mergers in the pay-TV industry have recently received significant attention in the antitrust community. But problematic MFNs raise a number of interrelated competition policy concerns that have been largely overlooked. Restrictive MFNs may significantly distort competition within the industry. They may naturally induce double marginalization, creating a strong impetus for integration. This simultaneously raises a question as to whether a merger is necessary to achieve EDM. The MFNs may also induce anticompetitive effects in cross-licensing between integrated rivals.

Near the end of the Obama administration, the FCC issued a proposed rulemaking that would prohibit unconditional MFNs.[46] The proposed rule was ultimately not put into effect. However, given the MVPD industry's recent trend toward integration, the social costs of these potentially-anticompetitive MFNs will only continue to grow. To that end, we emphasize that the antitrust authorities should investigate restrictive MFNs in the television industry, and that such arrangements should be accounted for when evaluating vertical mergers.

---

43 Carl Shapiro, *Patent Licensing and R&D Rivalry*, 75 Am. Econ. Rev. 25, 26 (1985). In the patent case, the firms are product market competitors who also cross-license patents in the "upstream" licensing market, with each firm charging a per-unit royalty to the other.

44 *See* Erik Hovenkamp & Jorge Lemus, *Proportional Restraints in Horizontal Patent Settlements,* at 26-30 (manuscript under review, 2018), *available at* https://papers.ssrn.com/abstract=3026380.

45 Note that, for this reason, the concerns discussed here are not limited to cases involving dominant integrated firms.

46 Proposed MFN Rulemaking, *supra* note 12, at 1.

AN ALGORITHM FOR ANALYSIS OF VERTICAL CONCERNS

BY MALCOLM B. COATE[1]

1 Senior economist in the Bureau of Economics at the Federal Trade Commission. This paper extends an existing analysis completed in 2004 to address the current interest in vertical analysis. It is not an FTC work and thus the standard disclaimer suggesting the opinions expressed in this paper are those of the author and do not represent those of the Federal Trade Commission, a Commissioner or a Bureau is not technically necessary, but is applicable to avoid confusion. I would like to thank Jeffrey Fischer for helpful comments on this note.

I. INTRODUCTION

Given the current interest in vertical mergers, it is important to understand that the anticompetitive effects are horizontal in nature, with the vertical conduct merely enabling the horizontal injury.[2] In complex cases, it will be necessary to balance efficiency effects in the vertically related market with the net adverse effects in the horizontal market under review. Thus, for vertical analysis, it seems useful to develop evidence on the adverse horizontal effects, before investing resources to fully investigate the more complex upstream vertical relationships and the even more complex balancing review.

This multi-stage analysis can be illustrated by reviewing the *Microsoft* case of the 1990's.[3] Although not a merger, the alleged vertical conduct plays the role of a merger, and thus seems easily generalizable. It is generally known that the U.S. Department of Justice's *Microsoft* litigation involved collection of exclusionary conduct that could allow Microsoft to maintain their monopoly in Windows-based operating systems for IBM-compatible personal computers ("PCs"). Vertical concerns can be categorized as either contractual or *de facto* exclusion.[4] Contractual exclusion tends to be relatively easy to explore (the contracts exclude or they do not); while *de facto* exclusion requires extensive analysis, as exclusion is often difficult to distinguish from competition. Both theories appeared relevant to some *Microsoft*-related issues and may be applicable to current antitrust issues in platform competition on the Internet, suggesting insights based on the *Microsoft* matter may aid current analysis of various forms of vertical behavior, including vertical mergers.

One key point that will become obvious is the outcome of the review process may depend on the magnitude of the competitive effect identified in the review. If the market effect is very large, it may make sense to find a concern for quite moderate probabilities associated with the exclusionary concern. On the other hand, if the market effect is moderate or small, larger probabilities would be required to generate a comparable effect.

For both contractual and *de facto* exclusion, the vertical activity in the related market is alleged to protect market power in the core market (hence the name, "monopoly maintenance"). For the more complex *de facto* exclusion cases, which require extensive investigation, serious attention should be given to the credibility of this competitive concern before undertaking a full investigation.

This paper provides an algorithm to structure vertical competitive analysis, relevant to both merger and non-merger activity. Once defined by a review of the *Microsoft* case, the algorithm is applied to an overview of the potential effects of the *Facebook/Instagram* merger. The reader is cautioned that this application is for illustrative purposes only and any real antitrust case would need to be based on a deep dive into the relevant facts.

II. AN ALGORITHM FOR VERTICAL ANALYSIS

The basic structure of the algorithm is simple, first evaluate the potential for an anticompetitive effect; if the horizontal concern is credible, invest the resources to fully explore the potential for sufficient exclusion in the relevant vertically-related market to trigger the concern. If the vertical exclusionary tactics also offer competitive benefits, the final analysis determines if the relevant efficiencies outweigh the net potential anticompetitive effect triggered by the vertical exclusion.[5] As facts are unlikely to be known with certainty, the competitive analysis can only offer an

2 Economists have known since the early 90's that possibility theories can show vertical mergers have anticompetitive effects in one of the two related horizontal markets. See, Rasmusen Eric B., Ramseyer, J. Mark, and Wiley, John S., *Naked Exclusion* 81 Am. Econ. Rev. 1137 (1991). As economists work hard to win tenure, numerous other theoretical models exist, suggesting other possible ways for a vertical merger to increase price. Not surprisingly, some analyses are better than others.

3 For a detailed overview of the *Microsoft* matter, see Coate, Malcolm B. and Jeffrey H. Fischer "The Truth is Out There: The Microsoft Case Meets Market Realities," 2004, *available at* SSRN http://papers.ssrn.com/sol3/papers.cfm?Abstract_id=638243. Page 48 presents a quick overview of the court decision while the monopoly maintenance concern is discussed on pages 49-61 for Java investigation and pages 64-71 for the browser investigation.

4 *Id*. at section IV (pages 79-83). Some evidence exists to suggest that Microsoft engaged in contractual exclusion to prevent the installation of a dual Windows-Linux operating system. This tactic could have precluded the development of a collection of Linux based applications sufficient to enable a Linux based PC to have broad commercial use on the consumer market.

5 This structure borrows liberally from Coate and Fischer, Section IV (*supra*, note 3), although the organization of the presentation is tweaked, with the discussion focusing first on four of the five conditions associated with the monopoly maintenance effect, then picking up the four conditions associated with the exclusion in a vertically related market, before concluding with the efficiency condition. Coate and Fischer's approach provides a useful post-mortem of the *Microsoft* case, while the generalization in this paper offers a method that may be more useful in vertical analysis.

estimate of the expected value in which the potential adverse effects are weighted by the estimated probability of its likelihood of occurrence.[6] In effect, this approach could create an opportunity to generalize the concept of "likely to substantially lessen competition."[7]

Four questions are relevant in determining the potential for an anticompetitive effect in the horizontal market of concern. First, is the future of competition in a market likely to be affected by a specific change in the environment? In *Microsoft*, the concern involved the development of a middleware platform (enabled by the growth of the Internet) that would sit on top of Windows and run a broad collection of generic applications written for various computing devices. In theory, this turn of events could undermine Microsoft's pre-existing market power. Second, is the exclusionary conduct related to an anticompetitive effect on that market? For *Microsoft*, the alleged exclusion focused on the elimination of market leaders in the vertically-related Java-technology and/or browser markets to prevent these firms from developing extensions that would serve as the procompetitive middleware platform. Third, do any alternatives exist to negate the potential impact of the exclusionary concern? Again, in *Microsoft*, Java and browser products seemed to offer the best approaches to aid the development of middleware and no other technologies offered similar promise. Finally, the evidence would need to show that the anticompetitive effect of concern was material, suggesting its occurrence would be likely to substantially lessen competition. Thus, the *Microsoft* litigation would be expected to show that loss of middleware would serve to protect the Windows-based market power.

An evaluation of the evidence associated with the competitive concern did not offer a clearly dispositive conclusion. However, some insights were available. The Internet was seen as changing the world, although analysts were optimistic in envisioning the rapid development of what we now know as "cloud computing" to create a need for multi-platform middleware. Moreover, Java and browsers were two clear vectors for the development of middleware, with the evidence clearly stronger for the Java threat. No obvious alternative existed. Of course, insights on the implications of the development of middleware software remained predictive, as the development of middleware was a prediction. Overall, it does not seem possible to reach a dispositive conclusion on the merits. Thus, although the case was not clearly proven by traditional antitrust standards, it is impossible to conclude that no material exclusionary effect was possible. Here, it seems necessary to consider exactly what "likely to substantially lessen competition" means in an inherently unknown world?

Given the importance of the operating system to the PC, and more relevant for today, the importance of social media and search, should anticompetitive effects be taken seriously when they are possible, but not clearly likely by traditional rules? In effect, should an expected value standard be applied that would find a violation when a low probability is combined with a very large potential anticompetitive effect? When reconsidering the *Microsoft* court decision, maybe an expected value finding for the competitive injury was implicitly made. Thus, for extremely significant markets, should an expected value analysis be used, such that large losses of competition can be addressed even when the evidence confirming the effects' probability is limited? As competition in the high tech sector is so difficult to predict, should antitrust be fenced in by a definition of "likely" that evolved in the smoke-stack era of antitrust?

Another four considerations are needed to address the potential for exclusion in a vertically related market. First, does the firm under review hold sufficient market power in the related market to exclude a vertically related rival? For *Microsoft*, the answer was obvious, as the Windows operating system dominated the relevant PC business. Second, does the exclusion actually occur in the related market? The Java evidence is clearly weaker, as Microsoft implemented a collection of exclusive contracts related to its own brand of Java, but Sun's Java product remained relevant in the competitive process. In contrast, the browser wars showed Microsoft exploiting numerous opportunities to leverage its Internet Explorer browser into the market.[8] Third, was the exclusionary behavior successful at marginalizing its target? Here, the evidence is also much better for Netscape then Sun's Java, as Netscape's product was marginalized, Sun's suffered to a much smaller extent. Note the question of Microsoft competing with an efficient browser is delayed until the final analysis. Fourth, did any counterstrategies exist to negate the exclusion? Sun obviously worked hard to compete and maintain the viability of its product, while Netscape faced limited options, eventually merging with America Online ("AOL").

Although the evidence on the exclusion strategy is not dispositive, a few points can be made. The exclusion clearly worked better at marginalizing Netscape than Java, as Java remained a viable consumer choice. Moreover, Netscape's counter-strategy of merging with AOL was

6 Although economists can offer mathematical models and present simulation results, these analyses are also dependent on the accuracy of their assumptions and thus face similar problems. If their assumptions are wrong, the model presents only an illusion of quantification. For an example *see*, S. Moresi and S. Salop, *vGUPPI: Scoring Unilateral Pricing Incentives in Vertical Mergers*, 79 Antitrust L. J. 185 (2013).

7 As this note avoids any real discussion of the law, the term "likely to substantially lessen competition" should be interpreted to reflect on the relevant legal standard for the case involved in the analysis.

8 No discussion of exclusion is complete without noting the technical impossibility of absolute success, because the consumer can always download and install software. Thus, any discussion of this exclusion is likely to require an extensive factual discussion.

doomed once it became obvious that the AOL "parallel universe" was doomed by the growth of the open Internet. Basically, the exclusion analysis provides reasonable evidence for browsers, but weak evidence for Java. In effect, the analysis also must focus on expected values.

A final review would need to compare the efficiencies associated with the Microsoft browser (and Java) with the potential loss of competition due to the marginalization of middleware. Such a comparison must address the question of whether Microsoft's product ended up as more efficient only because the exclusionary tactics managed to "cut of their [Netscape's] air supply [money]." Moreover, slower innovation in browsers might have simply led to faster innovation in plug-ins to provide the missing functionality. It would appear hard to argue that one firm (Microsoft) could have materially slowed the Internet. As these facts are not well developed in the record, it is difficult to do more than raise a few questions.

This staged approach to monopoly maintenance is readily generalized to other concerns by replacing the initial focus on undermining the incumbent's market power with an alternative analysis addressing some increase in market power associated with the alleged exclusion.[9] Likewise, the entire exclusion analysis is simplified in a merger case (or any other example of contractual exclusion). An example of a merger scenario is presented in the next section.

III. AN EXAMPLE OF A HYPOTHETICAL MERGER CASE

To illustrate the application of the methodology to a merger, consider a hypothetical antitrust analysis of the consummated *Facebook/Instagram* merger. Although the merger closed in 2012, the antitrust laws do not include a statute of limitations, allowing past mergers to be challenged once a transaction appears to generate substantial competitive concerns. When consummated, Instagram offered a simple social media application, one that focused on photo sharing. The product was experiencing explosive growth, having quickly acquired 27 million uses and expected to roll out on the Android operating system to increase that number to 50 million.[10] Although the product had no revenue stream, it had the potential to use innovative cell phone technology to become a leading social media product, in effect undermining the Facebook monopoly.

An *ex-post* vertical analysis would evaluate whether Instagram should be considered a competitive threat to the Facebook monopoly by observing how the competitive process played out by reflecting on the four questions addressed above. The first question would explore the potential (actual) impact of the development of cell phone technology on Facebook's social media monopoly. Here, casual observation suggests that a cell phone platform facilitates different types of social media communications, creating the potential for a new platform screen.[11] Second, did the Instagram products offer the alternative platform. Again, the answer seems clearly yes, as Instagram is designed for cell phones and their ability to take photographs. It appears that the Instagram platform is popular with younger people whose lives revolve around their phones.[12] Third, do any other disruptive products exist? Here, Snapchat is mentioned as a choice, but a quick review of that product suggests it is more of a communication tool, than a social media application. Moreover, if the current stock valuation is a guide (slow decline), Snapchat may be sliding towards fringe firm status. Finally, does the merger of Facebook and Instagram appear anticompetitive? It certainly looks like the merger combined two firms that are now closest competitors. And for lack of competition, is it really necessary to go any further than the sorry performance of Facebook with respect to consumer privacy?[13] This observation avoids the need to focus on price, because, for dominant services such as Facebook and Google, the loss of privacy seems to be the price.[14] More competition implies better protection of user privacy and an obvious gain in consumer welfare. *Ex-post*, the market would seem more competitive if Facebook and Instagram had their relationship status changed to single.[15]

---

9 In *ATT/Time Warner*, the key concern focused on the ability of AT&T to marginalize horizontal distributions by raising their costs of Time Warner content via the threat of exclusion (blackout) in the negotiation process. No commentary is offered on that case, because the litigation is not complete.

10 See, "Facebook buys Instagram for 1 Billion," *available at* https://techcrunch.com/2012/04/09/facebook-to-acquire-instagram-for-1-billion/.

11 *Id*. As noted in the article, some analysts thought the Instagram cell phone screen was superior to the more cluttered look of the Facebook interface.

12 One estimate suggests 71 percent of 18-24 year olds use Instagram, suggesting greater use than Facebook. "Social Media Use in 2018," *available at* http://www.pewinternet.org/2018/03/01/social-media-use-in-2018/. Note, this study takes a very broad definition of social media, including Pinterest, a product that seems to have generalized the idea of YouTube from videos to any content, LinkedIn, a professional site, Twitter, a commentary site best known for its 2 AM use by the President of the United States, and WhatsApp, a messaging site also owned by Facebook (suggesting the potential for additional work to explore if ownership of this product enhances Facebook's market power).

13 Citation to the numerous Facebook privacy protection failures does not seem necessary, as they qualify as public knowledge.

14 I am reluctant to cite the idea of "privacy as the price paid for the use of an Internet platform" to a particular author due to the risk of being wrong.

15 In effect, these regime shift questions address the same considerations studied in a merger, if one firm owned both products, could it impose an adverse unilateral effect on the market? Do any other firms have the potential to reposition and compete? Could entrants defeat the adverse effect?

Exclusion concerns can be quickly addressed, because mergers exclude rivals by acquisition and mergers that later lead to competitive concerns matter. This leaves only the first factor, the establishment of market power, and that answer is obvious, given Facebook's dominance both in 2012 and today. Possibly, one could consider counter-strategies to a merger, if large sophisticated end use customers existed, but social media serves individuals and thus the concern is moot.

For consummated mergers, a reasonable case can be made that balancing analyses are always required, because the efficiency of the original merger should be credited against anticompetitive effects, as should the quicker development of the products of the merged firm. For the Instagram acquisition, the initial efficiencies would seem to be *de minimis* as the firm was only a start-up. This leaves the claim that Facebook has created substantial consumer welfare due to its six years of investing in the Instagram brand. Consumers obtained goods that they would have otherwise had months or years later. Of course, these benefits would need to be measured net of the privacy sacrificed to Instagram and its Facebook parent. Moreover, if efficiency benefits count, then it also seems reasonable to count anticompetitive effects due to the loss of an independent Instagram over the last few years. Such a balancing could go either way, and thus hardly offsets the loss of privacy from the current Facebook market power. Moreover, Facebook might want to claim the joint ownership offers the firm substantial efficiencies. Here, it is not even clear what the claim of efficiencies would be, other than economies of scope and scale that might further entrench a monopoly.[16]

Finally, it useful to at least look at chilling effects associated with a policy that tells dominant firms that the government will dissolve your mergers if you are too successful competing with your core business. One response would be to note such an aggressive policy is a feature of antitrust enforcement in a platform world. Incumbent monopolists should defend their platform via internal growth, not by merging with potential threats. Second, a divestiture order merely requires a spin-off. Facebook stockholders would own two firms instead of one. Additional thought could uncover other issues that should be considered in this analysis.

IV. CONCLUSION

The *Microsoft* example certainly shows that vertical investigations are likely to be extremely complicated and require a deep understanding of the relevant facts. By addressing the horizontal concern first, vertical analysis avoids reviewing the exclusion evidence when an anticompetitive effect is not credible. Moreover, even with a detailed analysis of the facts, vertical cases are likely to be very complicated to prove. This leads to the second consideration, should the standard of proof be linked to the expected value of an anticompetitive effect when the potential adverse effect is extremely large? What standard should be used (was used implicitly in *Microsoft*) to set the concept of "likelihood" of an anticompetitive effect in vertical investigations of monopolists in some of the largest and most important markets in the economy?

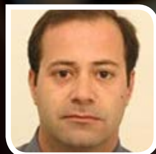
The same Microsoft-inspired algorithm performed relatively well in evaluating a hypothetical merger case focused on the consummated *Facebook/Instagram* merger. Here, the core analysis studied the monopoly related effect triggered by the merger. Although this review suggested that attention should be paid to efficiencies and the potential for chilling effects, the discussion noted efficiencies may not negate large monopoly effects and policy may benefit from an active enforcement program.

Analyses of vertical exclusion and mergers are likely to remain fact-specific, with theory generalized to address particular fact situations. However, the two examples in the paper do suggest a role of vertical analysis in innovative investigations of internet-based platform markets. As these monopolies are threatened by regime shifts that sweep away their power, careful vertical analysis may be necessary to ensure that regime-shifts remain viable and *ex-post* enforcement may be necessary to restore competition, when competitive benefits are lost to what, when consummated, was thought of as vertical merger. Traditional antitrust tools would seem effective in addressing these concerns, although broad interpretations of the basic concepts may be appropriate in special case situations.

16 In contrast, no one who experienced the "Blue Screen of Death" from an application choking the operating system was thrilled with the idea of one "baby-Bill" selling Office and another "baby-Bill" selling the Windows operating system. But here, the efficiencies are clearly vertical, with Microsoft ensuring this paper does not disappear in a crash before I save it. Possibly, Facebook could also note some vertical efficiencies lost by creating "baby-Zucks" in a divestiture.

INPUT FORECLOSURE IN TELECOMS/MEDIA VERTICAL MERGERS: THE *MEO/GMC* CASE

BY ALÍPIO CODINHA, MARIANA COSTA, MARTA RIBEIRO & PEDRO MARQUES[1]



1 Alípio Codinha is Deputy Director of the Merger Department. Mariana Costa, Marta Ribeiro and Pedro Marques are economists and were the case handlers in this transaction.

I. INTRODUCTION

In August 2017, MEO – Serviços de Telecomunicações Multimédia S.A.("MEO"), a wholly-owned subsidiary of Altice Europe N.V., a media and telecoms group announced it would acquire total control of Grupo Media Capital, SGPS, S.A. ("GMC"), the main media and contents company operating in Portugal.

This merger was notified to the Portuguese Competition Authority ("AdC"), which subsequently initiated an in-depth investigation on the potential negative impact the merger would have on competition in the telecom and media markets in Portugal. MEO submitted a set of behavioral remedies which did not adequately addressed the competitive concerns identified by the AdC.

The AdC decided to terminate the merger proceedings as the result of a decision by the notifying party, MEO, to withdraw the notification. Nevertheless, the AdC was able to conclude, in its competitive assessment, that the transaction would ultimately lead to serious impediments to effective competition in the telecom and media markets, with negative impacts on consumers.

II. BACKGROUND

MEO is the former state-owned telecoms company active in all segments of electronic communications services, including the management of the Digital Terrestrial Television network. MEO supplies telecom services (voice, video, data, and internet) supported on both mobile and fixed networks and is active in the retail supply of pay-TV channels through its pay-TV platform and multiple-play services (i.e., bundled services for voice, TV, and internet).

MEO had, in 2016, 39 percent of all pay-TV subscribers and represented 43 percent of multiple-play services revenues in Portugal.

The target, GMC, controls, *inter alia*, the television studio and content producer Plural, Portuguese-speaking TV channels under the TVI brand (TVI, TVI24, TVI Ficção, and TVI Reality), as well as radio stations Comercial, M80, Cidade FM, Smooth FM, and Rádio Vodafone. It also controls the internet portal IOL and the online content platform TVI Player.

TVI channels represented, in 2016, one quarter of average daily share view of all TV channels distributed in Portugal. Moreover, TVI programs (mostly produced by Plural) are consistently in the TOP 10 most viewed programs (first 6 out of 10 most-viewed programs in 2016, excluding football matches).

Advertising in TVI channels represented 40-50 percent of all TV advertising revenues in Portugal in 2016.

MEO and GMC supply few services that directly compete with one another. Their main relationship is that GMC provides TVI channels to MEO that are subsequently distributed to consumers. Therefore, this was primarily a vertical merger, between one of the main players in the telecoms sector, retail distribution of pay-TV services, and multiple-play services on the one hand, and the market leader for the wholesale distribution of audio-visual content and Portuguese-speaking TV channels, including the top-viewing channel (measured in terms of share of audience and advertising revenues), TVI, on the other.

III. INPUT FORECLOSURE ASSESSMENT

In a vertical merger, the possible competitive concerns are that the vertically integrated firm may have the incentive and ability to hamper or eliminate (actual or potential) rivals' access to supplies or markets thereby reducing their incentive and/or ability to compete in either downstream or upstream markets, thus harming competition and, ultimately, consumers.

Although this transaction involved the assessment of several vertical theories of harm involving a wide range of the parties' activities, this article focuses solely on foreclosure of GMC's TVI channels to MEO's rivals (input foreclosure).

In this context, the AdC's approach assessed the possibility that MEO would prevent rival pay-TV operators from obtaining access to TVI channels or would increase the prices of those channels (carriage fees) in such a way that would result in significant impediments to competition in the provision of pay-TV services (whether or not integrated in multiple-play offers).

A. Exclusion of Rivals (Total Input Foreclosure)

In this first step, the AdC assessed whether the transaction would increase GMC's ability and incentive to deny the provision of TVI channels (namely, TVI main channel and TVI24, a 24h news channel) to MEO's retail competitors, causing them to become less effective competitors.

The AdC concluded that TVI main channel and/or TVI24 are important to MEO's competitors and that there are no good substitutes from other sources that would allow MEO's rivals to implement effective and timely counter-strategies.

Furthermore, the AdC concluded that such strategy would be profitable for the vertically integrated firm.

Foreclosing TVI channels to MEO's rivals entails (i) losing carriage fees from the foreclosed rival pay-TV operators; (ii) losing advertising revenues from reduced viewer reach of these channels; and (iii) losing customer interaction revenues,[2] also from reduced viewer reach of these channels.

In the analysis it was assumed that advertising and customer interaction revenues were directly proportional to the subscriber share of each pay-TV platform prior to foreclosure. Thus, input foreclosure strategy results in a revenue loss corresponding to the pre-transaction advertising revenues of each rival platform reduced by the proportion of subscribers on these platforms that will switch to MEO or other non-foreclosed platforms in order to be able to continue watching TVI channels.

Moreover, it was assumed that a reduction in advertising and customer interaction revenues results in an equal reduction in GMC's profits, given that costs would not change.

The gains from total input foreclosure correspond to the additional profits earned by MEO resulting from new subscribers that will switch to MEO's platform in response to the loss of TVI's channels in the foreclosed platforms.

In order to estimate subscriber switching rates, the AdC had to the determine both the fraction of customers that would decide to leave MEO's rivals (the departure rate) and the fraction of these departing customers that would switch to MEO (diversion rate).

For the diversion rates, historical data collected by pay-TV operators was used. For the departure rate, the AdC conducted a consumer survey with 1,550 interviews where households were asked to qualify (on a scale of 0 to 10, where 10 is "I would switch for sure") the probability of switching in case their current pay-TV service provider would not offer TVI main channel and/or TVI24 in its channels *bouquet*.

The results of the consumer survey showed that a majority of MEO's rivals' subscribers would not switch from their current providers if TVI main channel and/or TVI24 were withdrawn from the channels *bouquet*.

However, a significant number of respondents showed a very high willingness to switch (considering only level 10 of the survey scale). Around 15 percent of respondents in the case of the withdrawal of TVI main channel, 7 percent for TVI24 news channel and 18 percent for both. From this survey it was thus possible to estimate the actual number of subscribers switching to MEO.

In order to estimate the incremental profit of each subscriber switching to MEO, the AdC used data provided by the notifying party where it estimated incremental profits *per* type of service.[3] The AdC assumed that subscribers switching to MEO generate a margin equal to MEO's average contribution margin *per* subscriber *per* service on the rival's existing customer base.[4]

2 Customer interaction revenues are generated from calls made by the viewers in the course of a particular show or TV contest. These revenues are significant for the main Portuguese channels such as TVI, SIC, and RTP.

3 From 2-play to quintuple play bundles that included pay-TV.

4 For example, if a rival's subscriber base is composed of 40 percent triple-play customers and 60 percent quadruple-play customers, than, the average subscriber switching from that rival to MEO will contribute to MEO's profits taking into account 40 percent of MEO's incremental profit in triple-play services and 60 percent in quadruple-play services (Incremental profit of a subscriber switching from the rival = (0.4 x MEO incremental profit in triple-play services) + (0.6 x MEO incremental profit in quadruple play)).

The AdC then assessed the incentives for MEO to engage in a number of input foreclosure scenarios involving the permanent withholding of TVI channels from its rivals. It concluded that MEO would have the ability and incentive to: (i) foreclose TVI main channel to the largest of its rivals; (ii) foreclose TVI24 to each one of its rivals; (iii) foreclose both TVI and TVI24 to the largest of its rivals; and (iv) foreclose TVI main channel and/or TVI24 simultaneously to all of its rivals.

In these situations, estimated gains in profits in pay-TV provision more than compensated losses in revenues from advertising and customer interaction services and carriage fees.

B. Raising Rivals' Costs (Partial Input Foreclosure)

Even though some total input foreclosure strategies would be profitable, the AdC also assessed the possibility that the vertically integrated firm would be willing to supply TVI channels to MEO's rivals although at significantly higher prices compared to the pre-transaction scenario, raising rivals' costs and hampering their ability to compete in the provision of pay-TV services.

Given that distribution contracts for TVI channels are negotiated bilaterally between GMC and pay-TV operators, the AdC assessed if the transaction significantly strengthened GMC's bargaining position *vis-à-vis* MEO's rivals.

In this situation, TVI channels would continue to be widely distributed across most or all rival pay-TV platforms increasing, on the one hand, revenues from carriage fees and, on the other hand, holding audience levels constant and, consequently, revenues from advertising and customer interaction services.[5]

For this assessment, the AdC used a Nash bargaining framework, such as the one used by the European Commission in its assessment of the *Liberty Global/Corelio/W&W/De Vijver Media* transaction and by the FCC in its investigation of the *Comcast/NBCU* merger.[6]

The AdC concluded that this transaction substantially increased GMC's bargaining position in negotiations with MEO's rivals over carriage fees for TVI channels in comparison to the pre-merger situation.

This was true for all scenarios taken into consideration (partial foreclosure of TVI main channel and/or TVI24 to each of MEO's rivals), regardless of whether or not total foreclosure was a profitable strategy.

In fact, the bargaining model showed that post-merger, GMC and MEO's rivals would always have an incentive to reach an agreement (i.e., total surplus from reaching an agreement was strictly positive in all situations). The vertically integrated firm would be able to obtain an increase in carriage fees at least as high as the increase in profits from total foreclosure. As for MEO's rivals, their losses from higher carriage fees would be lower than the ones resulting from lost subscriber revenues.

Even when total foreclosure was not a profitable strategy, GMC was able to extract higher carriage fees because failure to reach an agreement with MEO's rival post-transaction would harm GMC less than absent the transaction (because post-transaction, GMC internalized the profits of MEO).

The Nash equilibria post-transaction predicted several fold increases in carriage fees that amounted to substantial increases in total content acquisition costs for MEO's rivals.

The AdC therefore concluded not only that post-transaction the new entity would have an improved bargaining position in negotiations of carriage fees with MEO's rivals, but also that partial foreclosure would be the most likely result of this transaction, given that it would result in higher profits for the vertically integrated firm.

5 For a more in-depth discussion, please refer to, e.g., Helen Weeds (2016), *TV Wars: Exclusive Content and Platform Competition in Pay TV*, The Economics Journal, August 2016, Volume 126, Issue 594.

6 *See* Baker, Jonathan B., Comcast/NBCU: The FCC Provides a Roadmap for Vertical Merger Analysis (February 5, 2011). Antitrust, Vol. 25, No. 2. Spring 2011; Rogerson, William (2012): Vertical mergers in the video programming and distribution industry: The case of Comcast-NBCU, CSIO Working Paper, No. 0116, Center for the Study of Industrial Organization at Northwestern Univ., Evanston, Ill.

C. Effects

The AdC concluded that the merged firm would have the ability and incentive to implement total and partial foreclosure strategies attaching a higher probability to a partial foreclosure outcome.

Higher carriage fees for TVI channels would result in significant overall increases in content acquisition costs to MEO's rivals which would have to increase subscriber fees. Furthermore, MEO's rivals' ability to acquire competitive content would also be negatively affected.

In both cases, MEO's rivals would become less effective competitors, thus increasing the ability of the merged entity to increase prices to final consumers and/or decreasing pressures for high-quality content acquisition/production.

Furthermore, the AdC concluded that the transaction would raise barriers to entry, with particular emphasis to potential alternative low-cost online providers as these providers either would not have access to TVI channels or would have access at less favorable terms than absent the merger.

IV. CONCLUSIONS

The notifying party decided to withdraw its notification during the course of the in-depth investigation. For this reason, the AdC's final decision is limited to the termination of the procedure and detailed results cannot be reported here.

The Transaction relates to all the levels of the TV value chain and raised competitive concerns in several different vertically-related markets.

The most relevant anticompetitive effect identified by the AdC concerned the possibility of foreclosing GMC's TVI channels to MEO's rivals in the provision of pay-TV services.

This type of anti-competitive effect has been previously identified, for example, by the FCC in the *Comcast/NBCU* merger and by the EC, in the *Liberty Global/Corelio/W&W/De Vijver Media* transaction.

The AdC's assessment used a similar analytical framework to infer about the ability and incentive of the merged entity to engage in total or partial input foreclosure.

The results from the consumer survey allowed the AdC to quantify, precisely, subscriber departure rates in case TVI channels were withheld by the merged entity. These results confirmed that both TVI channels are important inputs for pay-TV operators to compete in the provision of pay-TV services.

Departure rates were sufficiently high to allow the merged entity either to profitably withhold TVI channels to MEO's rivals or to credibly threaten to do so, therefore strengthening GMC's bargaining position *vis-à-vis* MEO's rivals post-transaction.

The bilateral bargaining framework further showed that GMC's bargaining position would still be strengthened even in those situations where total input foreclosure was not a profitable strategy for the merged entity.

The AdC therefore concluded that partial input foreclosure, through higher carriage fees, would be the most likely result of this transaction. This would cause a significant increase in content acquisition costs, hampering MEO's rivals' ability to be effective competitors in the provision of pay-TV services, ultimately leading to higher consumer prices and/or decreased service quality.

These results would most likely be sufficient, on their own, to justify an opposition decision by the AdC.

THE REDISCOVERY OF VERTICAL MERGER ENFORCEMENT?

BY PAUL JOHNSON & ANTHONY GAMBLE[1]

1 Paul Johnson, Of Counsel, Baker McKenzie, Brussels and Anthony Gamble, Senior Associate, Baker McKenzie, London.

I. INTRODUCTION

Vertical transactions were for a long time a neglected area of merger control. Out there, but rarely, if ever, grabbing the attention of authorities or practitioners, let alone the broader public.

This is arguably a result of competition authorities being heavily influenced by the Chicago School of Economics' ("Chicago School") theories on vertical merger enforcement, particularly those of Robert Bork, whose theories implied that harm to competition as a result of a vertical transaction was highly unlikely.

However, this position now appears to be changing; the theories of the Chicago School are increasingly being challenged and competition authorities are rediscovering vertical merger control enforcement. One could argue that this shift in approach was needed. As the wider economy changes, economic theory evolves and the approach and analytical tools used by competition authorities should evolve as well.

With a focus on vertical merger control enforcement by the European Commission ("Commission"), this article briefly examines the Commission's approach to vertical mergers, the academic and policy debate relating to vertical merger control, and the practical implications for competition authorities grappling with these issues. Specifically, we consider that competition authorities should ensure that an appropriate assessment of vertical issues occurs during the pre-notification process. They should also undertake the necessary types and appropriate level of economic analysis, review internal documents and introduce/increase the use of screening. This should allow cases that raise no issues (or only a potential technical issue with limited practical risk) to proceed without the requirement to open an in-depth investigation.

II. THE COMMISSION'S APPROACH TO VERTICAL MERGERS

The basic legal test applicable to vertical mergers is set out in the EU Merger Regulation:[2] there must be a significant impediment to effective competition ("SIEC") in order for the Commission to be able to prohibit a deal, which is the same test that applies to horizontal mergers.

However, while the legal test is the same, the extent of the review undertaken by the Commission differs depending on whether the parties' activities horizontally overlap or are vertically related. The concerns that are the focus of vertical merger enforcement in the European Union are set out in the Commission's Non-horizontal Guidelines.[3] In brief, vertical theories of harm typically focus on actual or potential rivals' access to supplies or markets being hampered or eliminated ("anti-competitive foreclosure"),[4] and/or a change in the nature of competition that enables or facilitates coordination between competitors ("coordinated effects"). These concerns are balanced against a recognition that vertical mergers are generally less likely than horizontal mergers to result in an SIEC. This is because vertical mergers (generally) do not entail the loss of direct competition between merging firms in the same market and they may provide substantial scope for efficiencies/pro-competitive effects, particularly through the internalization of double marginalization.

The balancing act between the pro- and anti-competitive effects of vertical mergers has resulted in the Commission treating vertical mergers (in general terms) more favorably than horizontal mergers, and this same approach is taken in virtually all other major competition law jurisdictions.

III. REDISCOVERING VERTICAL MERGER ENFORCEMENT: THE ACADEMIC AND POLICY DEBATE

A. The Chicago School

The Commission's approach to the assessment of vertical mergers has in part been influenced by the Chicago School of economic thought, which provided a theoretical underpinning for a more relaxed approach to enforcement.

2 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32004R0139&from=EN.

3 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008XC1018(03)&from=EN.

4 There may also be concerns about "information sharing" as a result of the vertical combined entity having access to competitively sensitive information about downstream or upstream competitors as a result of the vertical integration.

Specifically, under a set of arguably extreme/unrealistic assumptions,[5] the Chicago School considers that any intervention in vertical mergers is irrational for the following reasons: (i) any foreclosure of rivals is merely a rearrangement of supplier-customer arrangements that is neutral in effect; (ii) a monopolist would not gain from a vertical merger by being able to foreclose competitors and leverage market power from the monopolized market into a vertically related market (the "single monopoly profit theory"); and (iii) vertical mergers are by their very nature efficient (e.g., through the internalization of double marginalization) such that they must be pro-competitive.

B. Past Enforcement Practice

Consistent with the Chicago School's view, past enforcement practice seems to indicate that dealmakers brokering a vertical merger should rarely have to lose sleep over the risk of authorities prohibiting a deal on competition law grounds. For example, national competition authorities responding to the International Competition Network's recent Vertical Mergers Survey reported that vertical mergers accounted for only 1 in 10 cases in which they intervened.[6] Indeed, there have been very few prohibition decisions by the Commission in vertical transactions since the establishment of the bloc's merger control in 1990.[7] Moreover, where vertical concerns have been raised and have resulted in a remedy in order to avoid a Phase II investigation or a prohibition, they have been far more likely to be behavioral, i.e., the merging parties pledging to conduct their future business in a certain way, which is arguably a lower level of intervention.

This apparent lack of focus on vertical mergers is further evidenced by the EU and U.S. merger control guidelines. The Commission published guidelines on the assessment of horizontal mergers in 2004,[8] whereas the non-horizontal guidelines were not published until 2008.[9] The situation in the United States is more extreme; the current non-horizontal guidelines were published in 1984, and are now arguably out of date with respect to analysis, relevant evidence, and best practices.[10]

C. A Change in Approach

Despite the Chicago School's apparent influence in enforcement practice, in recent years its views have been increasingly seen as out of step with the shift in modern economic theory to more realistic assumptions (e.g., taking into account conditions of imperfect competition). In particular, the presumption that vertical mergers are likely to result in efficiency benefits, and that the competitive harms are either unlikely or too speculative to be taken into account, is increasingly being challenged by new economic thinking.

Questions about the correct approach to enforcement are increasingly coming to the fore at a time when there is rising concern about high concentration levels in many key markets,[11] the economic implications of new types of markets and business models, and the increasing prevalence of barriers to entry derived from technology and network effects.

Reflecting the mounting questions about the Chicago School and the correct approach to enforcement, competition authorities are starting to exhibit a heightened level of interest in vertical mergers and 2017 in particular saw a resurgence in significant vertical merger cases. The ongoing *AT&T/Time Warner* merger in the United States is the most high profile of these,[12] but there have also been several notable investigations in the EU, including the Commission's prohibition of the merger between Deutsche Börse and the London Stock Exchange.[13] At EU Member State level (focusing on the UK by way of example), the UK Competition and Markets Authority ("CMA") prohibited (and required the unwinding of) the

---

5 For a detailed critique of the Chicago School approach, see Salop, S.C. (2018) *Invigorating Vertical Enforcement,* The Yale Law Journal, Vol 127(7).

6 http://icn2018delhi.in/images/ICN-survey-report-on-vertical-mergers-17-03-18.pdf.

7 Most of these decisions have been in the telecommunications and television industries – see for example Case IV/M.469, *MSG Media Service;* Case IV/M.490, *Nordic Satellite Distribution;* Case IV/M.553, *RTL/Veronica/Endemol;* Case IV/M.993, *Bertelsmann/Kirch/Premiere;* and Case IV/M.1027, *Deutsche Telekom/BetaResearch*.

8 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52004XC0205(02)&from=EN.

9 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008XC1018(03)&from=EN.

10 It is unclear yet whether these guidelines will be updated during the current U.S. Administration.

11 For example, the European Parliament has expressed its concern at the level of concentration in some sectors, such as the chemical sector, in light of recent mergers: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2017-0027+0+DOC+XML+V0//EN.

12 The ruling in this case (which allowed the transaction) is now subject to appeal by the U.S. Department of Justice.

13 The Commission also investigated and cleared, for example, *Rolls-Royce/ITP* (Case IV/M.8242) and *Broadcom/Brocade* (Case IV/M.8314) subject to vertical conditions.

completed acquisition by Intercontinental Exchange ("ICE") of Trayport, due to concerns that ICE's ownership of Trayport's trading platform would reduce competition between ICE and its competitors in the wholesale energy market.[14, 15] The CMA also cleared at Phase II the supermarket Tesco's acquisition of Booker,[16] a groceries wholesaler, following consideration of at least two different vertical foreclosure theories of harm.[17]

IV. REDISCOVERING VERTICAL MERGER ENFORCEMENT: PRACTICAL IMPLICATIONS

Clearly, to the extent that the Commission and the national competition authorities of EU Member States neglected vertical merger enforcement previously, we are now seeing vertical mergers return to the fore. Given the increase in enforcement activity, we consider how the Commission (and competition authorities in general) could improve its processes with respect to mergers that contain vertical aspects (this is likely to be particularly important in cases where the attention of the Commission and the parties might be focused upon horizontal overlaps). In summary, we consider the need for the following: (i) a heightened focus on vertical issues in pre-notification; (ii) undertaking the necessary types and appropriate level of economic analysis; (iii) extending the use of internal documents; and (iv) introducing/increasing the use of screening.

A. An Increased Focus on Vertical Issues in Pre-Notification

An issue that the Commission and the notifying parties face in any merger review is timing constraints, which can become a significant procedural issue if new issues occur during the merger review process. In particular, if the Commission continues to have "serious doubts" based on its concerns at the end of its Phase I review, including concerns raised by a vertical relationship, notifying parties face a difficult choice: they can offer the Commission remedies to address the "serious doubts" or let the investigation go to Phase II and try to dispel the anti-competitive foreclosure or coordinated effects concerns during the course of a more in-depth investigation.

Given the time constraints of Phase I, the Commission is often not in a position to limit its concerns to specific foreclosure scenarios, or to undertake a sufficiently detailed analysis to conclude that its initial concerns (which can be raised as a result of a complaint submitted by a competitor) are ultimately unfounded.

Yet, remedies in Phase I must be "sufficient to clearly rule out 'serious doubts.'" This means the parties may have to offer more (often significantly more) than would be necessary after the Commission has had the opportunity to precisely identify the competition concerns at Phase II, or reach a conclusion that the vertical relationship ultimately does not give rise to an SIEC.

The result is that the Commission often insists that Phase I remedies are very broad-brush in nature. Of course, the option to challenge the case team's initial analysis by taking the investigation to Phase II remains, but such investigations take a long time (typically around six months) and require an enormous amount of the parties' time and resources, and may not even be permitted under the merger agreement. Moreover, vertical concerns rarely threaten to tilt the commercial rationale of a transaction, thereby lowering the incentive to fight a case on substance instead of agreeing to remedies, resulting in theories of harm being unchallenged and potentially being used as guidance for future merger reviews by the Commission.

From the Commission's perspective, the question should therefore be whether initiating a Phase II investigation to assess vertical foreclosure concerns is always the right policy choice. After all, it's not just the notifying parties that have to invest resources, but the Commission as well. Why not invest additional but limited resources during the pre-notification period to bottom out concerns about issues raised as a result of a vertical relationship?

14 https://www.gov.uk/cma-cases/intercontinental-exchange-trayport-merger-inquiry.

15 Previous mergers which were prohibited as a result of vertical concerns by the UK competition authorities, include the acquisition by Bass Plc of Carlsberg-Tetley Plc see, *DTI Press Release P/97/424, 27th June, 1997; MMCReport Bass Plc Carlsberg A/S and Carlsberg-Tetley Plc No. 400 of June 1997* and the acquisition by BSkyB of Manchester United see, *DTI press release, 9th April, 1999, Monopolies and Mergers Commission report on the proposed merger of British Sky Broadcasting Group Plc and Manchester United Plc, April 1999(Cm 4305).*

16 https://www.gov.uk/cma-cases/tesco-booker-merger-inquiry.

17 The CMA also investigated and cleared at Phase I a subsequent similar vertical transaction consisting of the acquisition by the Co-operative Group (a retailer) of Nisa (a wholesaler): https://www.gov.uk/government/news/cma-clears-co-op-nisa-merger.

1. Assessment of the Ability and Incentive to Foreclose

The benefits of considering vertical issues in more detail during the pre-notification process are particularly apparent with respect to the examination of the incentive to foreclose and efficiency arguments.[18]

Any assessment as to the incentive to foreclose necessitates the gathering of margin data and the assessment of profits based on assumed price increases or restrictions of supply post-merger. This can potentially be for 31 EEA Member States (or even more splits if the relevant geographic market is defined as regional in scope). This process can be time-consuming and also raises issues when competition authorities review large global transactions, particularly those that are horizontal in nature but include limited vertical concerns. Specifically, these transactions could give rise, on a technical and economic basis, to the merged parties having the ability and incentive to foreclose when in reality any foreclosure is likely to be of low risk.[19] As a result, in such circumstances, and particularly in cases where the vertical issue only becomes live during the Phase I review, it can be very difficult to dispel such concerns.

Moreover, even with a full set of data, incentives to foreclose are not always clear cut and will clearly differ depending on market structure (e.g., a merger that is likely to result in a single dominant firm or an oligopolistic market with barriers to entry will have different incentives to foreclose as opposed to a perfectly competitive market). The market structure also has implications with respect to the single monopoly profit theory and the assumption that no additional market power can be gained from a vertical merger, which often falls away in a more typical situation where neither merging party has a monopoly (or even an oligopolistic position) protected by entry barriers. Therefore, countering the case team's assumption of there being an incentive to foreclose often requires an (econometric) analysis of whether the potential foreclosure scenarios would be profitable. As set out above, with the historical economic models being increasingly challenged, this assessment becomes increasingly difficult.

2. Efficiencies

Similarly, with respect to efficiencies, the initial assumptions around the elimination of double marginalization are also being increasingly challenged by both modern economic thinking and competition authorities on the basis that any double marginalization is either significantly reduced, or even entirely eliminated, by way of competitive contract negotiations. A risk therefore exists that vertical mergers are just as likely (or unlikely) to give rise to intrinsic harm as horizontal mergers and, as such, in order for authorities to reach an accurate assessment of the risk to competition, they should be devoting sufficient time to these issues upfront in order to ensure that they are able to reach a robust conclusion in Phase I.

Although the notifying parties have better access to the relevant information, they have the burden of producing the evidence to assess any efficiency benefits. In order to do so, they require sufficient time to produce such an assessment, particularly in cases which may be predominantly focused on horizontal overlaps. Ideally, this initial assessment should occur during the pre-notification process in order to steer data gathering.

3. Complaints Submitted by Competitors

Finally, authorities should be wary of complaints submitted by competitors that would benefit from either a delay in a decision or a remedy offered by the parties in cases that have involved a long pre-notification process (e.g., nine months) and a complaint only being submitted by a competitor once the formal review has commenced, restricting both the notifying parties and the Commission's ability to undertake an appropriate analysis of the concerns raised.

18 In contrast, absent existing contractual relationships with competitors, the European Commission finds it fairly easy to establish that a merged entity will at least have the ability to engage in foreclosure (and a review of Phase II decisions involving vertical concerns suggests that there has not been a single instance since 2005 where the Commission assumed a lack of ability to foreclose).

19 For example, in a global horizontal deal, a scenario could exist in which the risk of a vertical foreclosure may occur, but given the small size of the affected market in which the merging parties may have the ability and arguably economic incentive to foreclose (e.g., a market in Norway with less than EUR 50,000 in sales) relative to the size of the proposed transaction (e.g., an EUR 5 billion takeover), and the business priorities of the merging parties (a horizontal combination), the likelihood of any planned vertical foreclosure is incredibly low. It is also worth remembering in these circumstances that intervention should only occur to protect competition, not competitors.

B. Economic Analysis

The Commission should neither presume that a vertical merger in an oligopolistic market is inherently anti-competitive, nor automatically adopt a view that vertical mergers in an oligopolistic market are inherently unlikely to give rise to anti-competitive effects or that efficiency benefits will outweigh any potential anticompetitive effects. Instead, where appropriate, and if needed, modern economic tools should be used to assess transactions on a case-by-case basis.

Increasingly, new quantitative methodologies developed by economists can be used to determine the harm from foreclosure, including the following: (i) a vertical arithmetic methodology that can be used to assess whether refusal to deal would be profitable for the merged firm; (ii) the Nash Bargaining Equilibrium methodology to assess the impact of foreclosure threats on predicted negotiated prices; and (iii) the vertical gross upward pricing pressure index ("vGUPPI") methodology to assess partial foreclosure unilateral incentives to raise input prices to downstream competitors and the resulting upward pricing pressure on rivals' prices as well as the elimination or reduction of double marginalization.

C. Internal Documents

While quantitative methodologies are important and provide insight as to the likely effects of a vertical merger, they should also be combined with internal documents to understand the reality of a proposed merger, particularly where there is an arguable case that anti-competitive foreclosure would result from the transaction but in practice the parties consider that this is highly unlikely to occur. We note that the Commission and national competition authorities are increasingly requiring parties to undertake extensive document reviews. While this is imposing an increasing burden on the parties, it does have the potential to assist them in vertical cases.

D. Screening

While the EU Merger Regulation does not provide for a separate legal test for vertical transactions, the Commission could use its discretion, or introduce a *de minimis* market size screen similar to that used by the CMA, when it comes to requiring a remedy for merger clearance to be obtained in Phase I and/or the establishment of "serious doubts" and the referral of a transaction to Phase II. This additional review, in cases that merit it, would minimize the risk of parties facing the often difficult choice between arguing the case on its merits in Phase II or submitting a remedy in order to obtain conditional clearance in Phase I.

V. CONCLUSION

The Chicago School has influenced leading competition authorities and the merger control review of vertical transactions on a global scale. However, reflecting a shift in the academic debate as well as economic changes, the Commission and other competition authorities are re-discovering vertical merger control enforcement with more frequent interventions.

As the economic analysis of vertical mergers evolves, there is an increased risk of these issues arising late in the merger review process, resulting in a choice of offering a potentially unnecessary remedy to get clearance at Phase I or entering into a fight at Phase II to obtain an unconditional clearance.

Therefore, the processes and procedures of competition authorities should evolve. These changes should include an increased focus on vertical issues during the pre-notification process, undertaking the necessary types of economic analysis and document review, as well as introducing or increasing the level of screening, in order to ensure that those cases in which a genuine concern arises are challenged, whereas those cases that raise either no issues or only a potential technical issue with little practical problems are allowed to proceed, so that the efficiency of the merger review process is maintained, and painful delays and misallocation of resources can be avoided.

IMPLICATIONS OF THE *AT&T/TIME WARNER* DECISION FOR VERTICAL INTEGRATION AND MEDIA BUSINESS MODELS IN THE AGE OF DIGITIZATION

BY KALPANA TYAGI[1]

1 Project Consultant, Innove-in-Telekoms, Basel, Switzerland and PhD Candidate, Max Planck Institute for Innovation and Competition, Munich, Germany. This article is an excerpt from my forthcoming academic article Fixed/Mobile and Content Integration in the EU and the U.S.: Between Business Model Innovation and Merger Control. I am grateful to Prof. Dr. Thomas Fetzer, University of Mannheim & Mannheim Center for Competition and Innovation ("MaCCI") for his comments on my research dealing with Fixed/Mobile and content integration presented at the MaCCI Annual Conference 2018. Sincere thanks to Stefan Frübing and all the organizers of and participants at MaCCI. Special thanks to anonymous peer reviewers for their valuable feedback for the article. Errors if any, are mine.

You don't need a weatherman to know which way the wind blows. – Bob Dylan

I. INTRODUCTION

High speed internet access, portable smart devices, and digitization of content have brought a tectonic shift to the way content is created, distributed, and consumed. This disruption in the converged media and telecoms sector has not only led to the emergence of new business models,[2] it has also made a very clear way into the antitrust thinking of the decade.

On June 12, 2018, Judge Richard Leon of the U.S. District Court for the District of Columbia rendered his decision in the *AT&T/Time Warner* case – what for the coming decade will likely be remembered as one of the most influential decisions in U.S. merger control. As Judge Leon argued at the outset – it was one of those rare antitrust cases where the parties had "a dramatically different assessment of the current state of the relevant market and a fundamentally different vision of its future development"[3] which led to this epic battle in an "historic vertical merger case." If the three-to-two *Oracle/PeopleSoft* merger – one of the longest and most expensive litigations in the history of U.S. merger control – was the decision of the last decade; *AT&T/Time Warner* will very likely be the most expensive and most hotly debated merger decision of this decade. Little coincidence that both decisions concern the Information Communications Technology, media, and the converged telecoms sector (hereafter, collectively referred to as the ICT sector).

Despite these striking similarities, following key differences remain – whereas *Oracle/PeopleSoft* was a horizontal merger case where the U.S. Department of Justice's ("DOJ") failure to suitably delineate a clearly and well-defined relevant product market led to its pivotal defeat before the U.S. district court of New York; *AT&T/Time Warner* was a pure vertical merger, where the "familiar horizontal merger playbook is of little use" and in the words of Areeda/Hovenkamp – "there are no comparable theoretical basis for dealing with vertical mergers as we have for horizontal cases." Judge Leon's decision comes against a very dynamic situation wherein digital disruption and ever emerging new business models have shaken the very foundations of the industry. As one of the key witnesses during the *AT&T/Time Warner* trial observed, this period was "the most competitive phase in his 31 years in the media industry."[4] This decision comes in the wake of an evolving academic discussion calling for stricter non-horizontal merger enforcement in the digital age.[5]

The ICT sector can be best explained by Schumpeter's theory of creative destruction wherein competition is dynamic and disruptive, and entrepreneurs enjoy "transient monopoly power." Dynamism and the innovation-led nature of this sector has often left competition scholars divided on whether the ICT sector generally calls for a stricter or a more lenient vertical merger enforcement.[6] Innovation in the ICT sector is not only limited to technological innovation, business model innovation has been equally instrumental in promoting competition in innovation.

In this short note, I discuss how technological and business model innovation disrupted the media sector, followed by an analysis of Judge Leon's unconditional clearance decision. This inter-disciplinary approach using insights from business is increasingly meaningful in understanding mergers and acquisitions ("M&A") in the ICT sector. As Judge Leon reasoned – considering that a Section 7 enquiry vests the court with the "uncertain task of making a prediction about the future," to make meaningful decisions, the court "must engage in a comprehensive inquiry into the future competitive conditions in a given market."

II. DISRUPTION IN THE MEDIA SECTOR

High speed internet, algorithms, complex computing and processing power, data storage capacities, and other big data related capabilities led to the emergence of over the top services ("OTTs"). This led video and TV markets to experience a substantial decline in their Average Revenue per Unit ("ARPUs") on account of "cutters" (as consumers drop pay-TV all together) and "thinners" (as consumers actively slimmed down their cable bills). In the U.S., the subscription rate for a traditional expanded package can range anywhere from $50 to $100 per month, whereas the OTT-only option costs between $20 and $50 per month. This substantial cost difference led consumers to switch to alternatives like broadband

2 David J. Teece, "Business Models, Business Strategy and Innovation," (2010) 43(2, 3) *Long Range Planning* 43(2010) 172, 173-74.

3 *United States v. AT&T Inc.*, Civil Case No. 17-2511.

4 Randy Sejen, Director, Cable Once, Inc., quoted at p. 21 in the decision.

5 American Antitrust Institute, *AAI Applauds Move to Block AT&T-Time Warner Merger, Sets Record Straight on Vertical Merger Enforcement,* at p. 1-2; Lina M. Khan, Amazon's Antitrust Paradox, *The Yale Law Journal 126: 710* (2017).

6 Kalpana Tyagi, Promoting "competition in innovation" through effective merger control in the ICT Sector: A Comparative and Inter-disciplinary Study (forthcoming 2018).

without pay-TV services or bundles such as internet and the OTT.

In the U.S., the number of households that subscribe to cable or satellite TV are expected to decline by 11 percent from 103 million in 2012 to 92 million in 2018. Emergence of OTTs thus, led to "cord shaving" and "thinning," which put cable provider's "gatekeeper position" under significant threat. Following migration of viewers to online video, as traditional media experienced diminished market power and lost its conventional foothold, it tried to re-strategize through vertical integration and the launch of OTTs. OTTs too tried to move up in the value chain by investing in content creation. Simply put, as media companies tried to move down the value chain into content distribution, leveraging from their strong position in the upstream market for content creation; OTTs such as Netflix and Amazon quickly moved up the value chain to engage in content creation leveraging from their strong position in the downstream market for distribution.

Considering their world-wide reach and significant economies of scale, OTTs can quickly break even and recoup sunk costs. Increasingly, Netflix is not only spending in buying rights, it is also a big spender in the creation and distribution of original content. From $5 million in 2012, Netflix's spending on original programming rose to $550 million in 2017. This is expected to be $8 billion in 2018. Even though this may be small in comparison to its total spending on content, it indicates an over one hundred times increase in spending within a short span of six years. Top-tier network programs and cable shows cost anywhere between $3 and $5 million per episode. They also suffer the traditional disadvantage of ignorance – that is not knowing whether or not their message is effectively delivered to the target audience.

To assess which content is safe, OTTs on the other hand, enjoy a significant advantage from big data – an advantage that their traditional competitors such as Multichannel Video Programming Distributors ("MVPD") lack. With the immense volume of data, about "30 million plays, 4 million ratings and 3 million searches," it did not take Netflix long to identify that the fans of the original House of Cards, at the time aired in the UK, were fans of Kevin Spacey and were also addicted to David Fincher produced shows. With this recipe in hand, even before the managers at Netflix viewed a single episode of House of Cards, they committed to two seasons of the program (that is 26 episodes for $100 million, approximating $3.8 million per show). The program brought an additional 3 million customer base to Netflix, which helped it quickly recoup its sunk investment in the purchase of the program.[7]

In addition to the above observations, it may also be useful to add that the entrance of OTTs has led to disintermediation of the media industry. Traditionally, the video programming and distribution industry comprised of three level value chain of "content creation, content aggregation, and content distribution."[8] (Figure 1)

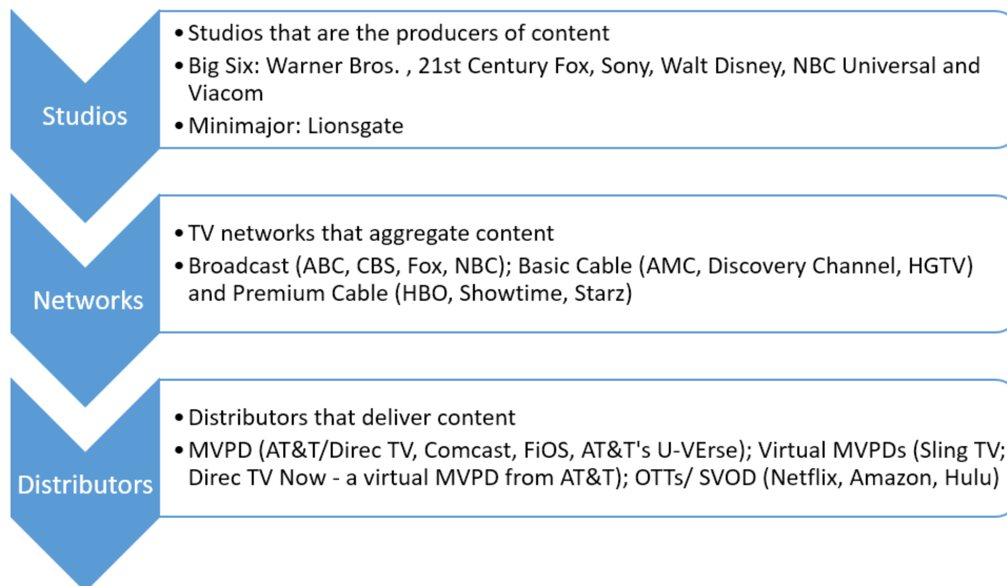


Figure 1 Video Programming Value Chain[9]

7 Zach Bulygo, Netflix, How Netflix Uses Analytics to Select Movies, Create Content, and Make Multimillion Dollar Decisions, *available at* https://blog.kissmetrics.com/how-netflix-uses-analytics/.

8 Christopher S. Yoo, Vertical Integration and Media Regulation in the New Economy, *19 Yale Journal of Regulation, 171, 220* (2002). Also referred to by Judge Leon in the decision.

9 The figure is based on the information in the article Jeffrey A. Eisenbach & Timothy Watts (NERA Economic Consulting), Effects of AT&T - Time Warner Transaction on Competition in the Premium Channels Industry: White Paper for the U.S. Department of Justice, dt. July 2017.

OTTs benefit from network integration as they aggregate and distribute under the same roof and are also increasingly engaging in content production. Netflix, for instance, recently entered into two significant arrangements – first, a poplar deal with the famous Nordic movie producer Kim Magnusson and second, with the former U.S. President and First Lady Barack and Michelle Obama to produce a show for the OTT.[10]

AT&T/Time Warner, one of the largest mergers in U.S. history, where AT&T proposed to acquire Time Warner for $108 billion was announced against this dynamic environment of technological innovation and emerging new business models. To avoid any confusion and distinguish business models from corporate strategy, it may be useful to add here that business models describe how the businesses are being run and how enterprises function in the digital age. This must be distinguished from competitive strategy which explains how to be better, effective, and more efficient then one's rivals.[11] It is true that in the long run a coherent, unique, and difficult to imitate business model, can be a key source of "sustainable differentiation." This is for example the case with Nestlé's Nespresso.[12] Interestingly, Nestlé is in the midst of acquiring Starbucks – another very interesting example of business models successfully making their way to competition policy! To dispel any doubts or resulting confusion, the U.S. district court's concern was limited to the changing business models in the disruptive digital environment. The decision does not deal with the issue whether big data offers an unparalleled competitive advantage to the now well-established OTTs such as Netflix and Amazon Prime or in the alternative, how the merger may offer the merged entity a sustainable competitive advantage. The key concern in the decision seems to be whether against the backdrop of these new business models, can a traditional "stuck in the middle wholesaler" like Turner continue to meaningfully compete or in the alternative, do they need inorganic growth (through M&As) to drive customer value?

III. THE U.S. DISTRICT COURT IN *AT&T/TIME WARNER*

Emergence of newer business models and more effective targeted advertising by big players such as Netflix, Amazon, Google, and Apple meant that the judge did not have the "crystal ball" to assess the merits of the case. The "spray and pray approach" of the traditional MVPDs was increasingly ineffective against the "digital, big data-led" algorithmic approach of the OTTs. According to the "spray and pray approach," the programmers sell advertisements on the basis of demographic data collected from different sources such as surveys and interviews. It may be useful to add here that this was one fundamental difference between the approach of the district court and the DOJ. Whereas the DOJ's case was sound and well-founded in the long-established "Nash equilibria bargaining theory" framework, emergence of new competitive dynamics in the converged media landscape challenged the very foundations of this well-founded theory. The DOJ's key argument was that although the merger would cause AT&T to lower the prices of DirecTV, which would bring an additional $352 million in savings annually to its customers; the proposed merger was expected to result in substantial lessening of competition ("SLC") in the following three mutually reinforcing ways.

First, enable Turner to charge AT&T's rival distributors – and ultimately consumers – higher prices for content on account of its post-merger relationship with AT&T; second, substantially lessen competition by creating an increasing risk that the merged firm would act, either unilaterally or in coordination with Comcast/NBCU to thwart the rise of low cost, consumer friendly virtual MVPDs; and third, prevent AT&T's rival distributors from using HBO as a promotional tool to attract and retain customers.

The court stated that as there was no crystal ball to assess the merger, allocation of burden of proof was particularly important. The court put this initial *prima facie* burden on the DOJ to offer sufficient evidence to establish the probable effect of the merger on future competition.

The merger was expected to substantially lessen competition in the "All Video Distribution Market" (comprising MVPDs, virtual MVPDs, and SVODs) and the "sub-market within the broader All Video Distribution Market" that is the "Multichannel Video Distribution Product Market"(-comprising MVPDs and virtual MVPDs).

The "Turner Network" was central to the DOJ's theory of harm. Time Warner owns valuable content as it owns "three of the top five basic cable networks" having rights to hit shows such as *Game of Thrones* and HBO, the world's "leading premium pay TV brand." It has three principal units – Warner Brothers, Turner, and HBO. Time Warner's most popular Turner network reaches over 91 million households of the 100 million U.S. households that subscribe to traditional video distribution. The DOJ's argument was that valuable content and wide reach has made it a must carry network and a "critical component of the basic cable bundle."[13]

---

10 http://variety.com/2018/film/news/netflix-first-look-deal-producer-kim-magnusson-nordic-movies-1202818115/; http://variety.com/2018/digital/news/barack-michelle-obama-netflix-deal-1202817723/.

11 Joan Magretta, Why Business Models Matter?, *Harvard Business Review* (2002).

12 Kurt Matzler et al, Business Model Innovation: Coffee triumphs to Nespresso, *Journal of Business Strategy* (March 2013).

13 Complaint, *United States v. AT&T Inc. et al.*, p. 4.

The DOJ's key argument was founded in the resulting increase in cost of content acquisition. This means that following the merger, the vertically integrated AT&T/Time Warner would have diminished incentives to license its content to other vertically non-integrated players. This theory rests on the premise that a vertically integrated firm can internalize the losses resulting from this refusal to deal with its competitors. As the profits from the downstream market compensate the loss of licensing revenues in the upstream market, the vertically integrated firm can strategically choose to deal with other non-integrated players to its own advantage. The defendant's key argument – which was accepted by the court – was that as "cord cutting" mattered a lot to the bargaining model, in order to effectively assess the merits of "increased leverage theory," this emerging market dynamic had to be taken into account.

The court not only questioned the validity of the data on which the DOJ based its econometric models; it also questioned other qualitative evidence – such as internal communications, emails, and statements by AT&T and Time Warner executives. In the opinion of the judge, it was not surprising that even in "colourful languages – executives would be avid boosters for their companies' products." The judge also rejected that the Turner network was a "must-have" network. Acknowledging that in the real world there had never been a permanent blackout of the Turner network, and bargaining was actually "an elaborate and stylized Kabuki dance," following trial, the court rejected each one of the DOJ's arguments in their entirety. As the DOJ had failed to meet its burden to show that the proposed merger would lead to substantial lessening of competition, the court refused to enjoin the merger.

IV. SUMMARY

The decision not only dismissed the government's increased vertical leverage theory in its entirety; it also emphatically stressed the benefits of elimination of double marginalization. It positively noted that following the merger between Time Warner and AT&T, annual savings to the tune of $352 million would flow "pretty quickly." The argument strikes a chord with the Chicago school and makes one wonder whether the decision may lead to the resurgence of the Chicago-style thinking in the U.S. antitrust enforcement.

Paying heed to the advice of Judge Leon that such a "stay pending appeal would be a manifestly unjust outcome" and would effectively freeze the deal, the DOJ did not request a stay. The department however, recently filed for an appeal against the decision of the district court. Irrespective of how the circuit court decides, the outcome of the appeal, unlike the decision of the district court, is expected to set even more far-reaching precedent. The decision of the circuit opinion will have a highly persuasive value that will not only be *res judicata* for the lower courts in D.C., it will also be a persuasive decision for other district and circuit courts across the country.[14]

The decision of the DOJ to appeal has had significant immediate, short-run implications as well. Shortly after the announcement of the department's decision to appeal, Raymond James, a financial services firm downgraded the ratings of AT&T from "outperform" to "market perform." In the long run, if the DOJ wins the appeal, it may have a chilling effect on the pace of big ticket M&A deals in the media and telecoms sector, as the merging parties would then need to consider the accompanying costs of the merger – such as the need to offer structural remedies and, in case of failure to reach a settlement, fight an expensive ensuing battle in the courts. As Makan Delrahim, the Assistant Attorney General at the DOJ's Antitrust Division, has said in a speech that the department clearly prefers structural remedies,[15] the decision of the circuit court will also have significant implications for the design of merger remedies. A decision in favor of the DOJ, in addition to stricter merger control, will also be accompanied by remedial designs with a clearly structural dimension. In case the circuit court upholds the decision of the district court, it may mean a return to a more Chicago-style enforcement. Either way, the final outcome in the historic *AT&T/Time Warner* merger will leave indelible footprints on the sands of competition policy.

14 Jeffrey Blumenfeld in Mathew Periman, Three Issues to Watch as Department of Justice Appeals AT&T/Time Warner Loss dt. July 13, 2018, *available at* https://www.law360.com/articles/1063313/3-issues-to-watch-as-doj-appeals-at-t-time-warner-loss.

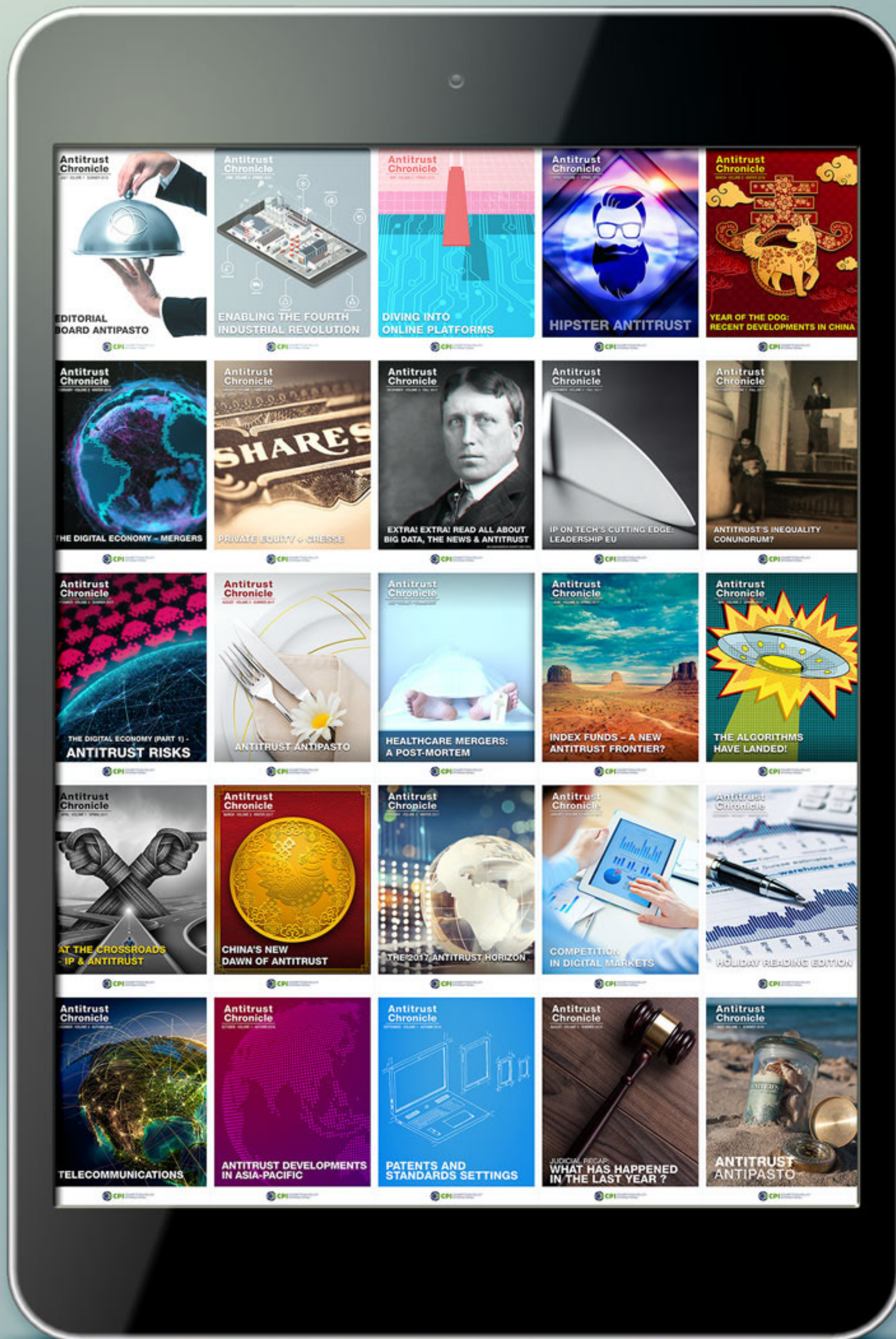
15 Keynote Address dt. November 16, 2017 by the Assistant Attorney General Makan Delrahim at the American Bar Association's Antitrust Fall Forum, *available at United States v. AT&T Inc.*, Civil Case No. 17-2511.

CPI COMPETITION POLICY INTERNATIONAL

CPI SUBSCRIPTIONS

CPI reaches more than 20,000 readers in over 150 countries every day. Our online library houses over 23,000 papers, articles and interviews.

Visit competitionpolicyinternational.com today to see our available plans and join CPI's global community of antitrust experts.



CPI COMPETITION POLICY INTERNATIONAL