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

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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."

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).

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 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)

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.

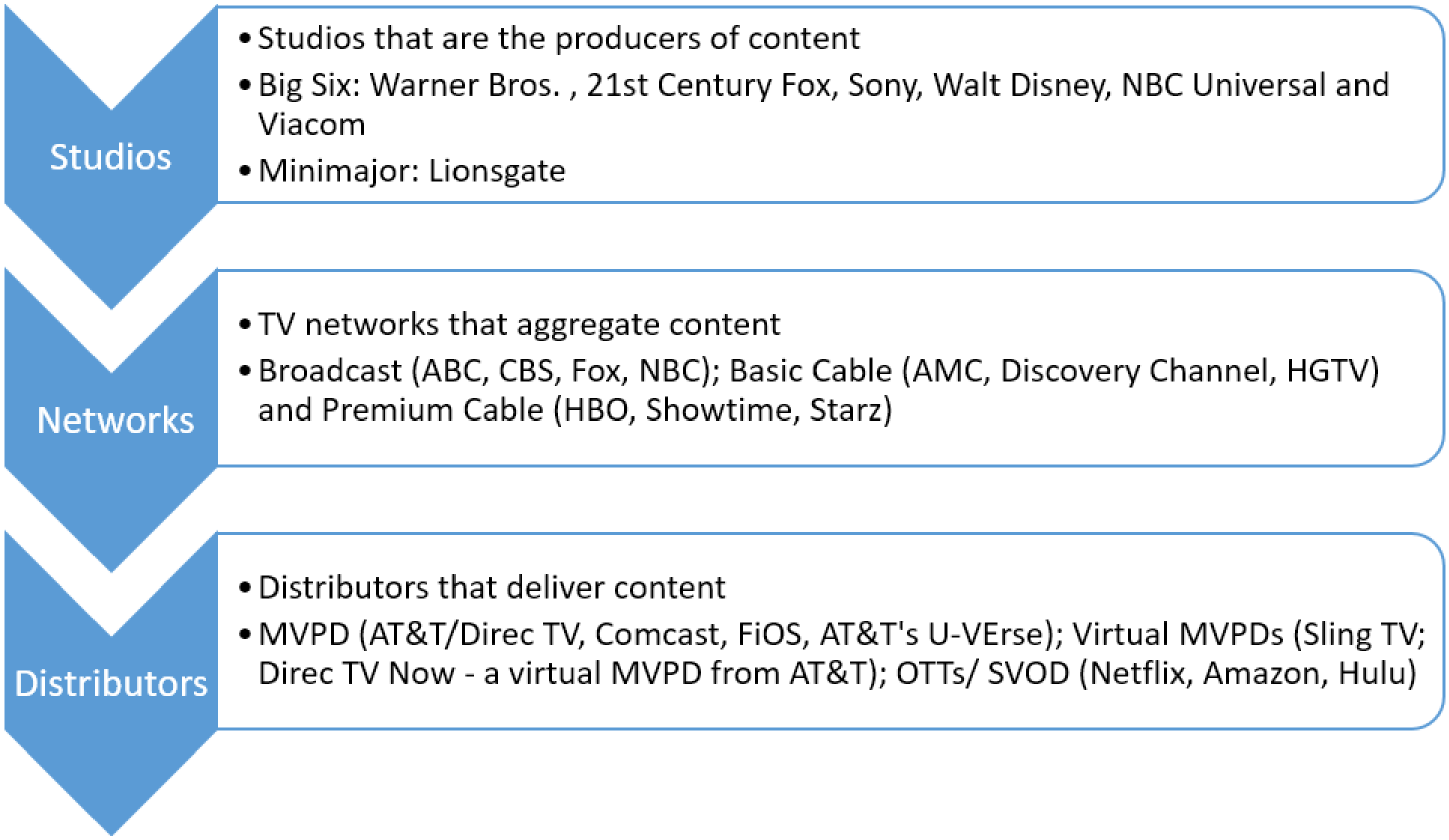

Figure 1 Video Programming Value Chain[9]

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?

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.

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).

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]

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.

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

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.