AT&T/TIME WARNER AND ANTITRUST POLICY TOWARD VERTICAL MERGERS

BY GREGORY S. CRAWFORD, ROBIN S. LEE, MICHAEL D. WHINSTON & ALI YURUKOGLU[1]




1 Department of Economics, University of Zurich; Department of Economics, Harvard University; Department of Economics and Sloan School of Management, MIT; Graduate School of Business, Stanford University.

I. INTRODUCTION

Merger control is one of the most central antitrust enforcement missions of the Department of Justice and Federal Trade Commission. Section 7 of the Clayton Act, prohibiting mergers where the effect "may be to substantially lessen competition, or to tend to create a monopoly," is regularly invoked by the agencies to block horizontal mergers that they deem problematic. In contrast, the agencies challenge few vertical mergers, and litigate almost none – the *AT&T/Time Warner* merger was famously the first litigated vertical merger case in over 40 years. As such, the case offers a unique opportunity to assess the criteria that in practice may be applied to such cases when litigated, and also to consider appropriate policy toward such mergers.

II. THE ECONOMICS OF VERTICAL MERGERS

In principle, vertical mergers can have either pro- or anticompetitive effects. The Chicago School emphasized the former, and especially the possibility that a vertical merger could eliminate double marginalization, the elevation of price that occurs when different levels of a chain of production and distribution price in a manner that fails to "internalize" (i.e. take into account) how their pricing decisions affect the profits of other levels. Work in organizational economics – starting with Coase and continuing with the work of Williamson and Grossman-Hart-Moore[2] – has also emphasized the efficiency effects that vertical integration can generate by reducing haggling and opportunistic "hold up." Notably though, unintegrated ("arms-length") contracting need not be plagued by double marginalization since firms may be able to avoid it with appropriately written arms-length contracts. Likewise, organizational efficiency can actually in some cases be *reduced* by integration (lower initiative by employees vs. owners being one reason; "costs of bureaucracy" being another). So, integration may or may not bring increased efficiency and consumer benefits.

Beginning in the 1980s, economists developed rigorous anticompetitive theories of vertical integration. Most significantly, models emerged showing that an integrated firm may have an incentive to foreclose rivals' access to inputs or distribution or to raise their costs of these items.[3] Other models showed that vertical integration might facilitate collusion.[4] These models answered the Chicago School challenge by showing that anticompetitive effects were a logical possibility.

2 See, e.g. R. Coase, *The Nature of the Firm*, 4 Economica 386 (1937); O. Williamson, The Economic Institutions of Capitalism (New York: The Free Press 1985); O. D. Hart, Firms, Contracts, and Financial Structure (Oxford University Press 1995).

3 See S.C. Salop & D.T. Scheffman, *Raising Rivals' Costs*, 73 Am. Econ. Rev. 267 (1983); J.A. Ordover, S. Salop & G. Saloner, *Equilibrium Vertical Foreclosure*, 80 Am. Econ. Rev. 127 (1990); O.D. Hart & J. Tirole, *Vertical Integration and Market Foreclosure*, 1990 Brookings Papers on Econ. Activity: Microeconomics 205 (1990).

4 V. Nocke & L. White, *Do Vertical Mergers Facilitate Upstream Collusion?*, 97 Am. Econ. Rev. 1321 (2007).

With rigorous models showing both pro- and anticompetitive effects, the question of whether vertical mergers are likely to cause harm, and in what circumstances, ultimately is an empirical one. As many commentators have noted, there are, to date, relatively few studies that document foreclosure effects, and fewer still that show that such effects reduce consumer welfare. Less well noted is that relatively few studies have documented consumer benefits from vertical integration. While one might think from the writings of some commentators that hundreds of studies have shown such beneficial effects, this conclusion would be wrong. In fact, while elimination of double marginalization is regularly cited as an almost certain benefit of vertical merger, surprisingly little empirical work has documented such effects. Moreover, the work that does exist has focused on a narrow set of industries.[5]

In a recently published paper,[6] we have studied the effects of vertical integration between cable distributors ("MVPDs") and regional sports networks ("RSNs"), a setting that is attractive for examining the effects of vertical integration because of the importance of RSNs, the variation in vertical integration among them, and the fact that both pro- and anticompetitive effects are plausible in these markets.

Our model allowed us to estimate the extent to which (i) vertical integration leads to internalization of profit effects across divisions, pro-competitively reducing double marginalization and also improving distributors' network carriage decisions; and (ii) vertical integration leads to anticompetitive foreclosure of rival distributors, either through complete denial of access to the RSN or through increases in the affiliate fees charged them. Specifically, we introduce and estimate a parameter that measures the share of each dollar of RSN profits that an integrated distributor considers in making its pricing and channel carriage decisions, and also a parameter that measures the degree to which an integrated RSN considers the benefits of rivals' foreclosure reaped by its owned downstream distributors. While economic theory would normally assume that these effects are both fully internalized, we wanted to allow the data to speak and tell us to what extent this is actually the case.

The results provide several key findings. Perhaps most importantly, we find that both anti and pro- competitive effects are present. On the pro-competitive side, we estimate that integrated distributors internalize $0.79 of every dollar earned by their commonly-owned divisions, providing a force for a substantial elimination of double marginalization and increase in carriage. This estimate is driven primarily by the fact that integrated cable systems in geographic locations relatively distant from teams' home stadiums – where the choice of whether it is worth carrying an RSN showing those teams' games could go either way – are much more likely to carry the RSN than cable systems who do not own the RSN.

On the anticompetitive side, we estimate that an integrated RSN fully, and perhaps more than fully, internalizes the benefits of foreclosure. This finding is driven by the fact that in two cities in which there is a "terrestrial loophole" exemption from the FCC's Program Access Rules that can protect unintegrated rivals (Philadelphia and San Diego), neither satellite distributor had access to the cable-owned RSN despite the fact that our demand estimates indicate that such foreclosure would be unprofitable if the RSN were less than fully accounting for the effects of satellite carriage on profits from its integrated distribution division.

We also are able to examine how these two effects net out for consumer welfare. We find a fair amount of heterogeneity, with some markets showing complete foreclosure and consumer losses from vertical integration at our point estimates. (However, we are not able to statistically reject that the possibility that those individual cases had no consumer harm.) Overall, however, on average across 26 RSNs, we find that there would be a statistically significant positive effect on consumer welfare from vertical integration, despite the incentives for foreclosure that it would create.[7]

5 Sam Quinones' book *Dreamland* recounts how a 1980 *Letter to the Editor* in the *New England Journal of Medicine* describing how very few hospitalized patients became addicted to opioids came, over the years, to be cited by proponents of opioid treatment for pain (who most likely had never actually examined the letter itself) as a "an extensive study" and "a landmark report" showing that opioids were quite generally not addictive. A 1986 paper whose author later described it as having "weak, weak, weak data" also became very influential. The cited "fact" that vertical integration should be expected to eliminate double marginalization and generate other efficiency gains sometimes reads in a similar way. We feel that a more nuanced and cautious view is warranted: if it was inexorable that integration enhances efficiency, the Soviet Union would have been the most efficient economy ever.

6 G.S. Crawford, R.S. Lee, M.D. Whinston & A. Yurukoglu, *The Welfare Effects of Vertical Integration in Multichannel Television Markets*, 86 Econometrica 891 (2018).

7 We also find that behavioral conditions that require the integrated RSN to treat rival distributors as the RSN would were the RSN non-integrated would preserve the pro-competitive effects while eliminating the anticompetitive effects. It is an open question to what extent the actual behavioral remedies used in previous cable and satellite vertical mergers were able to achieve this goal.

Finally, we find that rival distributors are significantly harmed by vertical integration. Sometimes this is because of complete foreclosure, which tends to happen when the cable-owner of the RSN has a large footprint in the local market. Other times it is because the the affiliate fees that rivals have to pay go up. As well, the elimination of double marginalization and increased carriage by the integrated firm further reduces rivals' profits. Since we do not study how these profit reductions might affect rival firms' entry and investment decisions, our welfare analysis is only partial.

In sum, based on our work and reading of the literature, we believe that (i) foreclosure is a real phenomenon that could lead to welfare losses; and (ii) the "jury is still out" on the likelihood of pro vs. anticompetitive effects being the dominant force in the types of markets where vertical mergers are likely to be challenged (or, put differently, on whether there are market characteristics for which consumer harm is reasonably likely to occur, and what those are).[8]

III. THE TRIAL AND APPEAL

The *AT&T/Time Warner* merger case was tried before Judge Richard J. Leon, a George W. Bush appointee. As is well known, Judge Leon found for the defendants, allowing the merger to proceed, and his verdict was upheld on appeal. Judge Leon's ruling was based primarily on two factors.

First, Judge Leon came to doubt that anticompetitive foreclosure was likely to occur as a result of the merger. There were several reasons for this. NBCU executives testified that after their merger with Comcast they had never considered the effect on Comcast profits when negotiating with Comcast's rivals. Similarly, Time Warner executives testified that they too had never considered benefits of foreclosure when Time Warner was integrated with Time Warner Cable. These executives might, of course, not want to admit it even if they were in fact behaving in this way. Their testimony was also directly in conflict with both the usual presumption of within-firm internalization in economic modeling and antitrust law, and also in conflict with the evidence discussed above. Nonetheless, Judge Leon took these executives at their word. AT&T/Time Warner's expert Dennis Carlton also presented regression analysis that he said showed that three previous changes in the extent of vertical integration (including the NBCU/Comcast merger) had not increased prices for integrated channels.[9] This evidence seemed to be quite important to Judge Leon, reasonably so, and the government never successfully refuted it. Finally, AT&T had offered a remedy that allowed rival distributors continued Turner content access and baseball-style arbitration in the event of a dispute over terms with the merged AT&T/Time Warner. DOJ's expert Carl Shapiro's primary analysis did not consider this factor, and he offered only a limited defense of the proposition that the merger would still be harmful to consumers despite this remedy.

Second, Judge Leon came to doubt the robustness of Shapiro's results. Shapiro used a "Nash bargaining model" to model bargaining between content providers and distributors. This type of model has now been used in a number of economic studies, including our own described above, and has proven effective at explaining pricing in markets in which there are large buyers and sellers who negotiate terms. Anticompetitive effects in Shapiro's bargaining model were driven by the fact that Time Warner's internalization of Comcast's profits would reduce its perceived losses from failure to reach a deal with rival distributors. In Shapiro's model, this change – which reduces Time Warner's desire to reach an agreement with a downstream rival of AT&T's DirectTV service – raises the price that rivals end up having to pay.

Judge Leon's concerns about Shapiro's conclusions from this model were partly based on criticisms leveled by AT&T/Time Warner's lawyers and economic experts of his model's inputs (such as the subscriber loss that would result from a long-term blackout) that they argued could reverse Shapiro's conclusion that the merger would cause consumer harm.

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8 The two oft-cited surveys which view the existing evidence as of the mid-2000s as more favorable to efficiency effects than we do, both acknowledge that in particular circumstances vertical mergers may be anticompetitive. See F. Lafontaine & M. Slade, *Vertical Integration and Firm Boundaries: The Evidence*, 45 J. of Econ. Literature 629 (2007); J.C. Cooper, L.M. Froeb, D. O'Brien & M.G. Vita, *Vertical Antitrust Policy as a Problem of Inference*, 23 Int'l J. of Indus. Org. 639 (2005).

9 G.S. Ford, *A Retrospective Analysis of Vertical mergers in Multichannel Video Programming Distribution Markets: The Comcast-NBCU Merger*, Phoenix Center Policy Bulletin No. 43 (2017), reaches a similar conclusion about the Comcast-NBCU merger using S&P Global's *Market Intelligence* database of average affiliate fees received by channels. Carlton's analysis examined the average affiliate fees in the SNL Kagan database and also the affiliate fees paid by DirectTV.

But Leon's concerns also reflected criticisms of the model itself. Noting that blackouts are rare because the gains to both parties from reaching a deal are large, Judge Leon doubted that changes to no-deal payoffs caused by the merger would be salient in these bargaining situations.[10] While Nash bargaining models have been used successfully in a number of settings, including the cable industry, we do believe that more research usefully could be done examining this question.

One clear lesson for antitrust enforcers from these points is the importance of having a model that compellingly reflects factors industry participants consider important, results that are robust to reasonable variations in modeling assumptions and inputs, and compelling evidence about previous mergers or compelling arguments about why studies of previous mergers are either unrepresentative of the current merger, or flawed in other ways.[11]

IV. ANTITRUST POLICY TOWARD VERTICAL MERGERS

The current version of the *Non-Horizontal Merger Guidelines* is shockingly outdated, reflecting little of the types of concerns that actually arise in reviewing these mergers (such as in the *AT&T/Time Warner* merger). Of course, this raises the question of what these Guidelines, and antitrust policy toward vertical mergers, should be. Some commentators have advocated a very permissive attitude. These commentators typically interpret the literature as robustly showing efficiency benefits of vertical mergers, and rarely if ever showing harm. As noted above, we do not read the literature in this way. Others have advocated a much tougher stance, perhaps with presumptions of harm stated much as in the *Horizontal Merger Guidelines*. Given the current state of knowledge, we feel that such presumptions would be unwarranted at present. Rather, in our view, for vertical mergers in which at least one of the merging firms operates in a market in which producers have market power, courts and agencies would do well to consider carefully both possible pro- and anticompetitive effects, conducting the same kind of intensive fact-based inquiry that is common in horizontal mergers. Doing so would also allow the courts and agencies to gain more experience which, combined with continuing evolution of the economic literature, might in the future indicate the desirability of adopting presumptions or further safe harbors (beyond requiring the presence of either upstream or downstream market power).

10 Judge Leon's doubts were well reflected in his citation of Time Warner CEO Jeff Bewkes' colorful "1000-pound weight" analogy. See *United States v. AT&T, Inc.*, 310 F.Supp.3d 161, 224 n.36 (D.C.C. 2018).

11 Another interesting issue in the case was raised by AT&T/Time Warner's expert Dennis Carlton, who argued that, compared to an average monthly consumer bill of approximately $140, Shapiro's claimed $0.27 per month consumer price increase should not be considered "substantial" in the context of Section 7 of the Clayton Act. Time Warner content is a small fraction of available content, but at the same time is unique and Time Warner clearly has some market power (as evidenced by the affiliate fees it commands). Measured relative to those affiliate fees, the price elevation Shapiro predicted was not small: 16.2 percent. By ruling that he did not believe any of the DOJ's claimed anticompetitive effects, Judge Leon did not need to decide this issue. See *id.* at 241.