

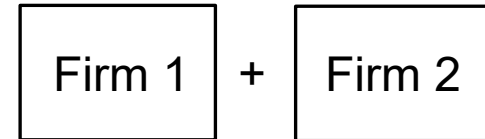
11. Vertical Mergers

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Transaction types

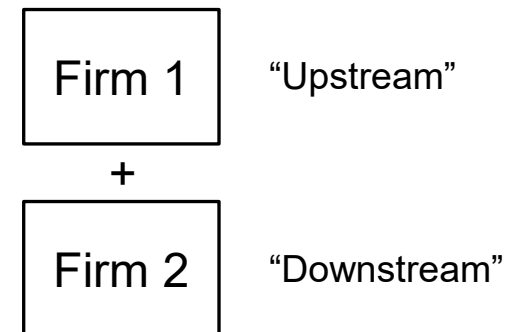
1. Horizontal transactions:

- ❑ Combine two competitors
- ❑ Sell *substitute* products



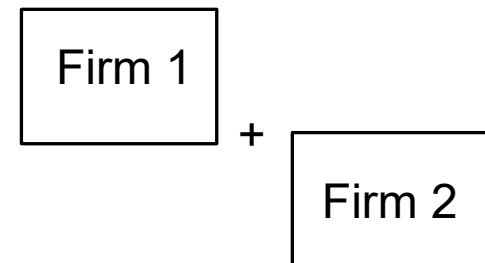
2. Vertical transactions:

- ❑ Combine two firms at adjacent levels in the chain of manufacture and distribution
- ❑ May be extended to two firms that sell—
 - *Complementary* products, or
 - Products in the chain or manufacture of distribution but not adjacent to one another



3. Conglomerate transactions

- ❑ Mergers that are neither horizontal or vertical



Vertical theories of harm: The roadmap

1. Unilateral exclusionary effects

- a. “Input foreclosure”
- b. “Output foreclosure”
- c. Creating the need for two-level entry

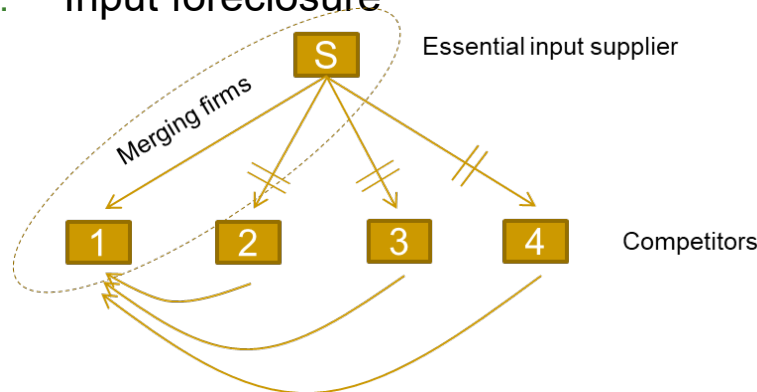
2. Coordinated effects

- a. Elimination of a disruptive buyer
- b. Elimination/disciplining of new disruptive competition
- c. Facilitation of tacit coordination through greater firm homogeneity
- d. Anticompetitive information conduits

Unilateral exclusionary effects

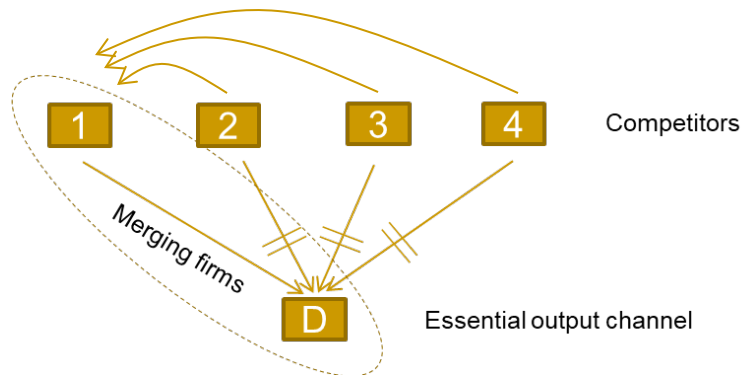
■ Two types of foreclosure

1. “Input foreclosure”



Premerger: S deals with all downstream firms
Postmerger: Combined firm causes S to foreclose Firms 2, 3, and 4

2. “Output foreclosure”



Premerger: D deals with all upstream firms
Postmerger: Combined firm causes D to foreclose dealing with Firms 2, 3, and 4

Unilateral exclusionary effects

- Two variations of foreclosure theories
 1. The combined firm could refuse to deal with its competitors (“true foreclosure”)
 2. The combined firm raises the price to its competitors rather than foreclosing them altogether (“raising rivals’ costs” or “RRC”)
- Modern practice
 - “True foreclosure” is rarely observed in business practice
 - “Raising rivals’ costs” is the primary theory today applied to vertical mergers

NB: It does not matter if the buyer is the upstream or downstream firm in a vertical merger. Antitrust law assumes that the combined firm will maximize its profits.

Unilateral exclusionary effects

■ Foreclosure: Ability and incentive

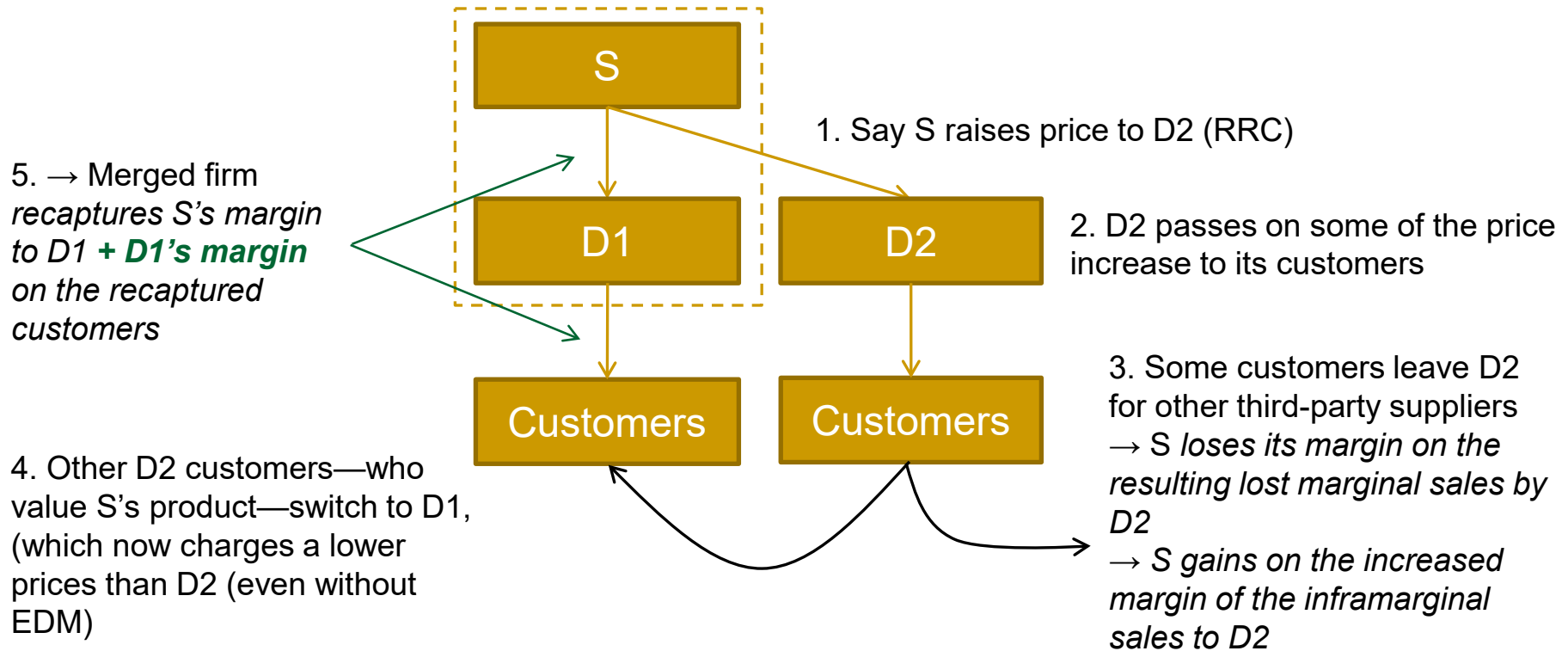
1. The *ability* of the merged firm to act anticompetitively depends whether the merged firm can competitively disadvantage its rivals by withholding its products
 - If targeted rivals can substitute suitable products at premerger prices and thereby protect themselves, the merged firm has no ability to reduce competition in the relevant market by foreclosing rivals
2. The *incentive* of the merged firm to act anticompetitively depends on—
 1. The residual elasticity of demand of the targeted rivals (which determines their loss of sales)
 2. The merged firm's profit gain on inframarginal sales to targeted rivals due to the price increase
 3. The merged firm's profit loss on marginal sales to targeted rivals due to the price increase
 4. The merged firm's recapture rate of its rivals' lost marginal resales of the merged firm's product
 5. The merged firm's profit gain (margin) on the recapture sales

Sometimes called
"vertical arithmetic"

Remember: When the merged firm increases price to its rivals, the merged firm will lose profits on reduced sales. Whether foreclosure is in the profit-maximizing interest of the merged firm will depend on its ability to earn even greater profits through recapture.

Unilateral exclusionary effects

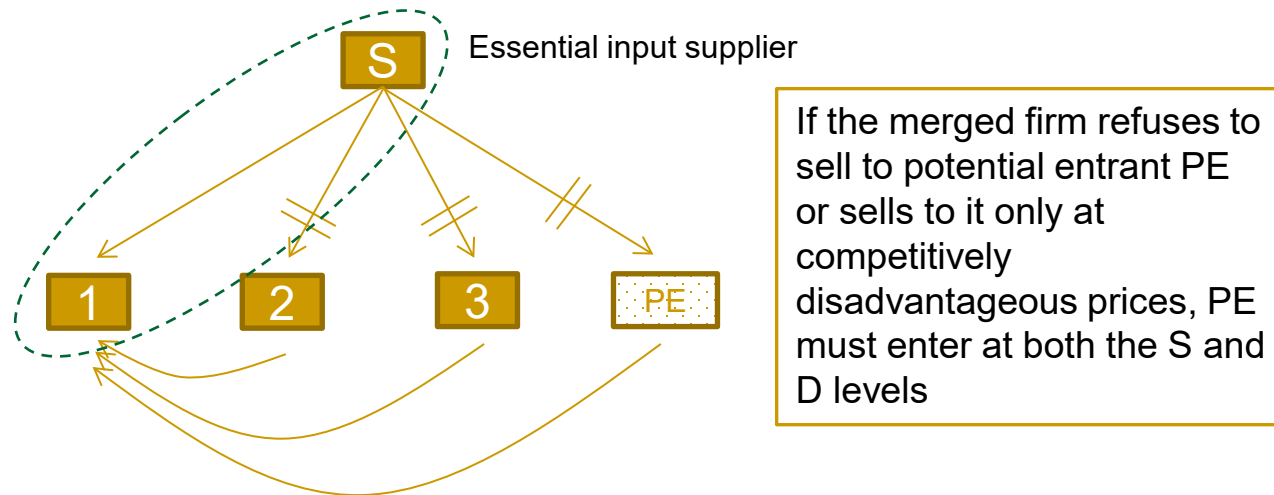
■ Foreclosure: The vertical arithmetic



Postmerger, the recapture of the *D1 margin* from marginal subscribers diverting to *D1* upsets the premerger marginal revenue = marginal cost condition and incentivizes the combined firm to *increase* the price of its content to *D1's* rivals. This is the vertical analogue to horizontal recapture unilateral effects.

Unilateral exclusionary effects

- Creating the need for two-level entry



- This sounds in the elimination of potential competition BUT—
 - The theory has been accepted by the Supreme Court in the 1960s/1970s cases when raising barriers to entry was enough in itself to be anticompetitive
 - Recognized as a theory of anticompetitive harm in the 1982 Merger Guidelines, the 2020 Vertical Merger Guidelines, and the 2023 Merger Guidelines¹

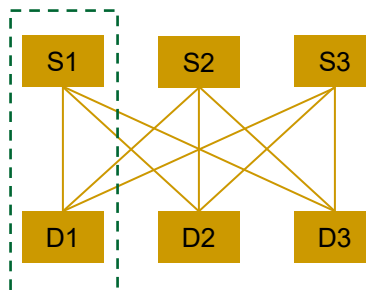
Now let's turn to coordinated effects from vertical mergers

¹ The FTC withdrew from the 2020 VMGs on September 15, 2020, as one of the first actions after the Democrat-appointed commissioners obtained a majority under Chair Lina Khan. See News Release, Fed. Trade Comm'n, [*Federal Trade Commission Withdraws Vertical Merger Guidelines and Commentary*](#) (Sept. 15, 2021). The 2023 Merger Guidelines, which address vertical and conglomerate mergers as well as horizontal mergers, recognizes this theory of harm in Guideline 5.

Coordinated effects

1. Elimination of a disruptive buyer

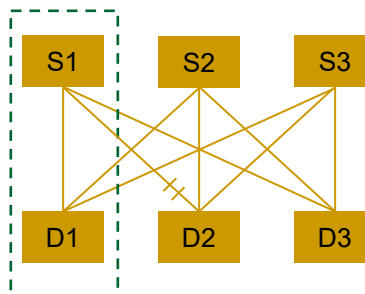
D1 is a disruptive buyer



Acquisition by S1 eliminates D1's "disruptiveness" to coordination among suppliers to charge supercompetitive prices to distributors

2. Elimination/disciplining of new disruptive competition

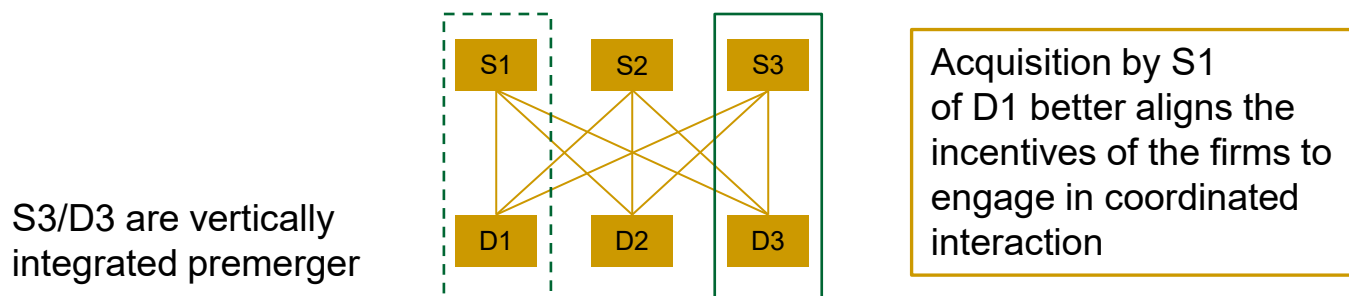
D2 is a disruptive competitor



Acquisition by D1 of S1 disciplines D2's "disruptiveness" to coordination among distributors by foreclosing S1 sales to D2

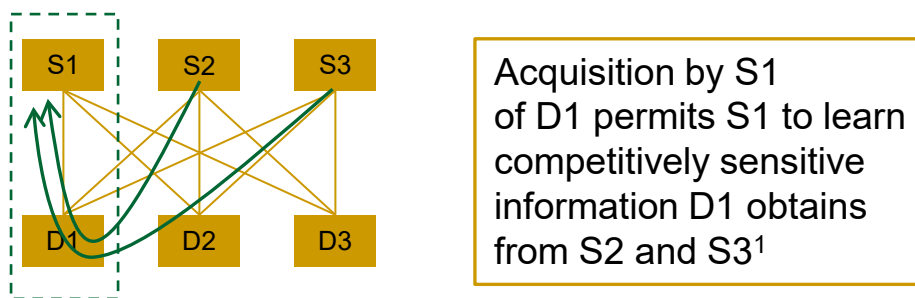
Coordinated effects

3. Facilitation of tacit coordination through greater firm homogeneity



- NB: This theory was not included in the 2020 Vertical Merger Guidelines

4. Anticompetitive information conduits



¹ D1 also could be used to pass information from S1 to S2 and S3 (making the communications bilateral).

Vertical theories of harm

■ Some observations

- In modern antitrust law, theories of anticompetitive harm in vertical mergers (as in horizontal mergers) should be on the harm to competition in the market and not on harm to competitors
- As with all Section 7 cases, the anticompetitive effect must be located in a relevant market
 - Determined by the usual *Brown Shoe* and HMT tests

Vertical theories of harm

■ Vertical mergers in the Supreme Court

❑ Decided three cases since 1950

1. United States v. E.I. du Pont de Nemours & Co., 353 U.S. 586 (1957)

- ❑ Requiring du Pont to divest its 23% ownership interest in General Motors for vertical
- ❑ *Output foreclosure*: du Pont's ownership in GM anticompetitively disadvantaged du Pont's fabrics and finisher competitors from selling to GM

2. Brown Shoe Co. v. United States, 370 U.S. 294 (1962)

- ❑ Requiring the #4 shoe manufacturer/#3 shoe retailer to divest the #12 shoe manufacturer/#8 shoe retailer for vertical foreclosure
- ❑ *Reciprocal output/input foreclosure*

3. Ford Motor Co. v. United States, 405 U.S. 562 (1972)

- ❑ Finding Ford's acquisition of spark plug manufacturer Autolite would raise barriers to entry in the spark plug market
- ❑ Requiring Ford to divest the Autolite name and its only spark plug factory, and prohibiting Ford from manufacturing spark plugs for 10 years
- ❑ Ford did not manufacture spark plugs prior to the acquisition but rather acquired them from independent companies such as Autolite
- ❑ *Input foreclosure*: Ford's ownership in Autolite anticompetitively disadvantaged Autolite's sparkplug competitors from selling to Ford

*But none of these cases has had much impact
on the modern vertical merger analysis*

Vertical theories of harm

■ Modern enforcement practice

- Historically, since vertical mergers do not eliminate a competitor and are generally accepted as creating meaningful efficiencies, the agencies until recently have not sought to block these transactions or require divestiture
- Instead, the agencies accepted behavioral remedies
 1. Non-discriminatory access undertakings
 2. Undertakings to maintain open systems to enable interoperability
 3. Firewalls to protect against sharing confidential information of competitors
- AT&T/Time Warner
 - Enforcement practice changed on November 20, 2017, when the DOJ sued to block AT&T (a subscription TV distributor) from acquiring Time Warner (a content creator/network assembler)
 - The conventional wisdom is that the DOJ concluded after examining the same markets in the Comcast/Time Warner Cable merger investigation that an access consent decree in the analytically similar Comcast/NBCUniversal transaction would not work

Query: Since the DOJ lost the AT&T/TW challenge, will vertical merger enforcement revert to behavioral remedies?

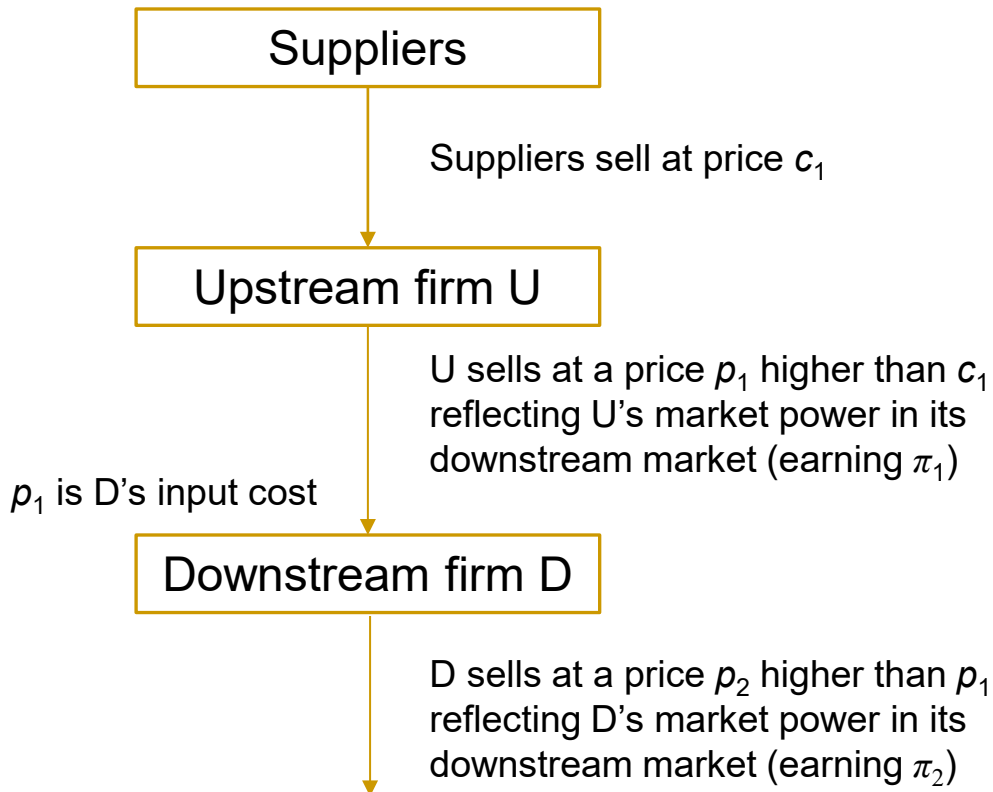
Efficiencies in vertical mergers

- Elimination of double marginalization
 - This is a widely accepted benefit of vertical mergers
 - Can lower price and increase output
- The idea
 - Consider a manufacturer and a retailer in the chain of distribution
 - Assume that both have some degree of market power
 - That is, they each face downward-sloping demand curves
 - They both then have an incentive to “markup” their price above their marginal cost
 - The “double markup” increases prices and reduces output
 - Vertical mergers change the profit-maximizing incentive from charging two markups to charging a lower single markup, which reduces price, increases output, *and* increases aggregate profits for the merged firm compared to the premerger levels
 - This drives enforcement policy to allow the merger subject to behavioral remedies but without requiring divestitures
 - NB: The efficiency gain from the elimination of double marginalization decreases as the upstream and/or downstream markets become more competitive
 - This is because the markup—and hence the market distortion to be corrected—decreases as the market(s) becomes more competitive

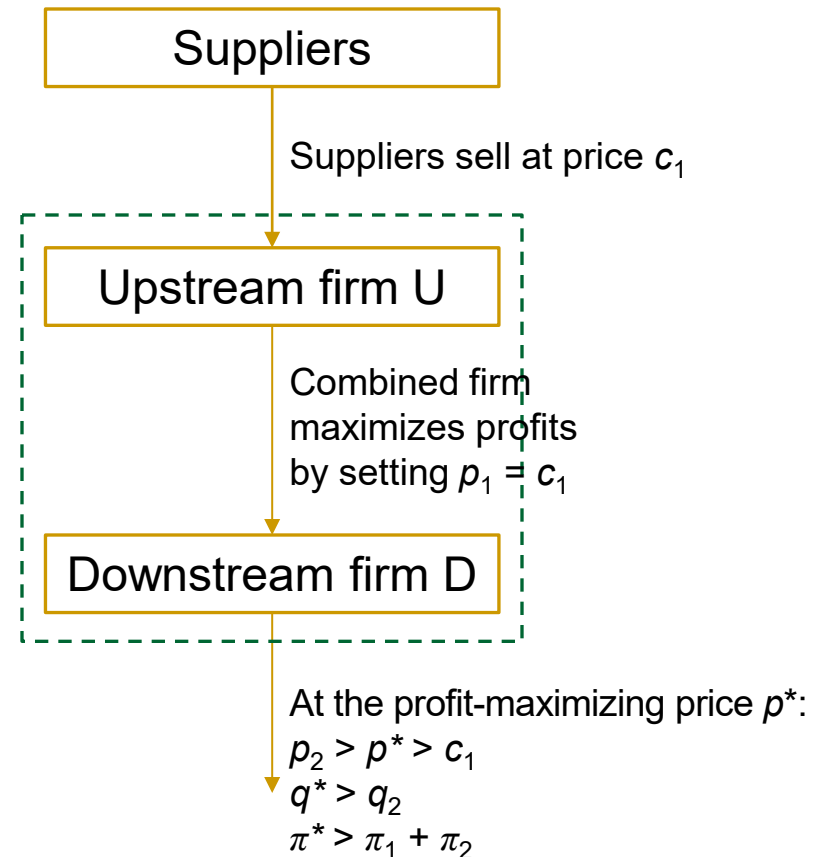
Efficiencies in vertical mergers

■ Elimination of double marginalization: The theory

Premerger



Postmerger

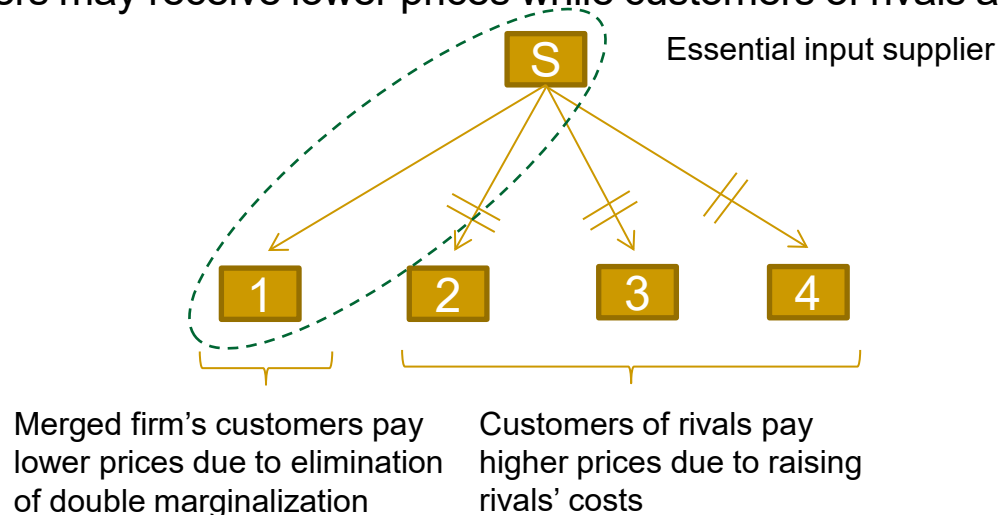


Applying the consumer welfare standard

■ Query:

How should the consumer welfare standard be applied if some customers in the relevant market benefit from the merger while other customers are harmed?

- When both RRC and efficiencies result from vertical merger, the merged firm's customers may receive lower prices while customers of rivals are charged higher prices



- Only one litigated case has raised this question (AT&T/Time-Warner)
 - *DOJ*: Look at net wealth effect comparing the aggregate savings from EDM to the aggregate incremental costs of RRC (on rivals or rivals' customers?)
 - *Court*: DOJ accepted without deciding DOJ's test

Ford/Autolite



Ford/Autolite

■ The parties

□ Ford

- Nation's second largest manufacturer of passenger cars and trucks
- Sales: 2 million units (28% share of cars)
- Revenues: Over \$5 billion

□ Autolite

- One of the nation's largest non-integrated auto parts manufacturer
- Manufactured a full line of automotive electrical products
 - Including batteries, generators, spark plugs, electrical motors, instruments, and ignition systems
- Supplied—
 - Original Equipment Manufacturers (OEMs)
 - Aftermarket

Ford/Autolite

■ The deal

- On April 12, 1961, Ford Motor Company acquired selected assets of the Electric Autolite Company for \$28 million
 - Autolite's spark-plug plant in Fostoria, Ohio (one of six Autolite facilities)
 - Autolite trade name
 - One of Autolite's six operating battery installations
 - Limited distribution rights
- Scope and limitation
 - Acquisition gave Ford partial vertical integration into spark-plug production
 - Fostoria's capacity was insufficient to meet all Ford OEM needs
 - Ford therefore continued to source from Champion and other suppliers
 - Nonetheless, the deal gave Ford the capacity and incentive to internalize a substantial share of its spark-plug needs—representing up to about 10% of total industry demand—reducing independent suppliers' accessible sales base.
- Strategic motivation
 - Reduce dependence on outside suppliers, especially Champion
 - Capture aftermarket margins under the Autolite brand
 - Align with GM's AC integration and Chrysler's prior Autolite sourcing relationship

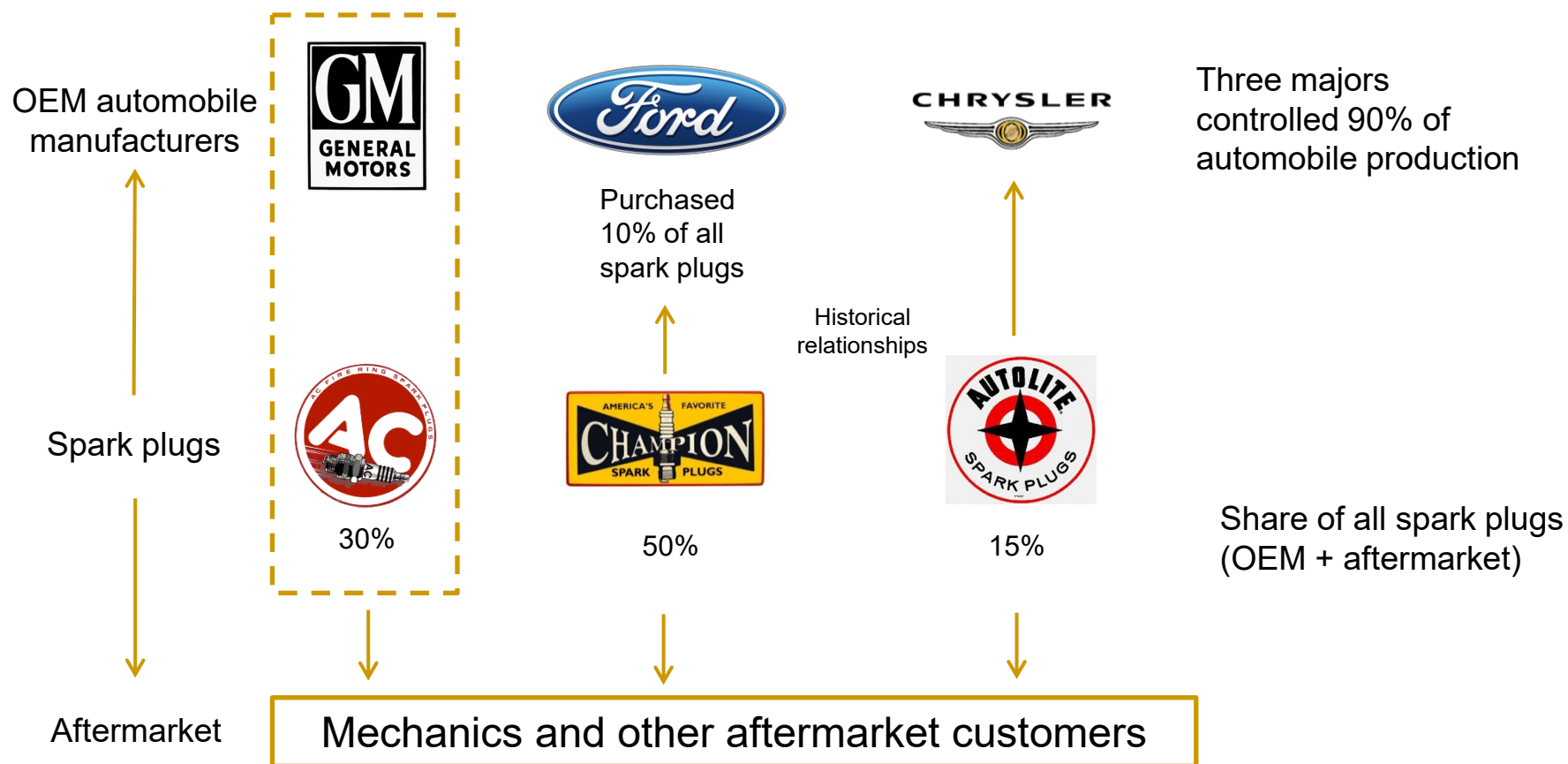
Ford/Autolite

■ Spark plug economics

- Spark plugs have to be replaced about five times in the life of a car
- The OEM market
 - Each OEM contracted to purchase spark plugs from an exclusive supplier
 - Non-integrated spark plug manufacturers bid for exclusive OEM contracts, selling to OEMs below cost
- The aftermarket
 - Aftermarket plug was the same brand as the OEM product and mechanics tended to replace spark plugs with the OEM brand
 - Spark plug manufacturers charged higher prices in the aftermarket to recover their losses in the OEM market and make profits
 - NB: Spark plugs were replaced as part of the car's tune-up and comprised only a small fraction of the tune-up service fee → customer demand for spark plug was relatively inelastic, permitting an oligopolistic equilibrium with high margins

Ford/Autolite

■ The spark plug landscape premerger



Ford/Autolite

■ District Court

- ❑ Complaint filed November 27, 1961
- ❑ Final judgment rendered on December 18, 1970, finding a Section 7 violation and ordering relief
 - No manufacture of spark plugs for 10 years
 - Divest Autolite plant and name
 - Purchase one-half of its spark plug requirements from the divested plant for 5 years
 - Enjoined from using its own trade names on spark plugs for 5 years

■ Supreme Court

- ❑ Affirmed: March 29, 1972
- ❑ Four theories
 1. The acquisition eliminated Ford as an actual and perceived potential entrant into the manufacture of spark plugs:

An interested firm on the outside has a twofold significance. It may someday go in and set the stage for noticeable deconcentration. While it merely stays near the edge, it is a deterrent to current competitors. This was Ford uniquely, as both a prime candidate to manufacture and the major customer of the dominant member of the oligopoly. Given the chance that Autolite would have been doomed to oblivion by defendant's grass-roots entry, which also would have destroyed Ford's soothing influence over replacement prices, Ford may well have been more useful as a potential than it would have been as a real producer, regardless how it began fabrication.¹

¹ Ford Motor Co. v. United States, 405 U.S. 562, 567-68 (1972) (quoting the district court) (internal citation omitted).

Ford/Autolite

■ Supreme Court

□ Three theories (con't)

2. The acquisition foreclosed Ford as a purchaser of about 10% of total industry output of spark plugs (output foreclosure)
3. Ford's entry had the effect of raising barriers to entry into the spark plug market, further reducing the chances of future deconcentration of that market:

In short, Ford's entry into the spark plug market by means of the acquisition of the factory in Fostoria and the trade name "Autolite" had the effect of raising the barriers to entry in to that market as well as removing one of the existing restraints upon the actions of those in the business of manufacturing spark plugs.

It will also be noted that the number of competitors in the spark plug manufacturing industry closely parallels the number of competitors in the automobile manufacturing industry and the barriers to entry into the auto industry are virtually insurmountable at present and will remain so for the foreseeable future. Ford's acquisition of the Autolite assets, particularly when viewed in the context of the original equipment (OE) tie and of GM's ownership of AC, has the result of transmitting the rigidity of the oligopolistic structure of the automobile industry to the spark plug industry, thus reducing the chances of future deconcentration of the spark plug market by forces at work within that market.¹

- The Court could have added a fourth theory: The acquisition facilitated oligopolistic coordination in the aftermarket sale of sparkplugs
 - This is suggested in the second paragraph of the quote above, although the Court focused more on raising barriers to entry and thereby reducing the prospect of future deconcentration

¹ Ford Motor Co. v. United States, 405 U.S. 562, 568 (1972) (quoting the district court).

Ford/Autolite: Comparing approaches

1. Ford seen as both actual and perceived potential entrant constraining spark plug pricing
 - ❑ The 1972 approach: Focused on market structure
 - Not ability, incentives, or competitive effects
 - Sufficient that there was a mere *risk* that the acquisition eliminated future entry or deterrence, without proof that Ford was likely (or perceived as likely) to enter imminently
 - ❑ The modern approach: Focuses on ability, incentive, and competitive effects
 - Actual potential competition: Looks to—
 - ❑ Ability to enter de novo or via toehold acquisition
 - ❑ Incentive to enter absent the merger
 - ❑ Likely timing of entry absent the merger
 - ❑ Effect on competition if entry occurred
 - Perceived potential competition: Looks to—
 - ❑ Incumbents' perception of the ability to enter
 - ❑ Incumbents' perception of the likelihood of entry if the market operated more anticompetitively
 - ❑ Incumbents' observable actions to deter entry
 - ❑ Whether the acquisition would remove a meaningful competitive constraint and result in the market operating less competitively

Ford/Autolite: Comparing approaches

2. *Output foreclosure*: The acquisition foreclosed Ford as a purchaser of about 10% of total industry output of spark plugs
 - The 1972 approach: Focused on market structure
 - Presumed Ford postmerger would source all of its OEM spark plug requirements from Autolite, foreclosing 10% of the spark plug demand from Autolite's rivals
 - Suggests that foreclosure of a significant share of demand is a significant factor in establishing a Section 7 violation—but not set a threshold
 - The modern approach:
 - Assesses RRC in addition to complete foreclosure
 - Focuses on ability, incentive, and competitive effects
 - Ability to foreclose/raise rivals' costs
 - Does the merged firm control an input or customer channel sufficiently important that it could disadvantage rivals?
 - Incentive to foreclose/raise rivals' costs
 - Would doing so be profitable, given lost sales, recapture, and downstream margins?
 - Competitive effect of foreclosure/raise rivals' costs
 - Would the conduct substantially lessen competition by reducing rivals' ability or incentive to compete, leading to higher prices, lower quality, or slower innovation?

Ford/Autolite: Comparing approaches

3. *Raises “barriers to entry”*: Ford's entry had the effect of raising barriers to entry into the spark plug market, further reducing the chances of future deconcentration of that market
 - The idea here is that, with the merger, Ford will shift some of its demand for OEM spark plugs from the merchant market to captive supply, which reduces market demand, and so makes entry by new firms less attractive
 - The incremental reduction in merchant market demand was significant to the Court because GM was already vertically integrated with AC
- The 1972 approach
 - The Court found that Ford’s acquisition of Autolite would result in cognizable Section 7 harm by internalizing a large OEM buyer’s demand, thereby reducing demand for third-party suppliers and with it the prospects for deconcentration
- The modern approach
 - There is no modern analogue to this theory

NB: In finding the acquisition violated Section 7, the Court looked at the totality of the competitive effect from the three theories and did not find that any one theory was sufficient to sustain a Section 7 violation

Coca-Cola/Coca-Cola Enterprises



Coca-Cola Enterprises

Coca-Cola/Coca-Cola Enterprises (2010)

■ Transactions

- Coca-Cola to acquire CCE's North American operations for over \$12.3 billion
- Separately, Coca-Cola paid Dr Pepper Snapple Group (DPSG) \$715 million to distribute DPSG brands (including Dr Pepper and Canada Dry) in specific geographic areas

■ Parties

- Coca-Cola: The largest manufacturer of soft drink concentrate and carbonated soft drinks
- CCE: Coca-Cola's largest independently owned North American bottler
- DPSG: The third largest soft drink competitor after Coca-Cola and PepsiCo

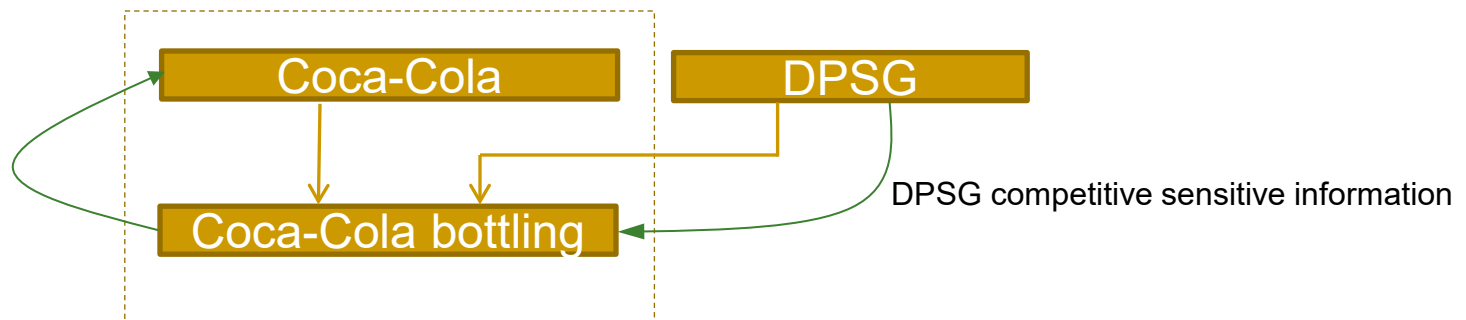
■ Soft drink bottling

- Soft drink shares: Coca-Cola (40%), PepsiCo (30%), DPSG (17%)
- Soft drink concentrate manufacturers license bottlers to produce, bottle/can, and distribute the manufacturer's soft drinks in a prescribed geographic area
- CCE
 - Accounted for 75% of Coca-Cola's U.S. sales of bottled and canned soft drinks
 - Accounted for 14% of DPSG's U.S. sales of bottled and canned soft drinks

Coca-Cola/Coca-Cola Enterprises (2010)

■ FTC concerns

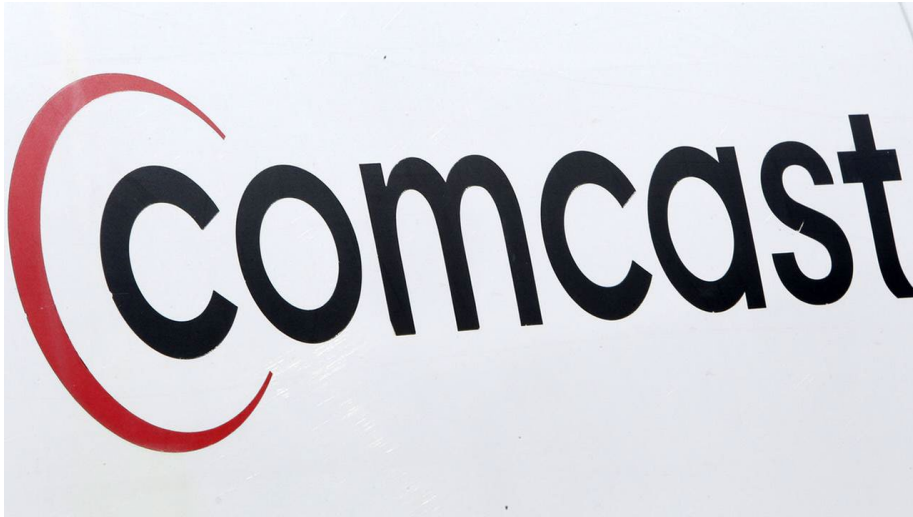
- ❑ Concentrate manufacturers need to provide their bottlers with advance confidential information (CSI) regarding their advertising, marketing, and promotion strategies and their new product introductions
- ❑ The DPSG distribution agreement with Coca-Cola did not provide adequate safeguards against access by Coca-Cola's competitive operations to DPSG's CSI obtained by Coca-Cola's bottling operations
- ❑ Likely to result in:
 - Elimination of direct competition between Coca-Cola and DPSG
 - Increase in the probability that Coca-Cola could unilaterally exercise market power or influence and control DPSG's prices
 - Increased in the probability of coordinated interaction



Coca-Cola/Coca-Cola Enterprises (2010)

- Investigation settled by consent decree
 - Firewall
 - Coca-Cola to set up a “firewall” to ensure that its ownership of the bottling company does not give certain Coca-Cola employees access to commercially sensitive confidential Dr Pepper Snapple marketing information and brand plans
 - Shareable information
 - CCE can only share DPSG information related to bottler functions and then only with Coca Cola Bottling Operations Personnel or approved “Additional Firewalled” personnel
 - Each person must sign a nondisclosure agreement (NDA)
 - Monitor
 - Consent order term: 20 years

Comcast/NBCUniversal



Comcast/NBCUniversal

■ The deal

- Comcast to buy a controlling interest in NBCUniversal from GE for contribution of assets + cash
 - Announced December 3, 2009
- To form a 51%/49% joint venture between Comcast and GE (NBCUniversal LLC) to be run by Comcast

Comcast/NBCUniversal

- Contributions to the new NBCU joint venture

New NBCU

NBCU – Valued at \$30B



Comcast Businesses– Valued at \$7.25B



+

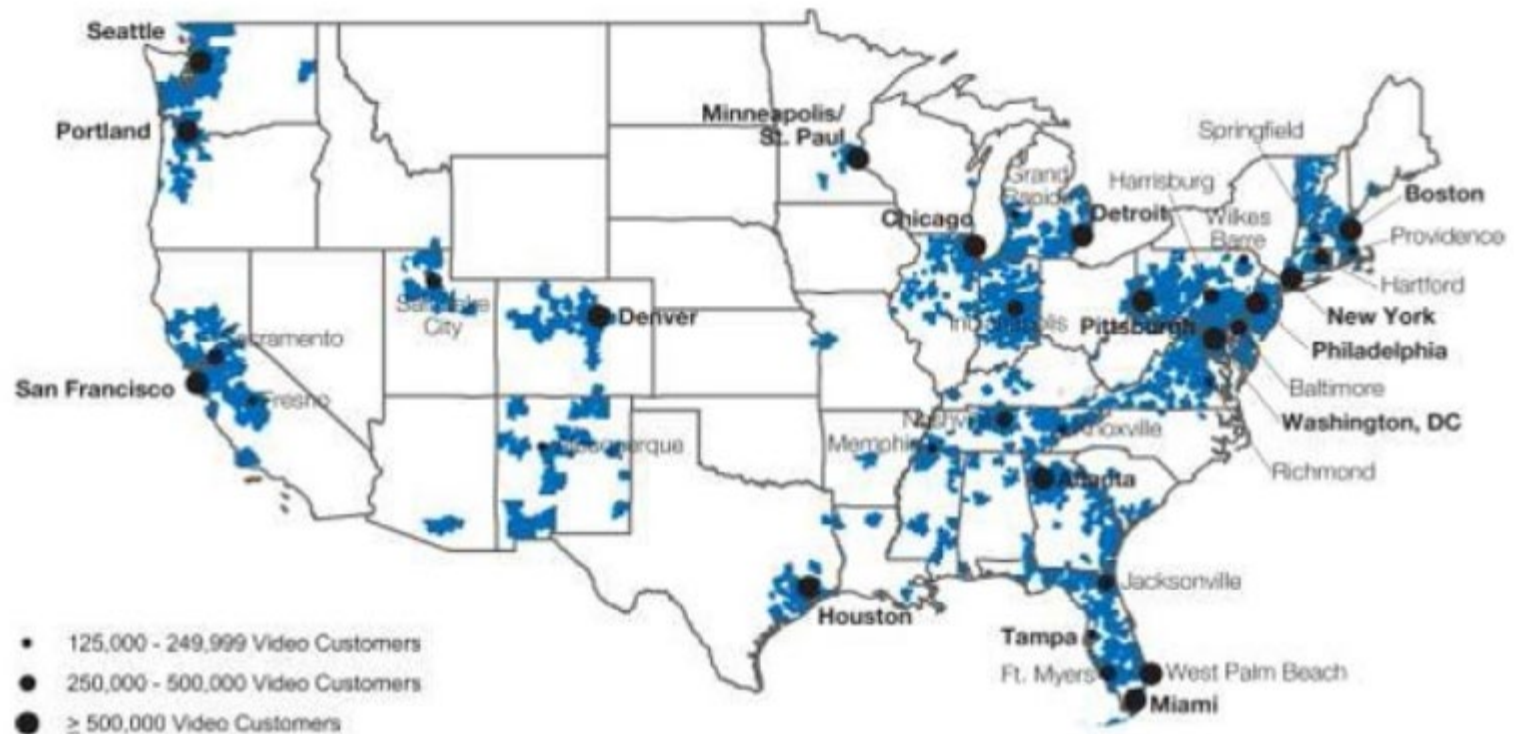
- ✓ Expanded cable offering ... strong management team
- ✓ Chance to create new offerings in key segments – i.e, sports
- ✓ Larger Internet presence ... additional capabilities



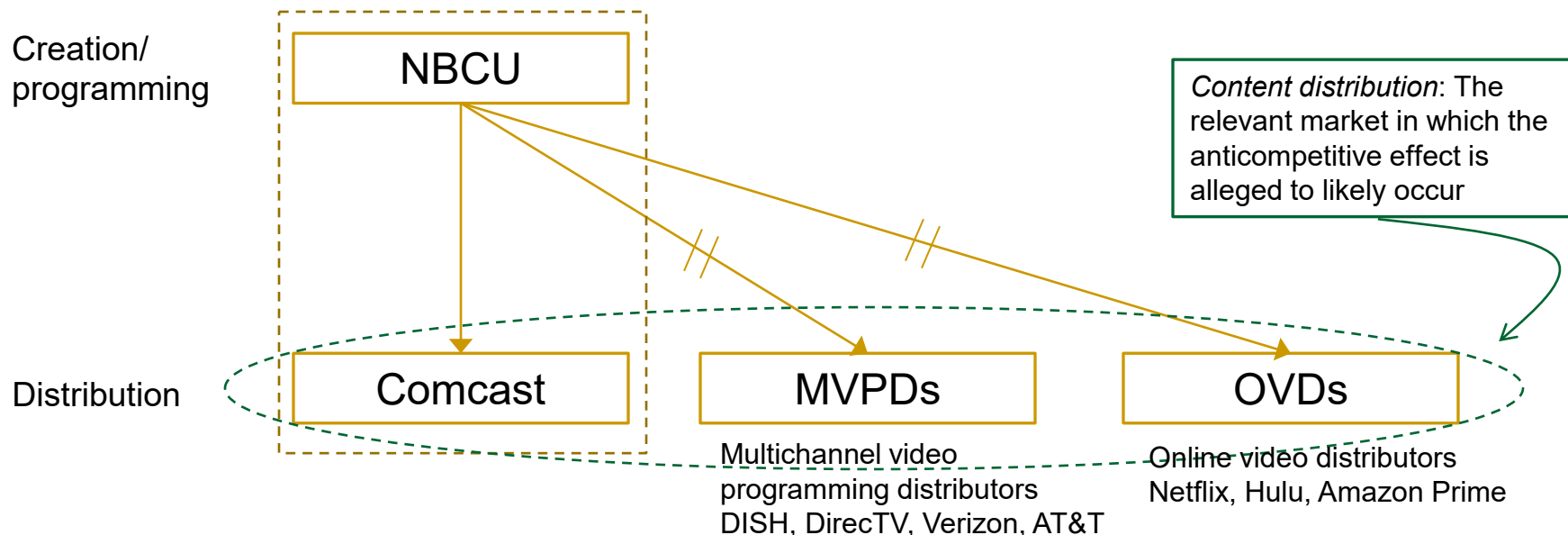
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Comcast/NBCUniversal

■ Comcast cable service areas (2014)



Comcast/NBCUniversal



■ Premerger

- NBCU has an incentive to deal with all content distributors

■ Postmerger

- Combined company has an incentive to withhold (or, more likely, increase the prices of) NBCU content to Comcast distribution competitors in Comcast service areas
 - NBCU-produced essential content
 - Local content produced by NBC's 10 O&O TV stations
- “Related products”
(in VMG terms)

Comcast/NBCUniversal

■ DOJ vertical concerns

1. JV gives Comcast control over NBCU's video programming
 - Comcast could limit competition with its cable systems by refusing to license (or, more likely, license at higher prices) NBC's essential programming content to—
 - Multichannel Video Programming Distributors (MVPDs),¹ and
 - Online Video Programming Distributors (OVDs)²
2. JV gives Comcast control of NBC's 10 O&O TV stations and their local content
 - Comcast could raise fees for retransmission consent for the NBC O&Os or effectively deny this content to certain video distribution competitors of Comcast cable systems

■ DOJ horizontal concern

3. JV gives Comcast control over NBCU's 32% interest in Hulu³
 - Comcast could use its rights to impede Hulu's development as a OVD competitor

¹ Includes cable overbuilders (primarily RSN), direct broadcast satellite services (DirecTV and EchoStar DISH), and telephone companies (e.g., Verizon Fios).

² Includes “over the top” (OTT) services delivered over the Internet but not through a cable system set-top box.

³ Premerger, Hulu was a joint venture among Fox, NBCU, Disney, and Providence Equity Partners.

Comcast/NBCUniversal

- Source of the threatened vertical anticompetitive harm:

The power to refuse to license highly consumer-valued content to programming and distribution rivals for which the rivals have no adequate substitutes

- **Solution:** Eliminate market power otherwise created by the vertical arrangement by providing for—
 - ❑ Mandatory licensing of content
 - ❑ Arbitration over pricing disputes

Comcast/NBCUniversal

■ DOJ consent decree¹

1. Traditional competitors

- Coordinated with the FCC—FCC order requires the JV to license NBCU content to Comcast's cable, satellite, and telephone company competitors
- Not included in DOJ consent decree as redundant

2. Online video distributor competitors

- a. Must make available the same package of broadcast and cable channels that JV sells to traditional video programming distributors
- b. Must offer broadcast, cable, and film content similar to, or better than, the distributor receives from JV's programming peers
 - NBC's broadcast competitors: ABC, CBS, Fox
 - Largest cable programmers: News Corp., Time Warner, Viacom, and Walt Disney
 - Largest video production studios: News Corp., Sony, Time Warner, Viacom, Walt Disney
- c. Requires commercial arbitration if parties cannot reach an agreement on license terms
- d. Prevents restrictive licensing practices and retaliation
- e. Prohibits Comcast from unreasonably discriminating in the transmission of an OVD's lawful traffic over Comcast ISP

¹ DOJ action joined by five state attorneys general: California, Florida, Missouri, Texas and Washington.

Comcast/NBCUniversal

- DOJ consent decree

- 3. Hulu

- Requires Comcast to relinquish voting and other governance rights in Hulu
 - Precludes Comcast from receiving confidential or competitively sensitive information about Hulu's operations
 - BUT allowed Comcast to retain NBCU's equity interest in Hulu



AT&T

TimeWarner

The deal

- AT&T to acquire Time Warner for \$85.4 billion

- Announced Saturday, October 22, 2016

- Valued at \$107.50 per share of TWX

- About 35.7% premium over 10/19 closing price (\$79.24)

- Indicates a \$22.2 billion premium over preannouncement market cap

- Half cash/half stock

- \$53.75 per share in cash

- AT&T stock valued at \$53.75 per share

- Subject to a collar:

- 1.437 AT&T shares if below \$37.411 at closing

- 1.3 AT&T shares if above \$41.39 at closing

- TW shareholders will own about 15% of combined company

- Accretive with first 12 months

- Synergies

- > \$1 billion in annual run rate cost synergies within 3 years of closing



Combined firm

Content Creation/Programming

Time Warner

2016 revenues: \$29.3

HBO

\$5.9 billion

- HBO
- HBO Now
- HBO Go
- Cinemax

Turner

\$11.4 billion

- CNN
- TBS
- TNT
- Cartoon Network
- Adult Swim
- Bleacher Report
- Turner Sports
- Others



\$13.0 billion

- Warner Bros. Pictures
- New Line Cinema
- Warner Bros. Home
- Warner Bros. Television Group
- Warner Bros. Digital Networks
- The CW
- Others

Content Distribution



AT&T

2016 revenues: \$163 billion



AT&T

- 2d largest wireless: 138.8 million mobile subscribers
- 3.7 million TV subscribers (U-verse)
- 3d largest broadband: 14.3 million consumer broadband subscribers
- 10.3 million consumer voice subscribers



DIRECTV

- Largest MVPD: 20.6 million satellite TV subscribers
- 0.8 million IPTV subscribers (DirecTV Now)

Subscriber figures as of 2017 Q3 (U.S. only)

Business rationale

■ The AT&T problem

- Landline business in decline
- Core wireless business had slowed with market saturation
- Massive increase in wireless data usage straining network and creating serious public perception problems

■ Aborted purchase of T-Mobile in 2011

- Announced: March 20, 2011
 - \$39 billion purchase price in stock and cash
 - Purpose: Relatively inexpensive way to add additional spectrum
- Terminated: December 10, 2011 in the face of DOJ court action and FCC staff opposition
 - Paid antitrust reverse termination fee of \$4.2 billion



■ Purchased DirecTV in 2014

- Nation's second-biggest pay TV provider (behind Comcast)
- \$48.5 billion equity value / \$67.1 billion transaction value
 - Deal premium: About 30%
 - Generates about \$2.6 billion in free cash flow annually for investment in mobile spectrum/infrastructure
 - Provides nationwide pay-TV footprint for bundles in an increasingly competitive “triple play” world
 - Increases scale when competitors are consolidating (see then-pending Comcast/TWC merger)
 - Cost synergies expected to exceed \$1.6 billion annual run rate by year three



Business rationale

- Acquisition of DirecTV creates new problems
 - ❑ Created largest pay TV provider but owned little content
 - ❑ New content-driven companies causing declining video subscriptions for traditional pay TV business
 - ❑ Distribution competitors buying content companies (squeezing available content)
 - ❑ TV advertising revenues declining as advertisers increasingly shift to “targeted” advertising on Google, Facebook and other digital platforms



PlayStation Vue



Deal rationale

■ Solution: Buy Time Warner

- Time Warner could provide AT&T with—
 - The Time Warner content libraries
 - Major networks (including TBS, TNT, CNN, HBO)
 - New and innovative content through Warner Bros.
 - The ability to experiment with and develop innovative video content
- AT&T could provide Time Warner with—
 - Access to customer relationships
 - Valuable data about the consumers of its programming enabling more “targeted” advertising
- Combined company could create sweeteners for AT&T’s broadband, cable, and wireless bundles
 - E.g., discounted or free HBO
- Combined company could use TW’s annual net income of almost \$4 billion and expected annual run-rate synergies of \$1 billion to help—
 - Finance further investments in spectrum and infrastructure, *and*
 - Maintain AT&T’s shareholder dividend



The AT&T/Time Warner purchase agreement

AGREEMENT AND PLAN OF MERGER

among

TIME WARNER INC.

AT&T INC.

and

WEST MERGER SUB, INC.

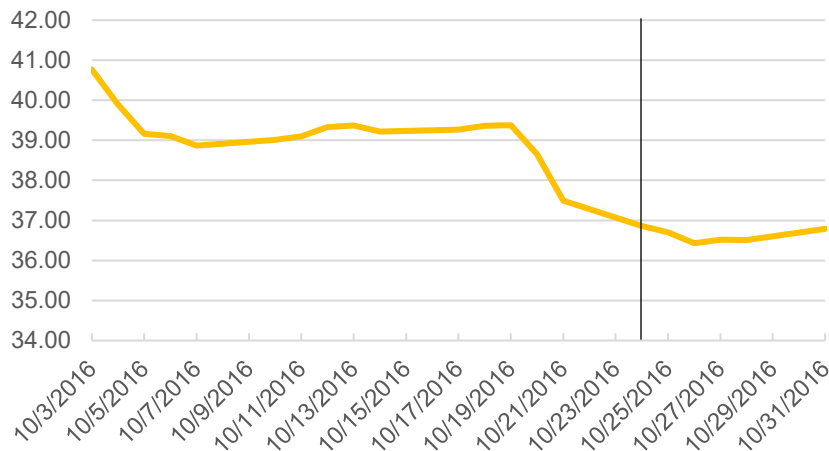
Dated as of October 22, 2016

- Covenants
 - “Reasonable best efforts” to consummate deal
 - Cooperation/consultation covenant (but no “buyer control” provision)
 - Litigation covenant
 - Qualified “hell or high water” (HOHW)—
 - No Combined Entertainment Group Effect
 - No Regulatory Adverse Material Effect
 - No increase in aggregate capital expenditures
- Conditions
 - HSR waiting period expiration or termination
 - Other merger control clearances
 - Brazil, Canada, China, the European Union, and Mexico
 - No government consent having a Regulatory Material Adverse Effect
 - No law or order enjoining transaction
- Termination
 - Termination date: October 22, 2017 (one year)
 - If antitrust conditions fail, may be extended by either party by written notice up to April 22, 2018 (six-month extension)
 - Antitrust reverse termination fee: \$500 million
 - 0.6% of equity value (\$85.4 billion)
 - Public deals over last three years: Mean: 4.7%; Median: 4.4%

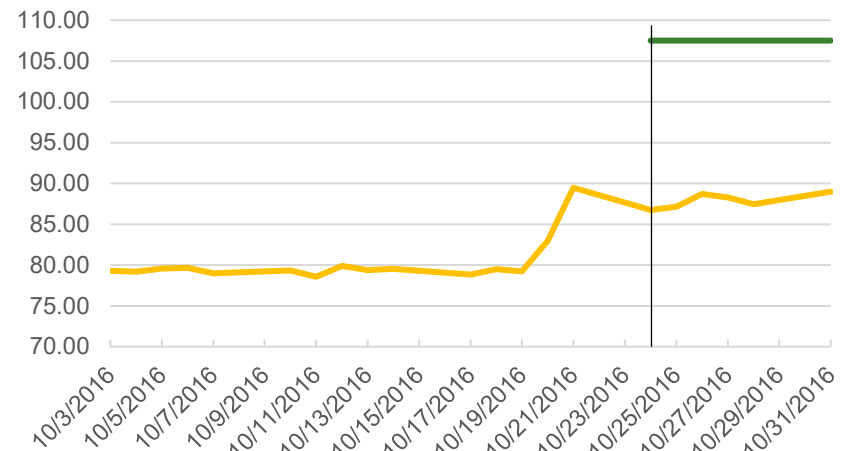
Market reaction

- Market skeptical
 - Was this the second coming of AOL Time Warner?
 - Will the deal be blocked by antitrust concerns?

**AT&T (T) STOCK PRICE
October 2016**



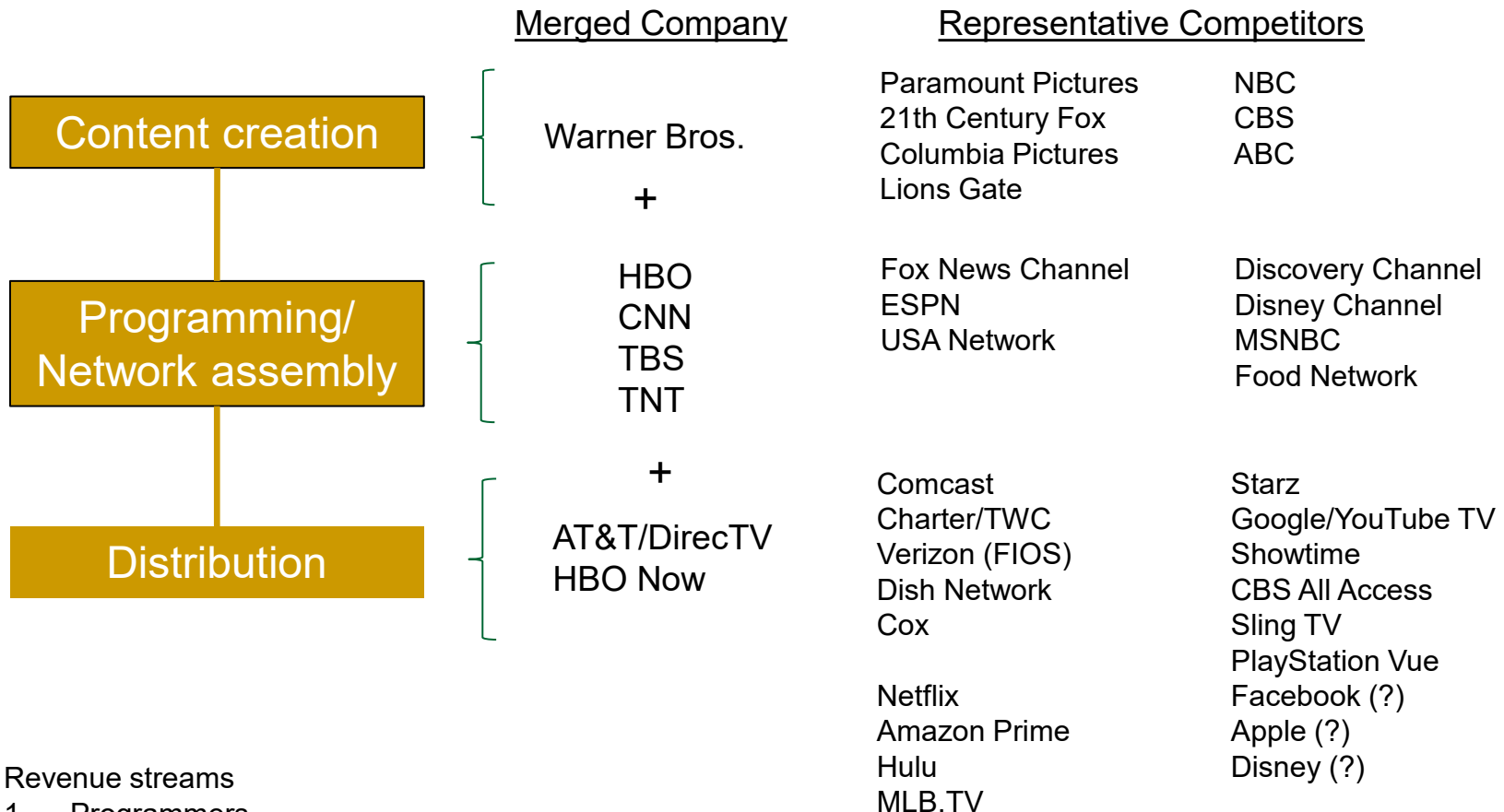
**TIME WARNER (TWX) STOCK PRICE
October 2016**



Announced Saturday, October 22, 2016

	AT&T			TW		
	Closing	%Δ		Closing	%Δ	Offer
October 19, 2016	39.38			79.24		
October 24, 2016	36.30	-7.8%		86.74	9.5%	-19.3%

AT&T/Time Warner as a vertical merger



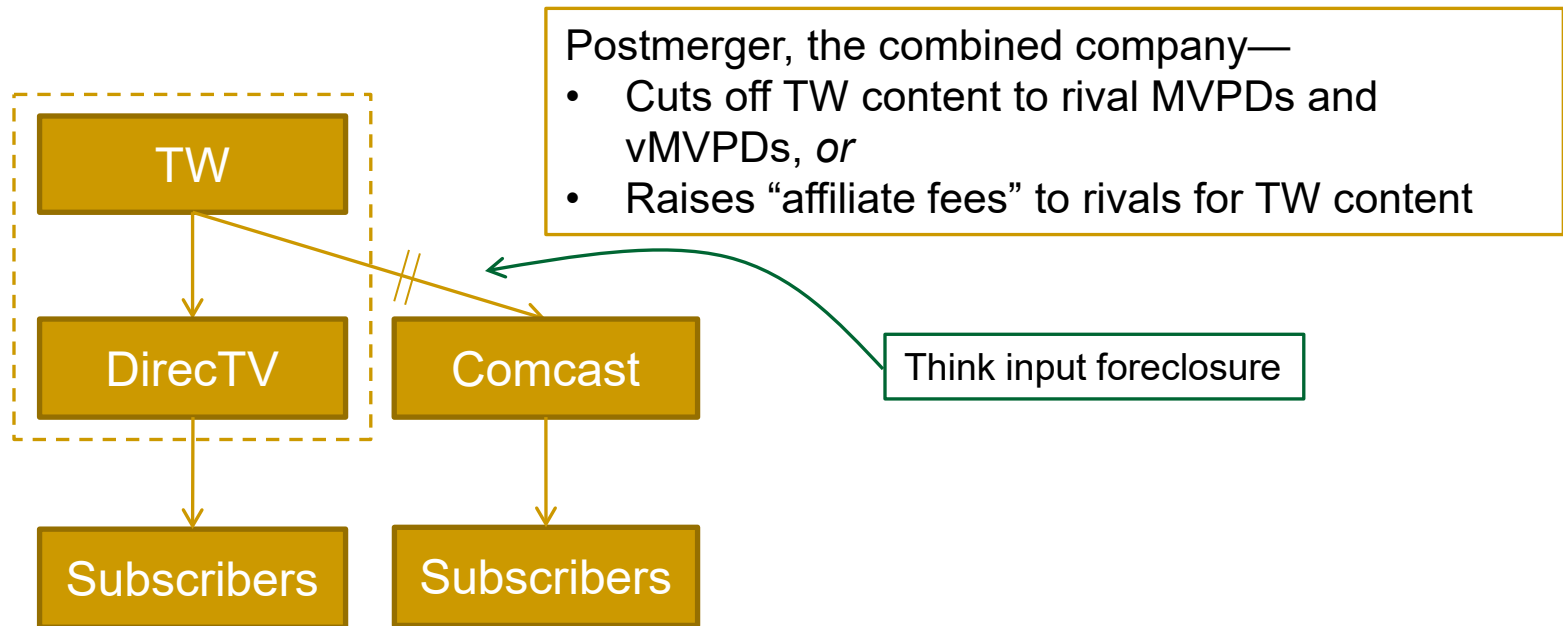
Revenue streams

1. Programmers
 - a. Affiliates fees paid by distribution companies to display programmer's content (usually on a per subscriber basis)
 - b. Advertising fees (usually involving 16 of the 18 minutes per hour of total advertising time)
2. Distribution companies
 - a. Subscriber fees
 - b. Advertising fees

SO WHAT WAS THE PROBLEM?

The DOJ's three theories of harm

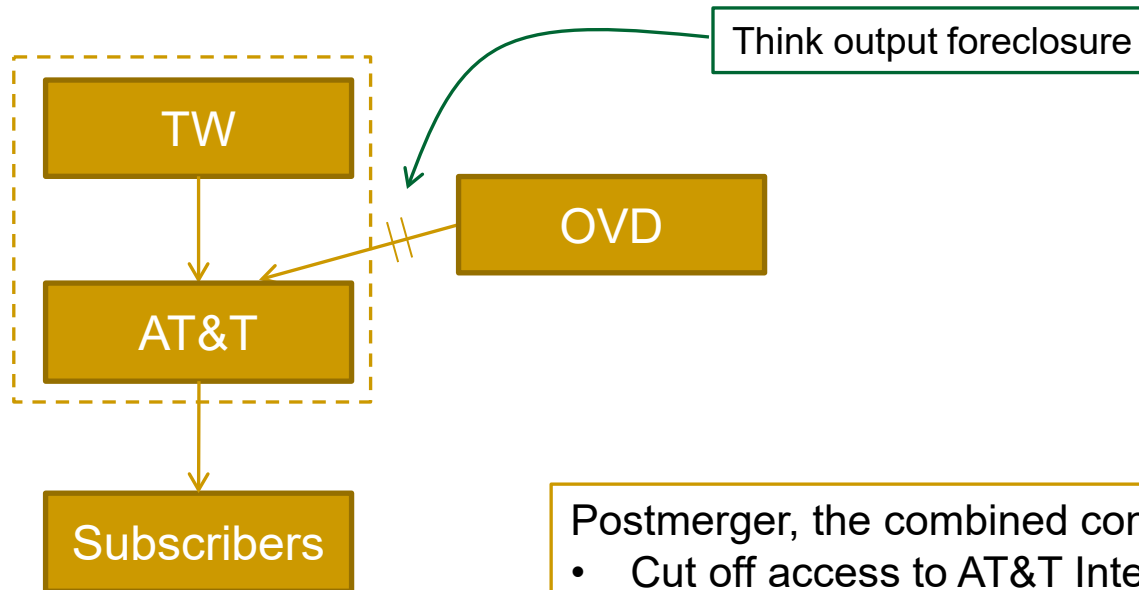
1. Foreclosure/raising rivals' costs (the "leverage theory")



Higher content prices means higher MPVD affiliate fees and subscriber rates

The DOJ's three theories of harm

2. Eliminate/discipline new disruptive competition



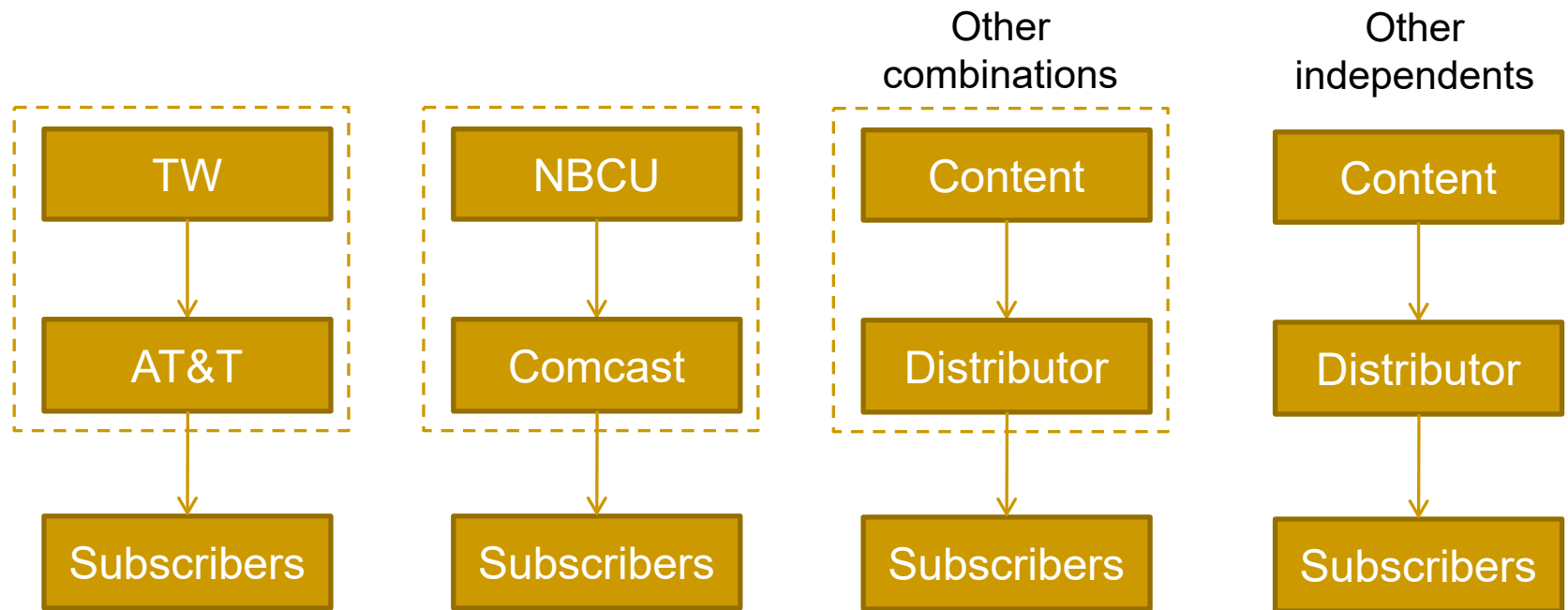
- Postmerger, the combined company could—
- Cut off access to AT&T Internet “pipes,” *or*
 - Raise prices for access to AT&T Internet “pipes”*

* Mechanically, DirecTV would demand lower affiliate fees for content

*Less competition from disruptive OVDs
means less innovation and higher subscriber rates*

The DOJ's three theories of harm

3. Facilitate tacit coordination through greater firm homogeneity



More vertical integration leads to higher subscriber rates

DOJ concerns were easy to anticipate

- Comcast/NBCUniversal was analytically similar in its vertical aspects

Content

Distribution



Comcast cable channels, inc.

- Versus
- The Golf Channel
- E Entertainment
- + pay G.E. \$6.5 billion in cash



- NBCUniversal cable channels (including USA, Bravo, E!, SyFy, CNBC and MSNBC)
- NBC network
- Universal Studios



Distribution

*Posed similar concern re foreclosure/RRC
of content for Comcast's rival MVPDs and OVDs*

Comcast/NBCUniversal vertical solution

- Source of the threatened vertical anticompetitive harm:

The power to refuse to license highly consumer-valued content to programming and distribution rivals for which the rivals have no adequate substitutes

- **Solution:** Eliminate market power otherwise created by the vertical arrangement by providing for—
 - Mandatory licensing of content
 - Arbitration over pricing disputes
- **Application to AT&T/Time Warner**
 - Offer to accept the same mandatory licensing/arbitration provisions as in the Comcast/NBCUniversal consent decree and FCC order

SO WHAT HAPPENED?

The DOJ investigation: 13 months

October 22, 2016	Deal announced
November 4, 2016	HSR reports filed
November 8, 2016	Trump elected president
December 8, 2016	DOJ issues second request
July 7, 2017	Reports of Trump's opposition to deal
September 27, 2017	Makan Delrahim confirmed to head the Antitrust Division
November 7, 2017	Reports of DOJ settlement demands for asset divestiture*
November 20, 2017	DOJ complaint filed

20 Depositions
25 million pages of documents

WHY DID THE INVESTIGATION TAKE SO LONG?

- * In a February 16, 2018, status conference, the DOJ revealed that it had made four settlement proposals to AT&T for the divestiture of various networks or DirecTV

Why did the DOJ reject the parties' fix?

- AAG Delrahim took a surprising strong position against “behavioral” relief in antitrust cases generally and AT&T/Time Warner in particular:
 1. Makes the Antitrust Division a regulatory agency when it is a law enforcement agency
 2. Behavioral relief is difficult to enforce
 - The sanction is contempt of court
 - Requires—
 1. “Clear and convincing evidence”
 2. Of a “clear and unambiguous” violation of the consent decree
 - Behavioral relief in vertical cases is almost inherently are not “clear and unambiguous”
 - Here, Delrahim would accept only divestiture relief and then only if Comcast divested either—
 - DirecTV, or
 - “Essential” Time Warner content (i.e., the Turner networks)
- } Designed to eliminate the vertical aspect of the transaction
- AT&T's response
 - Divestiture relief would eliminate all the reasons for the deal
 - Mandatory licensing/arbitration removes any possibility of anticompetitive harm
 - “*Litigate the fix*”: Make a binding mandatory licensing/arbitration contractual commitment to rival distributors and argue to the court that the deal is not anticompetitive with this fix in place

The DOJ complaint

- Filed November 20, 2017
 - Alleged the three theories of anticompetitive harm
- No states joined as plaintiffs
 - Compare Comcast/NBCUniversal with five states

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA
450 Fifth Street, NW
Washington, DC 20530;

Plaintiff,

v.

AT&T INC.
208 South Akard Street,
Dallas, TX 75202;

DIRECTV GROUP HOLDINGS, LLC
2260 E. Imperial Hwy,
El Segundo, CA 90245; and

TIME WARNER INC.
One Time Warner Center,
New York, NY 10019;

Defendants.

COMPLAINT

AT&T/DirecTV is the nation's largest distributor of traditional subscription television. Time Warner owns many of the country's top TV networks, including TNT, TBS, CNN, and HBO. In this proposed \$108 billion transaction—one of the largest in American history—AT&T seeks to acquire control of Time Warner and its popular TV programming. As AT&T has expressly recognized, however, distributors that control popular programming “have the incentive and ability to use (and indeed have used whenever and wherever they can) that control as a weapon to hinder competition.” Specifically, as DirecTV has explained, such vertically integrated programmers “can much more credibly threaten to withhold programming from rival

The DOJ complaint

- Query: Who in the Antitrust Division was not on the complaint?

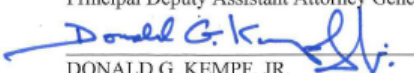
Dated: November 20, 2017

Respectfully submitted,

FOR PLAINTIFF UNITED STATES OF AMERICA:


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Assistant Attorney General for Antitrust


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United States Department of Justice
Antitrust Division
Telecommunications and Broadband Section
450 Fifth Street, N.W., Suite 7000
Washington, DC 20530
Telephone: (202) 514-5621
Facsimile: (202) 514-6381

The litigation: Preliminaries

- Tried in the District Court for the District of Columbia
- Bench trial before Judge Richard Leon
 - Appointed by George W. Bush
 - Assumed office on February 19, 2002
 - Began senior status on December 31, 2016
 - Same judge who entered the Comcast/NBCUniversal consent decree
 - Known for a sharp tongue and aggressive management of his courtroom



The litigation timetable

6.5 months	November 20, 2017	DOJ complaint filed
	November 27, 2017	Parties extend termination date to April 22, 2018 (latest date permitted by merger agreement)
	November 28, 2017	Parties file answer (includes commitment to arbitration solution to “litigate the fix”)
	December 7, 2017	Judge Leon sets trial to start on March 19, 2018 Expects decision in late April or May
	December 21, 2017	Parties amend merger agreement to extend termination date to June 22, 2018
	March 22, 2018	Six-week trial starts
7.5 months	June 12, 2018	Decision announced dismissing complaint
	June 14, 2018	Deal closes
	July 12, 2018	Notice of appeal filed
	July 19, 2018	Motion for expedited consideration granted
	December 6, 2019	Argued
	February 26, 2019	Decision announced affirming dismissal

The litigation: Burdens of proof

- Judge Leon applied same *Baker Hughes* three-step burden-shifting approach used in horizontal mergers—
 1. DOJ must prove a prima facie case of likely anticompetitive effect in a relevant market
 2. Burden of going forward shifts to merging parties to dispute the DOJ's prima facie case by showing sufficient evidence for the fact-finder to find that there was no anticompetitive effect
 3. Burden of persuasion returns to plaintiff to prove by a preponderance of the evidence that the transaction is in fact anticompetitive
- Other courts have followed Judge Leon in vertical cases¹

¹ See, e.g., *Illumina, Inc. v. Fed. Trade Comm'n*, 88 F.4th 1036, 1048 (5th Cir. 2023) (*Illumina/GRAIL*); *FTC v. Microsoft Corp.*, 681 F. Supp. 3d 1069, 1084 (N.D. Cal. 2023) (*Microsoft/Activision*); *United States v. UnitedHealth Grp. Inc.*, 630 F. Supp. 3d 118, 129 (D.D.C. 2022) (*UnitedHealth/Change*).

The litigation: Burdens of proof

- Judge Leon: Two initial observations on the DOJ's burden
 1. DOJ does not have the advantage of any presumptions in proving a prima facie anticompetitive effect
 - There is nothing like the *PNB* presumption outside of horizontal mergers
 - So Judge Leon modified Step 1 to eliminate reliance on the *PNB* presumption and generalized the requirement to prima facie proof of an anticompetitive effect in a relevant market
 2. Since market shares do not play a critical role in the analysis, the relevant market need not be as rigorously defined as in a horizontal merger, where market shares predicate the *PNB* presumption

The key litigation question

Will the merger give the combined company additional bargaining power in the licensing of content that will lead to increased prices for Turner content and hence to subscribers?¹



- DOJ: Yes
 - ❑ Business documents say so
 - ❑ Rival distributors say so
 - ❑ Expert economic analysis says so

¹ The DOJ agreed at trial that the combined company would not completely foreclose rival distributors and that the content would be licensed. It only litigated the case on raising rivals' costs.

The key litigation question

Will the merger give the combined company additional bargaining power in the licensing of content that will lead to increased prices for Turner content and hence to subscribers?

■ AT&T/Time Warner: No

- ❑ Transaction eliminates no competitors/increases no market shares
- ❑ Any increase in prices could result only from an increased willingness to walk away from a licensing deal and withhold content
- ❑ The incentive of the merged company is to license its content as widely as possible
- ❑ The DOJ agrees that license agreements will be reached with all rival companies and the merged company will not withhold its content
- ❑ The DOJ's evidence shows that there is a gross procompetitive savings of \$352 million annually to DirecTV from the elimination of double marginalization
- ❑ Prior vertical deals in industry did not result in increased prices
- ❑ No customer testified that it would accede to higher affiliate fees postmerger



The DOJ's evidence

1. Business documents
2. Testimony from rival MPVDs and OVDs representatives
3. DOJ expert economist

*The bulk of the trial and the opinion concerned Theory 1: Raising Rivals' Costs.
This will be our focus.*

The DOJ's evidence

1. Business documents



- DOJ: Three types of documents
 - *Business documents* showing that Turner content was very valuable to rival distributors
 - AT&T and DirecTV *regulatory filings* before the FCC in Comcast/NBCUniversal and other proceedings showed that each believed that the vertical integration would give the merged firm the power to raise content prices
 - *Ordinary course documents* from AT&T to the same effect

The DOJ's evidence

1. Business documents: Value of Turner content



- *Court:*
 - Most documents spoke to the value or “must have” nature of Turner content
 - BUT Turner content had this value premerger—need an explanation of how the merger would increase this value
 - The documents did not purport to explain the mechanism the combined company could use to increase the value of the content and so achieve higher negotiated affiliate fees postmerger than TW could obtain premerger

Court: Documents were not probative on the ability of the merged company to obtain higher prices for TW content

The DOJ's evidence

1. Business documents: AT&T/DirecTV regulatory filings in Comcast/NBCU



- *AT&T/DirecTV:*
 - Submitted comments to the FCC arguing that the Comcast/NBCU deal would result in higher prices for NBCU content to Comcast rivals
- *Court:* Context must be assessed carefully to determine probative value
 - Submitted in opposition by a competitor or a customer to a rival's transaction
 - Industry has changed significantly since the filings were made in 2010
 - Even accepting arguendo that vertical integration would increase bargaining power, says nothings about—
 - What the size of the price increase would be here, *or*
 - Whether it would outweigh the admitted savings to subscribers from the elimination of double marginalization

Court: Regulatory filings have little probative value on this deal and given very limited credit

The DOJ's evidence

1. Business documents: AT&T/DirecTV ordinary course documents



- The hearsay rule
 - *FRE 801(c)(definition)*: “Hearsay” means a statement that:
 - the declarant does not make while testifying at the current trial or hearing; *and*
 - a party offers in evidence to prove the truth of the matter asserted in the statement¹
 - *FRE 802 (rule)*: Hearsay is not admissible unless any of the following provides otherwise:
 - a federal statute;
 - these rules; or
 - other rules prescribed by the Supreme Court²

Is there an exception for ordinary course documents?

¹ Fed. R. Evid 801(c).

² *Id.* 802.

The DOJ's evidence

1. Business documents: AT&T/DirecTV ordinary course documents



- FRE 803(6) (exceptions to the hearsay rule):

Records of a Regularly Conducted Activity. A record of an act, event, condition, opinion, or diagnosis if:

- | | | |
|--------------|---|--|
| Requirements | { | (A) the record was made at or near the time by—or from information transmitted by—someone with knowledge; |
| | | (B) the record was kept in the course of a regularly conducted activity of a business, organization, occupation, or calling, whether or not for profit; |
| | | (C) making the record was a regular practice of that activity; |
| Proof | { | (D) all these conditions are shown by the testimony of the custodian or another qualified witness, or by a certification that complies with Rule 902(11) or (12) or with a statute permitting certification; and |
| | | (E) the opponent does not show that the source of information or the method or circumstances of preparation indicate a lack of trustworthiness. |

The DOJ's evidence

1. Business documents: AT&T/DirecTV ordinary course documents



- *Court:*
 - Would not admit under the “business document” hearsay exception without a foundation, including testimony by the author on—
 - Reason for creation
 - Knowledge of the author about the subject matter
 - Reliance on the document by senior decision-makers

“Witnesses would be able to contextualize and explain the technical and lengthy documents at issue, which might otherwise be misunderstood or selectively cited in post-trial briefs.”

Court: DOJ elected not to present foundation witnesses, so AT&T and DirecTV ordinary course documents on which the DOJ planned to rely were not admitted into evidence

The DOJ's evidence

2. Testimony from rival MPVDs and OVDs



- *DOJ:* Would show that rival distributors believed—
 - The transaction would give AT&T increased bargaining power
 - AT&T would use this power to raise the prices to rival distributors for TW content

- *Court:*
 - In vertical cases, where customers are also competitors, testimony could reflect self-interest rather than genuine concerns
 - Witnesses could not explain the mechanism by which the bargaining postmerger would result in prices higher than those reached in premerger bargaining
 - No customer would testify that it would accede to demands by the merged company for increased affiliate fees

Court: Testimony from rivals that transaction would raise prices and diminish innovation not credited