



2018

The AT&T/Time Warner Merger: How Judge Leon Garbled Professor Nash


Steven C. Salop

Georgetown University Law Center, salop@law.georgetown.edu

This paper can be downloaded free of charge from:
<https://scholarship.law.georgetown.edu/facpub/2094>
<https://ssrn.com/abstract=3247845>

Journal of Antitrust Enforcement, Vol. 6, Issue 3, 459–477

This open-access article is brought to you by the Georgetown Law Library. Posted with permission of the author.
Follow this and additional works at: <https://scholarship.law.georgetown.edu/facpub>

 Part of the [Antitrust and Trade Regulation Commons](#), [Evidence Commons](#), and the [Law and Economics Commons](#)



The AT&T/Time Warner merger: how Judge Leon Garbled Professor Nash

Steven C. Salop 

I. INTRODUCTION

The US District Court in the AT&T/Time Warner vertical merger case has issued its opinion permitting the merger.¹ At of this writing in August 2018, the

* Professor of Economics & Law, Georgetown University Law Centre.

◆ I have benefited from several Amicus Briefs: Brief for 27 Antitrust Scholars as *Amici Curiae* in Support of Neither Party, *United States v AT&T, Inc*, No 18-5214 (DC Cir 2018) (13 August 2018) (hereinafter, *27 Scholars Brief*); Proof Brief of Amici Professor William P Rogerson and American Cable Association in Support of Appellant, *United States v AT&T, Inc*, No 18-5214 (DC Cir 2018) (13 August 2018) (hereinafter, *Rogerson Brief*); Brief of Amici Curiae American Antitrust Institute, Consumers Union, and Public Knowledge In Support of Appellant, *United States v AT&T, Inc*, No 18-5214 (DC Cir 2018) (13 August 2018). Before the DOJ complaint, I consulted with a third-party that was concerned about the competitive impact of the then-proposed merger. This article was prepared independently. I would like to thank Jonathan Baker and Erik Hovenkamp for helpful comments. All opinions and errors are my own.

1 *US v AT&T*, No 1:17-cv-2511 (Hon Richard J Leon) <<http://www.dcd.uscourts.gov/sites/dcd/files/17-2511opinion.pdf>> accessed 31 October 2018 (hereinafter, 'Op.').

Department of Justice (DOJ) has appealed to the DC Circuit and filed its brief, as have several Amici. I was disappointed that the DOJ was unable to prove its case to the satisfaction of Judge Leon, the trial judge. Notwithstanding the court's confidence that the merger is procompetitive, I remain concerned that it will have anti-competitive effects, both on its own and following the subsequent vertical mergers in the TV industry, which this decision may will encourage and permit.²

This commentary offers some reflections on Judge Leon's opinion, not the future of the industry. It sets out a critical analysis of the court's sceptical treatment of the Nash bargaining theory that formed the basis of the DOJ's complaint and the economic errors he made. Judge Leon also rejected the empirical inputs that were used by DOJ's expert economist, Professor Carl Shapiro, in his quantitative analysis, though this article will not analyse these issues. It will, however, raise questions about whether Judge Leon's economic errors in analysing the bargaining model might have affected his interpretation of the evidence. The commentary also will offer some critical thoughts about the DOJ's treatment of efficiencies from the elimination of double marginalization.

II. JUDGE LEON'S OPINION

The DOJ's anticompetitive input foreclosure theory did not allege that the Turner cable networks owned by Time Warner would be withheld from AT&T's downstream distribution rivals. Instead of a 'total foreclosure' theory, the DOJ alleged that the merger would permit Time Warner to negotiate higher prices, which would raise rivals' costs and thereby allow AT&T to raise downstream prices.³

The government's bargaining theory

DOJ's theory was that AT&T would have the power to negotiate higher prices for Time Warner's Turner networks after the merger by threatening to withhold the content from a video distributor, if its higher pricing demands were not accepted. Failure to reach agreement would lead to a 'blackout' of these networks, which would cause DirecTV (AT&T's main distribution entity) to gain more subscribers at the expense of the negotiating distributor. This subscriber diversion means that the merged

- 2 One allegation in the DOJ complaint was that the merger would facilitate coordination between AT&T and Comcast, an allegation that Judge Leon also rejected. There is also a longer-term concern that this decision will lead to a Pay-TV distribution market dominated by a few vertically integrated firms. As I have written in a recent article, the resulting market structure could lead to a reciprocal licensing outcome with severe anticompetitive coordination effects. These integrated firms might well be able to facilitate credible pricing coordination among themselves with reciprocal program content contracts at high-input prices, supported by MFNs, contractual provisions that discourage discounting. The higher prices would then be passed on to consumers, allowing the firms to achieve an outcome closer to the cartel outcome in the downstream video subscription market. See Steven C Salop, 'Invigorating Vertical Merger Enforcement' (2018) 127 *Yale LJ* 1962, 1977.
- 3 Input foreclosure can involve total withholding of an input, raising price (unilaterally, as the result of a negotiation, or in a coordinated fashion with other input suppliers), reducing quality, delayed access to a new generation, and so on. See Steven C Salop and Daniel P Culley, 'Revising the U.S. Vertical Merger Guidelines: Policy Issues and an Interim Guide for Practitioners' (2016) 4 *J Antitrust Enforcement* 1.

Time Warner/AT&T would have less to lose from a failure to reach a negotiated agreement than did Time Warner absent the merger. For this reason, the merger would raise Time Warner's bargaining leverage and lead to a higher negotiated price for the Turner networks.

The DOJ's theory was not novel but goes back to the seminal Binmore, Rubinstein and Wolinsky article that showed how the Nash bargaining solution would arise as the equilibrium to a non-cooperative, alternating-offer negotiation game.⁴ This approach forms the basis for economists' analysis of negotiation markets. It is embedded in articles,⁵ the US Merger Guidelines,⁶ and has been applied in recent merger cases.⁷

Judge Leon was highly sceptical—if not dismissive—of this anticompetitive leverage theory. There were two main prongs of his scepticism. Firstly, he concluded that the Turner negotiators would not take into account the interests of DirecTV in making their negotiation demands. Secondly, he concluded that a permanent blackout would dramatically reduce Turner's profits, so a blackout threat would not be credible. In his view, the fact that almost all blackouts are temporary supported his conclusion that blackout threats are not credible. However, both of these conclusions are erroneous. Long-term blackouts are not required for the validity of the bargaining theory. And instructing corporate divisions to ignore the interests of the corporation is inconsistent with fundamental antitrust law and economics that a rational firm maximizes the totality of its profits.

Judge Leon restricted the amount of economic evidence, which may have led to the errors. The economic reports were not made part of the record and expert testimony was limited. As noted in the *DOJ Appeal Brief*, Professor Shapiro's direct testimony was limited to just 2.5 hours. The brief quotes Judge Leon as saying, 'If you don't finish, well, it's too bad.'⁸ These limitations may well have led to the errors.

4 John Nash, 'The Bargaining Problem' (1950) 18 *Econometrica* 155; Ken Binmore, Ariel Rubinstein and Asher Wolinsky, 'The Nash Bargaining Solution in Economic Modeling' (1986) 17 *Rand J Econ* 176.

5 See, eg Henrick Horn and Asher Wolinsky, 'Bilateral Monopolies and Incentives for Merger' (1988) 19 *Rand J Econ* 408; William P Rogerson, 'A Vertical Merger in the Video Programming and Distribution Industry: Comcast-NBCU (2011)' in J Kwoka and L White (eds), *The Antitrust Revolution* (Oxford University Press, 6th edn, 2014) 534; Gautam Gowrisankaran, Aviv Nevo and Robert Town, 'Mergers When Prices Are Negotiated: Evidence from the Hospital Industry' (2015) 105 *AM Econ Rev* 172; Gregory S Crawford and others, 'The Welfare Effects of Vertical Integration in Multichannel Television Markets' (2018) 86 *Econometrica* 891.

6 US Dep't of Justice and Fed Trade Comm'n, *Horizontal Merger Guidelines* (2010) (hereinafter *US Horizontal Merger Guidelines*) at § 62, <<https://www.ftc.gov/sites/default/files/attachments/merger-review/100819hmg.pdf>> accessed 31 October 2018.

7 See, eg *ProMedica Health Sys, Inc v FTC*, 749 F.3d 559, 562, 570 (6th Cir 2014); *St Alphonsus Med Ctr-Nampa Inc v St Luke's Health Sys Ltd*, 778 F.3d 775 (9th Cir 2015); *In re Comcast Corp*, 26 FCC Rcd 4238, 4258-58, 4294-96, 4382-4404 (2011).

8 Proof Brief Of Appellant United States Of America Public Copy—Sealed Material Deleted *United States v AT&T, Inc*, No. 18-5214 (DC Cir. 2018) (6 August 2018) (hereinafter, *DOJ Appeal Brief*) at 23 (quoting Tr 2153:23-25).

Behaviour of vertically integrated firms

As stated by the DOJ in its appeal brief,⁹ and the Amici cited earlier,¹⁰ Judge Leon did not reject Nash bargaining theory outright, but he strongly criticized the premise that Time Warner executives would work to maximize the ‘joint profits’ of the vertically integrated company, as if this were just an ‘economists’ assumption’ made for convenience, rather than a good description of the real world.¹¹ But, it is economically rational for the Time Warner negotiators to take into account the interests of DirecTV since they are both part of the same vertically integrated firm.¹² This is also a fundamental assumption in US antitrust law: that firms are rational and rational integrated firms will maximize the ‘joint profits’ of all of its divisions, as explained in the Supreme Court’s *Copperweld* decision.¹³

Allowing firms to escape antitrust liability on the grounds that their divisions would maximize their individual divisional profits is not just incorrect; it also would represent a dramatic and dangerous policy shift. Firstly, it would apply to horizontal mergers as well as vertical mergers. Coca Cola and Pepsi could defend their merger by saying that the corporation would instruct each of them to focus solely on their divisional profits, not corporate profits. Secondly, the instruction could be changed by after the merger is consummated. Nor could a court enforce the instruction, in that divisional executives could choose to maximize corporate profits without being explicit, and it would be very difficult for a court to determine that their bonuses were affected accordingly.

Judge Leon also erroneously assumed that if AT&T instructed Time Warner to maximize joint profits, Turner would sacrifice its divisional profits in order to increase the total profits of the corporation (by raising the profits of AT&T’s downstream distribution division). Such divisional profit-sacrifice would occur from total foreclosure (which is not what the DOJ alleged). But it does not apply to the foreclosure *threats* in bargaining theory, which was the central DOJ allegation. The opposite would occur. By threatening a blackout on the grounds that the corporate profits would rise because of the benefits downstream, Time Warner will be able to negotiate a higher price, and actually achieve *higher profits* for its own division. Time Warner could demand a higher price and the rival distributors would recognize the beneficial impact of a blackout to DirecTV and thus concede the need to pay more. In other words, the Nash bargaining model implies that Turner’s divisional profits would *increase*, not be sacrificed.¹⁴

9 *ibid.*

10 Above (n 1).

11 *Op.* (n 1) at 114.

12 Moreover, as explained by Professor Shapiro, the assumption of joint profit-maximization is also a premise of the elimination of double marginalization (EDM) efficiency theory. Tr 2251:7-11. As discussed below, Judge Leon embraced the EDM theory without reservation while rejecting joint profit-maximization for the bargaining leverage theory. *Op.* (n 1) at 67.

13 *Copperweld Corp v Independence Tube Corp*, 467 US 752 (1984).

14 This point also was made by the DOJ Appeal Brief, (n 8); 27 *Scholars Brief*; AAI Brief.

Actual versus threatened blackouts

Judge Leon understood that blackout threats are made in the context of programmer/distributor negotiations, referring to them as part of a 'Kabuki dance'.¹⁵ He also noted that they often try to determine the costs of a blackout.¹⁶ However, he nonetheless was sceptical of the bargaining leverage model because leverage is calculated on the assumption that failure to reach agreement would lead to a *permanent* blackout of the content being negotiated. This conclusion also involves an erroneous analysis of bargaining theory. The fact that permanent blackouts rarely if ever occur is not inconsistent with leverage theory. The leverage theory is premised on blackout *threats*, not actual blackouts.

This is straightforward to understand. In negotiation markets, the outcome depends on the parties' relative losses from a failure to reach a negotiated agreement.¹⁷ The greater one party's relative losses, *ceteris paribus*, the greater will be the other party's bargaining leverage, and the higher price the other party can achieve in the negotiation. If a merger changes the relative losses from failure to reach agreement, that change will alter the equilibrium negotiated price.

Horizontal mergers significantly increase the merged firm's bargaining leverage over a buyer if there is a significant probability that the buyer would purchase instead from the acquired firm if it does not agree with acquiring firm, and vice versa.¹⁸ This reduces the merging firm's potential losses from failing to reach an agreement and will lead to a higher negotiated price. This same analysis applies to vertical mergers. Vertical mergers can increase bargaining leverage by reducing the losses to the merged firm from failing to reach agreement with a buyer.¹⁹ This is because the downstream merging firm can recapture some of the customers lost by the buyer.

These dynamics do not mean that blackouts would be common. To the contrary, economic analysis assumes that the parties normally would succeed in reaching an agreement.²⁰ Failing to reach agreement would inflict losses on both parties and thus would be inefficient. In fact, even if failure to agree would benefit the seller in a vertical merger, so that total foreclosure would be strictly profitable, it generally would be even more profitable to negotiate a higher price to compensate for those higher profits rather than forgo an efficient agreement.

Even though failure to agree is inefficient when an agreement is collectively profitable for the two sides, negotiators commonly make threats not to agree unless their demands are met. For example, both unions and management make strike threats,

15 Op. (n 1) at 17.

16 *ibid.*

17 Fisher and Ury refer to these losses relative to the parties' Best Alternative to a Negotiated Agreement (BATNAs). Roger Fisher and William Ury, *Getting to Yes: How to Negotiate Agreement Without Giving In* (Random House Business Books, 1981). The economics literature often refers instead to the 'disagreement point' or 'threat point'.

18 *US Horizontal Merger Guidelines*, (n 6) at s 6.2.

19 See, eg Salop and Culley (n 3) at 22. Instead of characterizing the change as reducing the losses of merged firm, Professor Shapiro and the *Rogerson Amicus Brief* instead refer to the merger raising the opportunity cost of reaching agreement.

20 See, eg Avinash Dixit and Barry Nalebuff, *Thinking Strategically: The Competitive Edge in Business, Politics, and Everyday Life* (W. W. Norton & Company, 1991) 286–99.

and strikes sometimes occur. These may occur as a result of imperfect information, which leads to miscalculation of BATNAs or from one or both sides trying to create a reputation for hard negotiating. Strikes do not result from a one-time breakdown in negotiation and are not permanent. They instead take place one period at a time until one side capitulates. Stated differently, while the threat of a permanent or long-term blackout may lack credibility, threats to delay the agreement for one more period are credible.²¹

Judge Leon's evaluation of the evidence and potential confirmation bias

Judge Leon rejected the DOJ's claims on the basis of the economic errors discussed above. As suggested by the DOJ in its brief, these economic errors then may have 'colored' the way in which he interpreted the other evidence.²² Put somewhat differently, these errors, or presumptions that he brought to or formed early in the case, may have led him unknowingly to commit what psychologists and behavioural economists call 'confirmation bias' in analysing certain evidence.²³

Rational decision makers begin with rational initial presumptions and then rationally update the presumptions by combining them with case-specific evidence according to Bayes Law.²⁴ Confirmation bias is different. It involves (unconsciously) interpreting evidence as supporting one's prior views, which amounts to dysfunctional Bayesian inference.²⁵ In a classic experiment, subjects reported their views on the deterrence effects of capital punishment.²⁶ The subjects then read a fictitious empirical study (written by the experimenter) that purported to provide certain evidence on the deterrence efficacy of capital punishment. The subjects who initially supported capital punishment reported that the study reinforced their view, and vice versa. Participants also said that the evidence in the study supporting their view was stronger than contrary evidence in the study. This is not to say that the participants were being dishonest. Confirmation bias is not a necessarily a conscious act.

Judge Posner discusses confirmation bias in his article on the law of evidence.²⁷ There also is no reason to think that judges are immune from confirmation bias. In his 2016 Op-ed article on the Supreme Court, Judge Posner makes a provocative

21 *ibid* at 294. See also Thomas Schelling, *The Strategy of Conflict* (Harvard University Press, 1960) 41–46. For an application to Pay-TV, see Steven C Salop and others, ('Economic Analysis of Broadcasters' Brinkmanship and Bargaining Advantages in Retransmission Consent Negotiations' (June 2010) (report submitted to the FCC on behalf of Time Warner Cable), <<https://ecfsapi.fcc.gov/file/020499521.pdf>> accessed 31 October 2018.

22 *DOJ Appeal Brief* (n 8) at 26.

23 Professor Shapiro, quantified the merger impact on the bargaining equilibrium and formulated a simulation model to estimate the harm to consumers. These inputs were criticized by Professor Dennis Carlton, AT&T's main expert economist. Professor Carlton also did an econometric study of natural experiments from previous Pay-TV vertical integration. Judge Carlton sided with Professor Carlton on all these issues. This short article will not discuss the various economic controversies.

24 See, eg Steven C Salop, 'The Evolution and Vitality of Merger Presumptions: A Decision-Theoretic Approach' (2015) 80 *Antitrust LJ* 269, 288–96.

25 For one survey, see Raymond S Nickerson, 'Confirmation Bias: A Ubiquitous Phenomenon in Many Guises' (1998) 2 *Rev General Psychol* 175.

26 Charles G Lord, Lee Ross and Mark Lepper, 'Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence' (1979) 37 *J Personality & Social Psychol* 2098.

27 Richard A Posner, '*An Economic Approach to the Law of Evidence*' (1999) 51 *Stan L Rev* 1477, 1495.

point about the possibly weak impact of evidence on judges' presumptions (what Bayesians call 'priors'). Posner concludes that '[t]he tools I am calling priors can in principle and sometimes in practice be overridden by evidence. But often they are impervious to evidence, being deeply embedded in what we are, and that is plainly true of judging'.²⁸

In fact, Posner himself once may have committed a confirmation bias in his treatment of competitor complaints in his opinion reviewing the FTC's decision in the *Hospital Corporation of America* (HCA) merger, Posner said that:

Hospital Corporation's most telling point is that the impetus for the Commission's complaint came from a competitor. . . . The hospital that complained to the Commission must have thought that the acquisitions would lead to lower rather than higher prices—which would benefit consumers, and hence, under contemporary principles of antitrust law, would support the view that the acquisitions were lawful.²⁹

This statement ignores the possibility that the complaining competitor may have been concerned with possible exclusionary conduct, not lower costs. In fact, Judge Posner earlier in the opinion flagged the very fact that colluding large hospitals could use the 'certificate of need' regulations to 'enable them to delay any competitive sally by a non-colluding competitor'.³⁰ Yet, he ignored that contrary evidence in saying that the competitor's complaint was the merging firm's 'most telling point'. This failing to credit evidence is consistent with confirmation bias.

Confirmation bias is associated with an individual having a strong presumption that he wants to protect from contrary evidence. In the case of Judge Leon, the economic errors discussed above could have generated that strong presumption.³¹

But Judge Leon also could have brought a strong initial presumption to the case. He provides one small clue to the latter interpretation. In a footnote setting out the legal standard, Judge Leon foregoes the defendants' invitation that he adopt a per se legality standard or else a procompetitive presumption.³² But the end of the footnote suggests that he might hold such a presumption. Citing current and former DC Circuit Judges Bork, Kavanaugh, and Douglas Ginsburg, he says that '[t]empting though it may be to agree with my appellate brethren, I need not, and will not, go that far to resolve this case'.³³ The fact that he might hold that personal presumption, but was not permitted by the law to take it into account in his judicial decision-making, could have led to confirmation bias. At the same time, while saying that he had no need to analyse efficiencies, Judge Leon also repeatedly mentioned the

28 Richard A Posner, 'The Supreme Court is a political court. Republicans' actions are proof' *Washington Post* (Washington, D.C., 9 March 2016).

29 *Hospital Corp of Am v Fed Trade Comm'n*, 807 F.2d 1381, 1391-92 (7th Cir 1986). In this hospital market, there were regulations designed to prevent excess capacity, and entrants and potential expanders were required to show that there was a 'need' for additional capacity in the market.

30 Salop (n 2) at 1387.

31 However, confirmation bias does not require irrational presumptions.

32 Op. (n 1) at 59 (n 20).

33 *ibid.*

efficiencies and expressed confidence (based on testimony from AT&T) that it would obtain considerable efficiencies.³⁴

To illustrate the way that confirmation bias might operate, this section examines Judge Leon's evidentiary rulings through this lens of unknowing confirmation bias. This analysis is intended to be more illustrative than a rigorous evaluation. Such evaluation would require a full analysis of his evidentiary rulings, including those still under seal.

Firstly, Judge Leon was highly sceptical of testimony by the rival distributors who supported the leverage theory. As downstream competitors of DirecTV, he believed that there was a 'threat that such testimony reflects self-interest rather than genuine concerns about harm to competition'.³⁵ But, competitors' testimony clearly is worthy of more credibility when the competitors are also customers, since their concerns are more likely to be harmonized with the impact on consumers.³⁶

Secondly, Judge Leon went even further by attaching no significant weight to concerns about bargaining leverage expressed to the Federal Communications Commission by DirecTV itself when Comcast acquired of NBC Universal.³⁷ His scepticism even included the bargaining leverage economics submission of its economic expert in that matter, Professor Kevin Murphy, who applied the bargaining model to that merger in the same manner as did Professor Shapiro in this matter.³⁸ One would have thought that this admission by the defendants would be highly probative, so this decision is very striking. At the same time, Judge Leon apparently did not apply this same degree of scepticism towards the testimony of the executives of the merging firms, though their testimony might similarly reflect self-interest in achieving market power rather than consumer welfare. Judge Leon's summary response to the DOJ's argument that the testimony of Time Warner executives similarly should be discounted was to exclaim 'Poppycock!'³⁹ This inconsistency in his approach to witness credibility could involve confirmation bias.

Thirdly, as discussed above, Judge Leon concluded that the divisions of the merged firm would not take actions to maximize the joint profits of the vertically integrated firm, concluding instead that each division would pay attention only to the profits of its own division. At the same time, he embraced the conclusion that the merger would lead to substantial benefits from the elimination of double marginalization (EDM).⁴⁰ Of course, EDM is premised on at least one of the divisions maximizing joint profits, not purely division profits, which is inconsistent with his earlier contrary determination.⁴¹ This inconsistency could have flowed simply from a lack

34 *ibid* at 54 (n 17).

35 *Op.* (n 1) at 92.

36 *US Horizontal Merger Guidelines* (n 6) at s 2.2.3.

37 *Op.* (n 1) at 81–82.

38 Kevin M Murphy, 'Economic Analysis of the Impact of the Proposed Comcast/NBCU Transaction on the Cost to MVPDs of Obtaining Access to NBCU Programming' (21 June 2010) (report submitted on behalf of DIRECTV).

39 *Op.* (n 1) at 108. He went on to explain that the testimony involved their experience in the industry, not their predictions about the future. *ibid.*

40 *Op.* (n 1) at 67.

41 *DOJ Appeal Brief* (n 8) at 57.

of understanding. But confirmation bias might be an explanation in that Professor Shapiro explicitly made the consistency point in his rebuttal testimony.

Fourthly, in his Amicus brief, Professor Rogerson pointed out another inconsistency.⁴² Judge Leon accepted the defendants' testimony that advertising revenues had been falling from increased competition from digital advertising, and that the reduction in advertising revenues caused negotiated license fees to rise. Judge Leon calling this a 'predictable result'.⁴³ This result is predictable in the context of the Nash bargaining model because the reduction in advertising revenues in programming is like an increase in costs. But, the inconsistency is that the gains to AT&T's downstream division from failure to reach agreement is a similar 'cost' (namely, an opportunity cost of licensing rivals) that has effects on bargaining leverage. The court rejected this latter impact on prices, despite accepting the former one, even though both involved the same economic logic. Again, this subtle inconsistency could be the result of lack of understanding. But, the error, or the lack of understanding itself, could be the result of confirmation bias.

Finally, Judge Leon concluded that, even putting aside any efficiency benefits, there was zero competitive harm. This is surprising in that there was no such testimony in the record, as the DOJ stated in its appeal brief.⁴⁴

One should, of course, treat this analysis of potential confirmation bias as suggestive rather than definitive. These are only anecdotal evidence. Judge Leon's inconsistent and erroneous conclusions instead could simply be the result of a lack of understanding of the underlying economics. They also could be the result of a judge attempting to write a strong decision after having drawn a strong conclusion based on unbiased analysis of the evidence. Finally, as stressed earlier, if he exhibited confirmation bias, it would have been unconscious.

III. THE DOJ'S ANALYSIS OF ELIMINATION OF DOUBLE MARGINALIZATION

This section sets out some criticism of the DOJ's approach to EDM. According to Judge Leon, Professor Shapiro calculated \$350 million in annual EDM cost savings to AT&T resulting from DirecTV being able to acquire the Turner networks at cost rather than at the higher affiliate fee.⁴⁵ These cost savings were about half of his estimate of the rivals' cost increases. In making his calculation, Professor Shapiro properly took into account the 'opportunity costs' of reducing prices.⁴⁶

Neither the opinion nor the *DOJ Appeal Brief* indicates that the DOJ's experts on the efficiency claims analysed whether or not these EDM efficiencies were *merger-*

42 *Rogerson Brief*.

43 *Op.* (n 1) at 27.

44 *DOJ Appeal Brief* (n 8) at 63–64.

45 Judge Leon overstated the consumer welfare benefits of this efficiency benefit because he assumed that they would be fully passed on to DirecTV customers. *Op.* (n 1) at 149. That assumption is erroneous for two reasons. Firstly, only a fraction of marginal cost reductions is normally passed on to consumers. Secondly, the fact that rival distributors would have higher costs resulting from AT&T's increased bargaining leverage would tend to reduce the pass-through of the EDM by even more.

46 Expert Report of Carl Shapiro (2 February 2018) at 63; See also Salop (n 2) at 1970–71.

specific, though AT&T's other efficiency claims were subjected to this standard. Failing to subject EDM to the merger-specificity test is the approach in the US Merger Guidelines⁴⁷ and US merger law.⁴⁸ Both credit only merger-specific efficiencies. This approach makes sense for mergers that otherwise would lead to a reasonable probability higher prices.

Horizontal merger law and policy also place the burden of production for showing that efficiencies are merger-specific on the merging parties, not the plaintiff. This requirement also makes economic sense for vertical mergers. As emphasized by Ronald Coase, vertical contracts can be a good substitute for vertical integration, absent significant transactions costs.⁴⁹ While the issue apparently was not analysed, it would appear that EDM benefits could have been achieved absent the merger by a vertical contract. An EDM contract might have involved 'non-linear' pricing (eg a two-part tariff) or a contract with a quantity-forcing (take-or-pay) contractual term.⁵⁰

If this burden were placed on the defendants, they would have had to explain with evidence why the EDM contract would have been infeasible as a practical matter. They might have argued that an EDM contract was impractical because Time Warner contracts with other distributors contained most-favoured nations (MFN) provisions. But, MFNs typically provide that a distributor obtains prices and terms at least as good as smaller firms. Because AT&T is the largest distributor, MFNs are not likely to constrain a contract with AT&T.⁵¹ If the impediment to non-linear pricing were that the high fees softened competition upstream, that also would suggest that AT&T would not pass on the cost savings because that lower price would induce upstream (as well as downstream) rivals also to reduce their prices. Simply saying that there were 'bargaining frictions' would not be sufficient. Nor would it be logical in that the parties were able to negotiate an \$85 billion merger.

IV. CONCLUSIONS

The DOJ has appealed to the DC Circuit court and the case in principle could eventually reach the Supreme Court. So, at this point, it is still too soon to tell how much weight Judge Leon's opinion will carry into the future. In the meantime, this opinion may finally spur the FTC and DOJ to revise the 1984 Vertical Merger Guidelines, which are hopelessly out of date.⁵² Another significant error was made by the DOJ

47 *US Horizontal Merger Guidelines* (n 6) at s 10.

48 *United States v Phila Nat'l Bank*, 374 US 321, 370 (1963).

49 Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386.

50 For example, if DirecTV's efficient output equaled Q^* subscribers, the contract could mandate an affiliate fee F that exceeds marginal cost, but requires the per subscriber payment on the maximum of the actual number of subscribers or some minimum take-or-pay quantity $Q > Q^*$. In this case, DirecTV's marginal programming cost would be zero at its efficient output Q^* .

51 If MFNs were alleged to constrain such discounting, that also might imply that they are anticompetitive. It might be delicate for the defendants to argue that they could not solve EDM absent the merger because Time Warner was a party to contracts with anticompetitive MFNs. See, eg Erik Hovenkamp and Neel Sukhatme, 'Vertical Mergers and the MFN Thicket in Television' *CPI Antitrust Chronicle* 2018 (forthcoming), <<https://www.competitionpolicyinternational.com/wp-content/uploads/2018/08/CPI-Hovenkamp-Sukhatme.pdf>>.

52 For my suggestions for revised Guidelines, see Salop (n 2); Salop and Culley (n 3).

in the previous administration by failing to revise those Guidelines. Had they been revised, Judge Leon's economic errors might have been less likely.
