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## Vertical Mergers and the MFN Thicket in Television

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# VERTICAL MERGERS AND THE MFN THICKET IN TELEVISION

By Erik Hovenkamp & Neel U. Sukhatme<sup>1</sup>

## I. INTRODUCTION

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

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

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<sup>2</sup> “MVPD” stands for “multichannel video programming distributor.”

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

<sup>4</sup> Shalini Ramachandran, *Comcast Drops Bid for Fox Assets, Will Focus on Pursuit of Sky*, WALL ST. J. (July 19, 2018), [www.wsj.com/articles/comcast-drops-bid-for-fox-assets-will-pursue-sky-1532004447](http://www.wsj.com/articles/comcast-drops-bid-for-fox-assets-will-pursue-sky-1532004447).

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

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

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

<sup>8</sup> *See, e.g.*, Shalini Ramachandran, *‘Favored Nations’ Fight for Online Digital Rights*, WALL ST. J. (June 14, 2012), <https://on.wsj.com/2uOSSvF>.



OTT competitors.<sup>9</sup>

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

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

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

While vertical mergers in the industry have received widespread attention recently, the

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<sup>9</sup> *Id.*

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

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

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

<sup>13</sup> One paper on Comcast’s (since-abandoned) bid to acquire TWC discusses unconditional MFNs in a footnote. See William P. Rogerson, *Economic Theories of Harm Raised by the Proposed Comcast/TWC Transaction*, in THE ANTITRUST REVOLUTION: ECONOMICS, COMPETITION, AND POLICY, at n. 107 (7th Ed., John E. Kwoka, Jr. & Lawrence J. White, eds., 2018).

<sup>14</sup> See Section III, *infra*.

<sup>15</sup> Some OTT distributors offer “skinny bundles” that include fewer networks.

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



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

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

## II. EFFICIENCY CONSIDERATIONS

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

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

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<sup>17</sup> See the next section for discussion of the double marginalization problem.

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

<sup>19</sup> Joseph J. Spengler, *Vertical Integration and Antitrust Policy*, 58 J. POL. ECON. 347 (1950); Michael H. Riordan, *Competitive Effects of Vertical Integration*, in HANDBOOK OF ANTITRUST ECONOMICS 145 (2008).

<sup>20</sup> See, e.g., Michael A. Salinger, *Vertical Mergers and Market Foreclosure*, 103 Q.J. ECON. 345 (1988).

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



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

### III. VERTICAL MERGERS AND EDM IN PAY-TV

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

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

In the absence of production-based efficiencies, EDM would seem to be the most broadly-plausible efficiency in MVPD-programmer mergers.<sup>24</sup> However, it is still important to ask whether it is merger-specific.<sup>25</sup> In fact, there is some evidence that fixed fee licensing of programming is often commercially practicable, at least when it is not frustrated by MFNs. For example, Netflix uses fixed fees for most of its licensing agreements.<sup>26</sup> More generally, even programmers who license mainly to MVPDs often use fixed fees when licensing with on-demand streaming services.<sup>27</sup> Finally, economic intuition suggests that, where transaction costs are

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

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

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

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

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

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



substantially outweighed by transaction *value*, as they are in the cable industry, then the parties are willing to work harder to overcome the demand-uncertainty that is often hypothesized to preclude contract-based EDM.<sup>28</sup>

#### IV. MFNS AND DOUBLE MARGINALIZATION

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

##### A. *The MFN Thicket*

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

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

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

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

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

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

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

<sup>32</sup> Proposed MFN Rulemaking, *supra* note 12, at 11.



corresponding re-tiering obligation.<sup>33</sup>

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

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

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

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

#### B. *MFNs and Double Marginalization*

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

Suppose a programmer would like to charge each MVPD a two-part tariff. Such a tariff is characterized by a pair  $(p, F)$ , where  $p$  is a variable (per-unit) price and  $F$  is a fixed fee. Thus, an MVPD pays a total amount of  $pQ + F$ , where  $Q$  is MVPD output (the number of subscribers).

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

<sup>34</sup> INSP Comments I, *supra* note 7, at 17.

<sup>35</sup> *Id.* at 18.

<sup>36</sup> See KSE Comments, *supra* note 18, at 3.



Assume for simplicity that a programmer wishes to license to two MVPDs, *A* and *B*, where *B* is larger than *A*. As noted earlier, if the marginal cost of licensing is effectively zero, double marginalization is eliminated by agreeing on pure fixed fee licensing (i.e.,  $p = 0$ ). Then the programmer could enter into two agreements with fixed fees  $F_A^*$  and  $F_B^*$  for MVPDs *A* and *B*, where  $F_A^* < F_B^*$ . And the MVPDs produce some output levels  $Q_A^*$  and  $Q_B^*$ , where  $Q_A^* < Q_B^*$ .

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

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

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

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

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

This analysis applies more generally, as other contractual means of achieving EDM may

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





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

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

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

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

### C. *Relationship to Vertical Merger Concerns*

To the extent that MFNs distort prices upward, this alone may be sufficient to attack them on antitrust grounds. But the double marginalization effects may also bear on considerations of vertical mergers between programmers and MVPDs. If widespread MFNs lead many or most

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

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

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



programmers to rely on variable prices, the cumulative effect may be substantial double marginalization throughout the industry. That, in turn, creates a stronger impetus for vertical integration, as this may provide some relief in the form of EDM. But, if the double marginalization problem is caused by one of the defendant's unconditional MFN commitments, then EDM may not be merger-specific.<sup>41</sup> Instead, it may be the parties' MFN commitments that are preventing them from contracting around a double markup.

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

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

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

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

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



## V. MFNS AND CROSS-LICENSING

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

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

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

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

As this illustrates, MFN obligations held by integrated rivals may essentially require such

<sup>42</sup> Salop, *supra* note 21, at 1977-78.

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

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



rivals to strike agreements that raise serious antitrust concerns. And such concerns are wholly separate from those attending vertical integration itself. Indeed, the relevant restraints are horizontal in the reciprocal dealing agreement.<sup>45</sup> Hence, MFNs might enlarge the broader competitive effects of vertical mergers.

## VI. CONCLUSION

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

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

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

<sup>46</sup> Proposed MFN Rulemaking, *supra* note 12, at 1.