Antitrust Regulatory Review Process and AT&T-Time Warner Case Study

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March 29, 2019

Presenter Background

- Michael Hilfiker is a second-year student in the Nicholas Center
- Worked at NERA Economic Research and KPMG before joining Nicholas Center
- Interned at Cornerstone Research in Summer 2018 and will be returning to Cornerstone after graduation to work in finance, intellectual property, and antitrust practice areas
- Antitrust experience includes:
  - $20 billion hardware company merger review and economic analysis
  - $6 billion retail merger review and economic analysis
  - Large communications transaction merger review and economic analysis
  - $600 million settlement analysis in anticompetitive enforcement against large food distributor

Why does this talk matter?

- Antitrust review is relevant for corporate finance executives in the context of mergers and acquisitions (M&A)
  - If over threshold of $84.4M (assets, securities), then need to file with Department of Justice
- M&A activity is increasing by deal size and number of deals
- Relevant to political discourse and increasing popularization of antitrust
- Antitrust is currently in an evolving landscape and ripe for disruption
  - High tech sector (e.g., Google, Facebook, Amazon) – how to regulate digital economies? FTC Technology Task Force recently created (02/2019)
  - Vertical mergers are in spotlight after AT&T/Time Warner merger

Why does this talk matter? Cont.

Agenda

1. Historical Timeline of Antitrust
2. Trends in M&A and Antitrust Enforcements
3. Key Actors
4. M&A Review and Antitrust Enforcement Process
5. Examples of Agency Enforcements in M&A
6. AT&T-Time Warner Case Study
7. Next-Generation Working Regulatory Frameworks

Section 1:

Historical Timeline of Antitrust

Historical Context of Competition Law Enforcement

Antitrust Law Has Evolved Significantly And Has Further To Go To Face Current Challenges

1890 — Sherman Act

- Enacted to address rising trusts and forbid "restraint of trade"

1911 — Break-up of Standard Oil

- Trust owned by John D. Rockefeller
- Split into 34 companies
- ExxonMobil is a parts of Standard Oil

1914 — Clayton Act

- Effect of any acquisition may not be to substantially lessen competition or tend to create a monopoly

1914 — Federal Trade Commission Act

- Established the FTC

1974 — Hart-Scott-Rodino Act

- Established that companies must file with Agencies before consummating merger
- Determined filing threshold
- Outlined modern Agency actions and timeline

Protect competitors

Protect consumers

1984 — Break-up of Bell Companies

- Bell was broken up into 7 companies due to monopolistic power in telephone market

2001 — Microsoft Trial

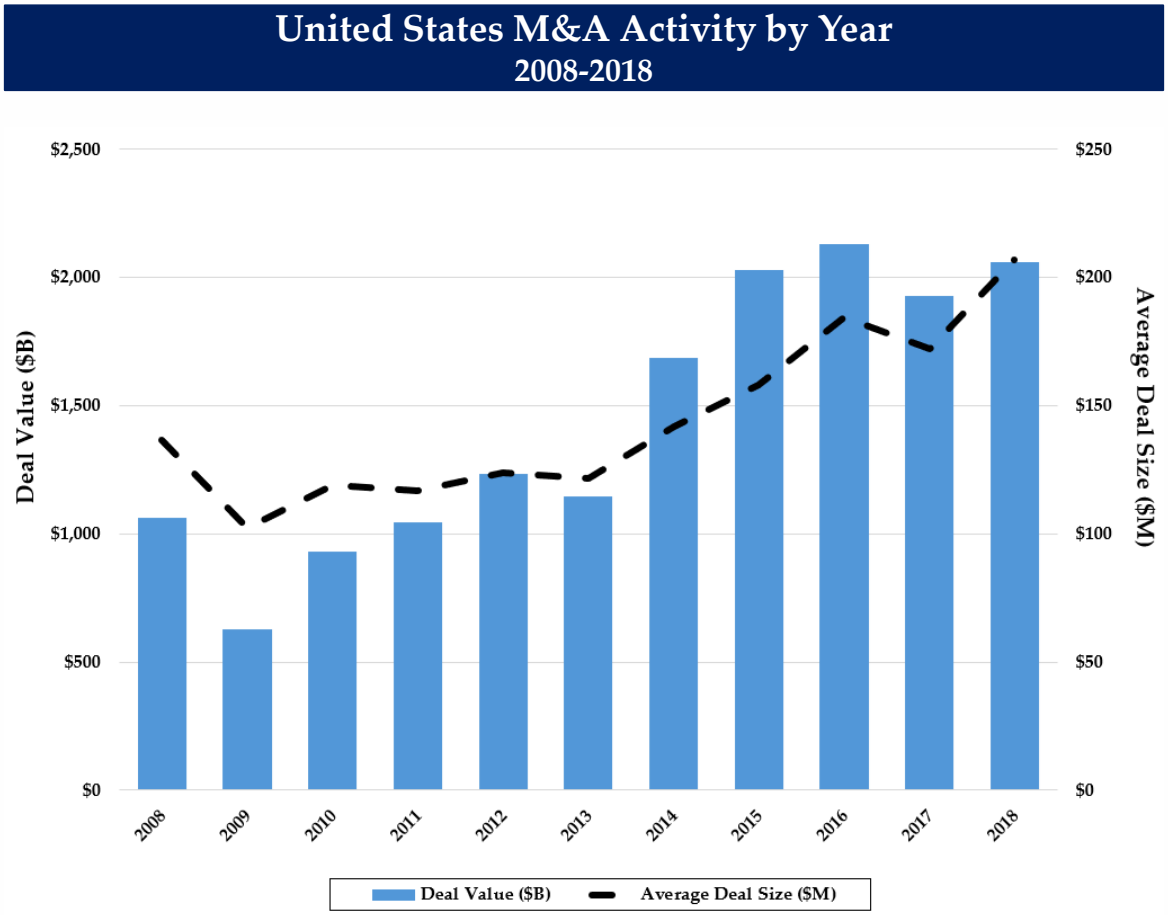
- Settlement reached that Microsoft was required to share its programming interfaces with third parties

Section 2:

Trends in M&A and Antitrust Enforcements

M&A Trends

M&A activity is increasing and deal size is drawing attention to increasing prevalence to larger deals

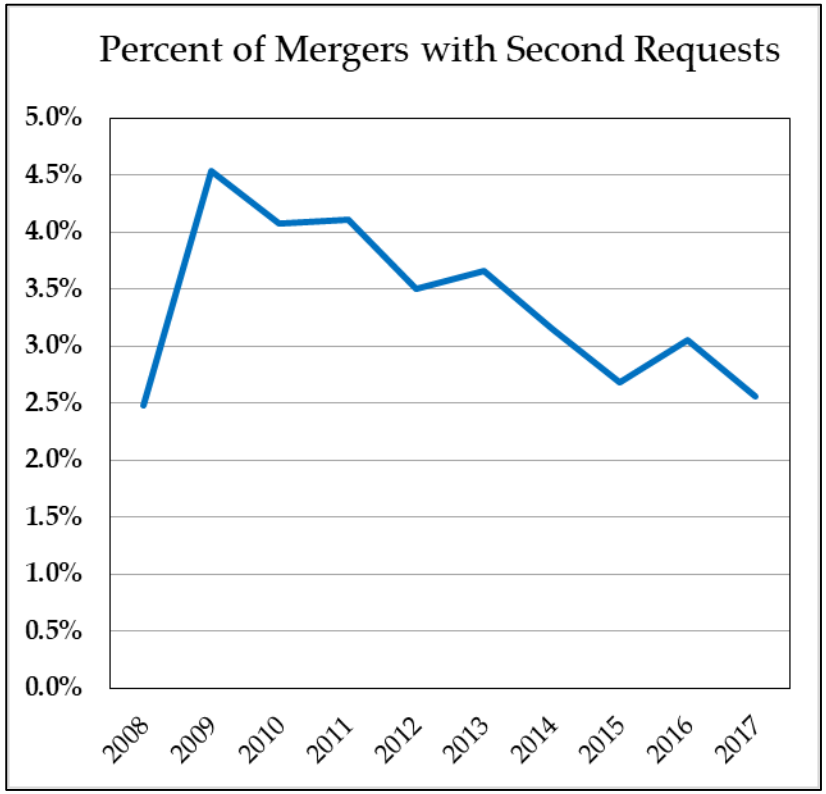


Source: Pitchbook

Antitrust Enforcement Action Trends

Enforcements on Merger Transactions

- Low variance in count over time
- Lower as a percent of total deals over time



Enforcement Focus by Sector

- High sectoral variance

Sector	Average FY2008-FY2017	
Pharmaceuticals	6.5%	Over-scrutinized
Manufacturing	5.7%	
Information Technology	5.1%	
Health Services	2.4%	
Transportation	1.6%	
Real Estate	-0.2%	Under-scrutinized
Agriculture	-0.2%	
Retail Trade	-0.2%	
Construction	-1.0%	
Utilities	-1.1%	
Mining	-1.2%	
Wholesale Trade	-2.3%	
Finance	-3.9%	
Other Services	-6.2%	
Professional Services	-8.3%	

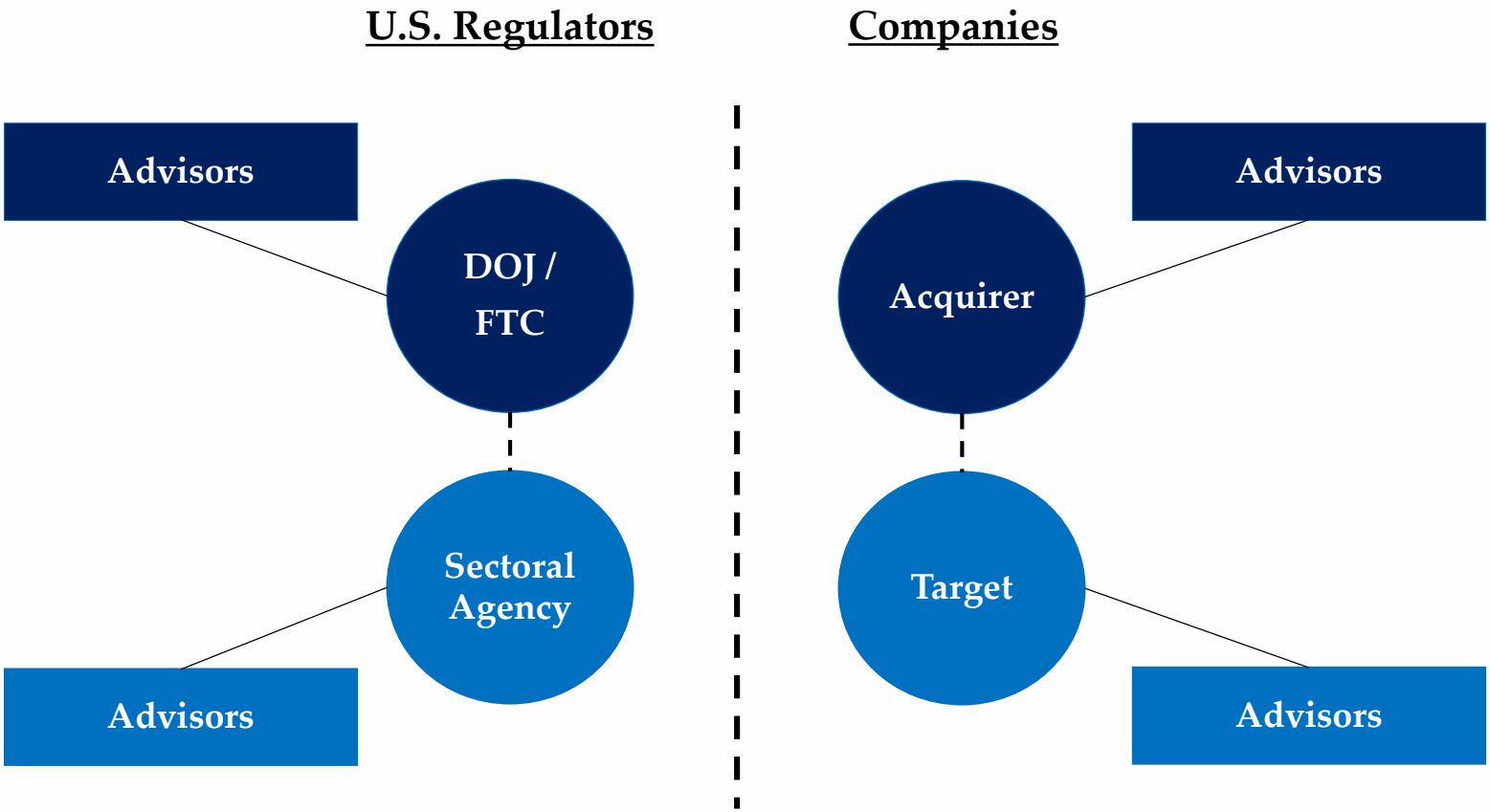
Note: Enforcement Focus is the excess of share of second requests over share of transactions by sector.

Source: Department of Justice; Federal Trade Commission; Cornerstone Research, "Trends in Merger Investigations and Enforcement at the U.S. Antitrust Agencies"

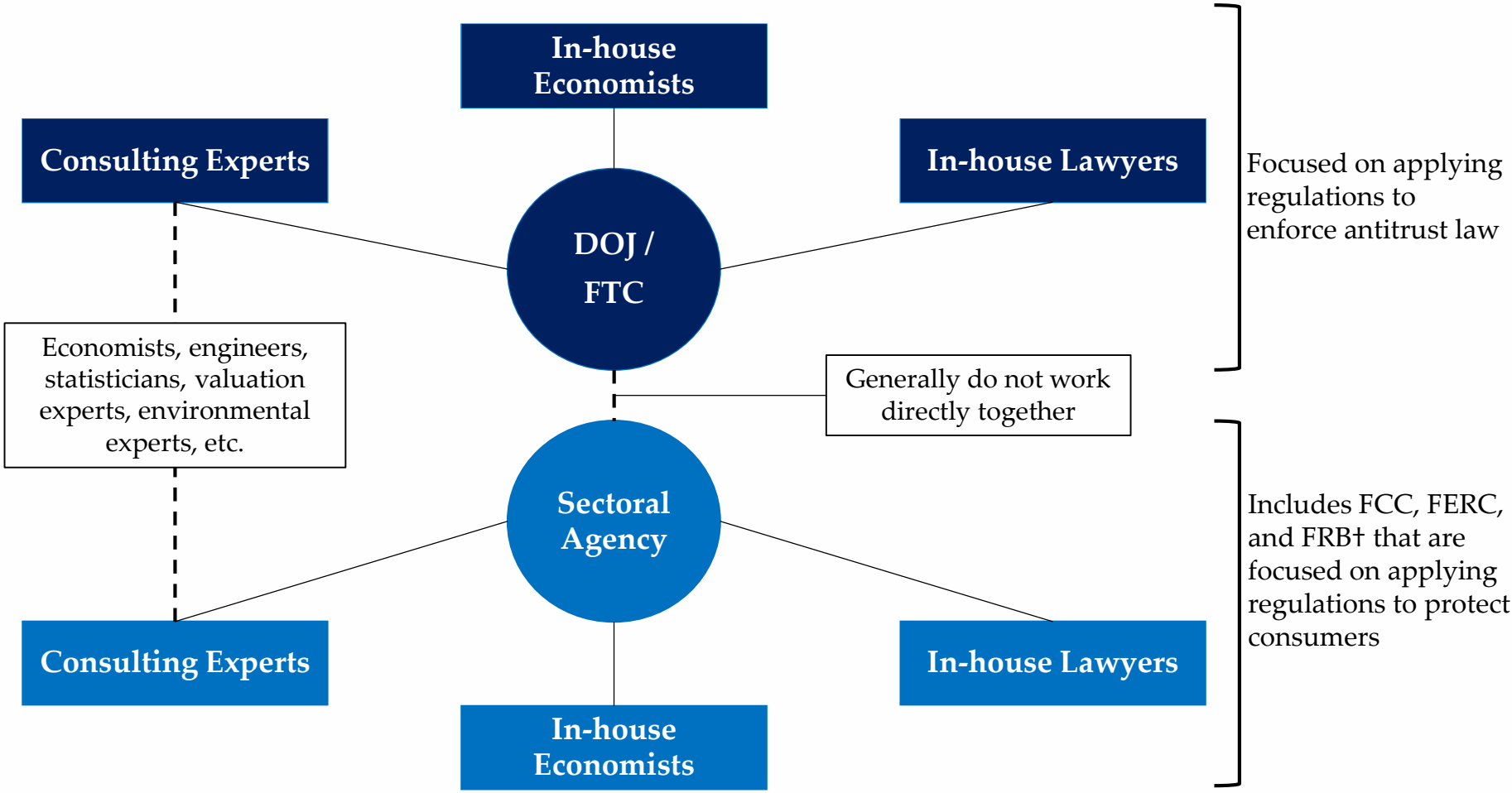
Section 3:

Key Actors

Overview of Key Actors in Antitrust

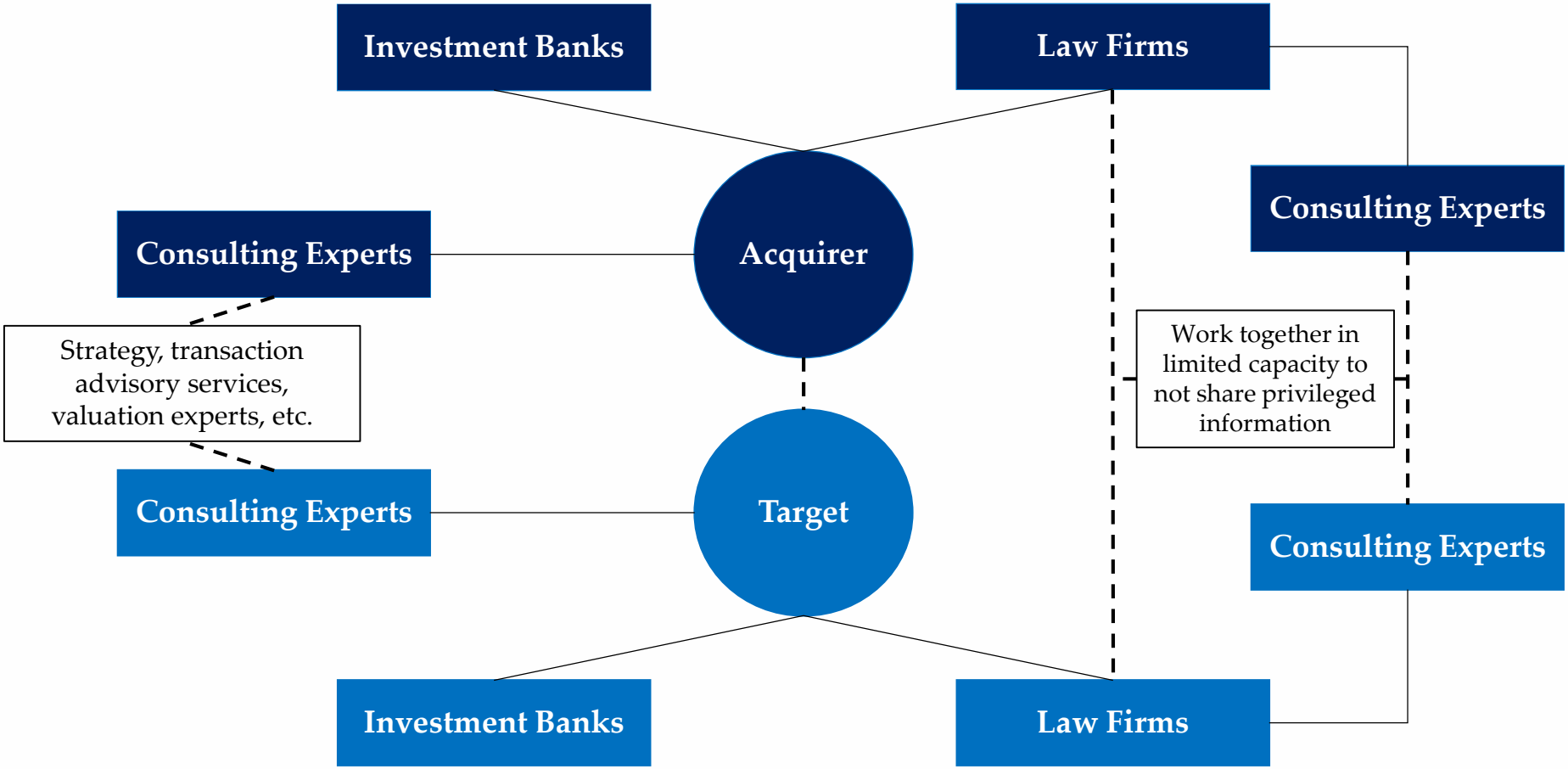


U.S. Regulatory Actors And Their Advisors



† Federal Communications Commission (FCC), Federal Energy Regulatory Commission (FERC), and Federal Reserve Board (FRB)

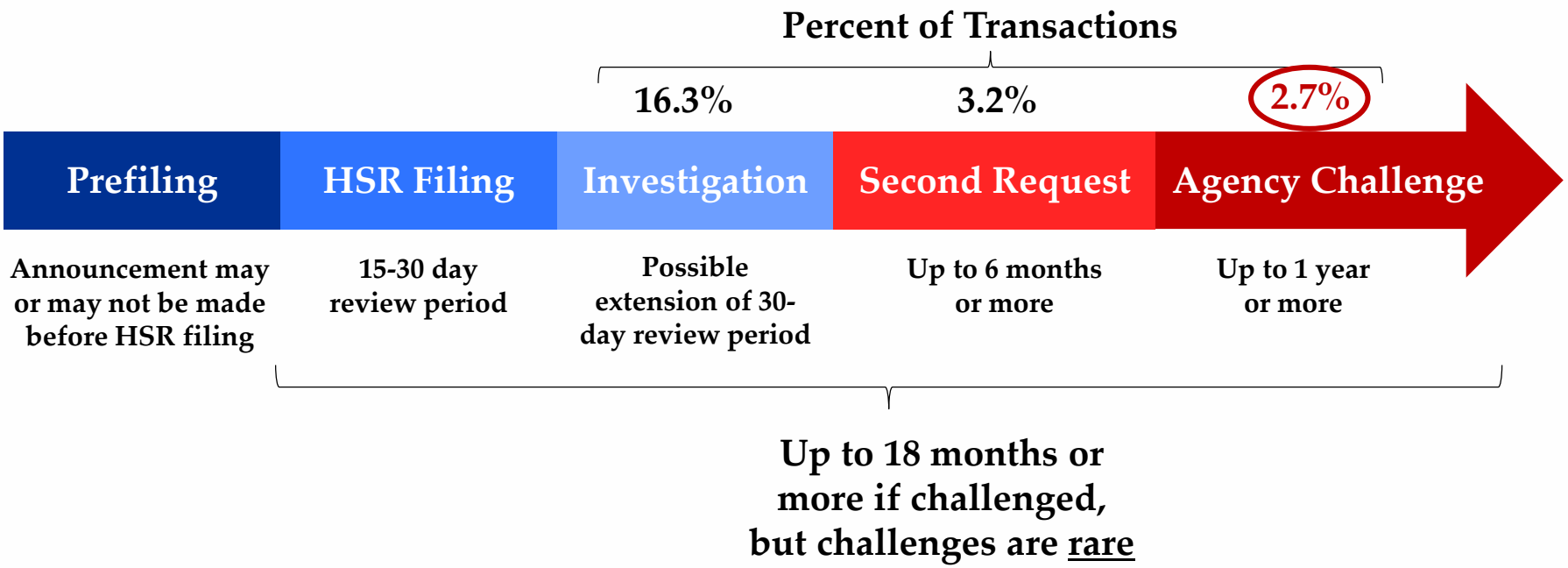
Key Company Actors And Their Advisors



Section 4:

M&A Review and Antitrust Enforcement Process

Overview of Merger Review Process



Deep Dive of Merger Review Process

Announcement may or may not be made before HSR filing	15-30 day review period	Possible extension of 30-day review period	Up to 6 months or more	Up to 1 year or more
Prefiling	**HSR Filing**	**Investigation**	**Second Request**	**Agency Challenge**

• Companies approach and assemble analyses from:
  • Investment banks
  • Transaction advisory
  • Tax experts
  • Others
• Parties are not allowed to "jump the gun"
	• Each company submits HSR filing that includes:
	  • Timing of transaction
	  • Segmented Financial statements and SEC filings
	  • Documents prepared for company officers
	  • Filing fee ($45k-$280k)
		• Occurs during 30-day review period
		• Company executives may be interviewed
		• Economists may be hired in this stage if sophisticated questions are asked by agency economists
			• Can take up to 6 months to produce and fully answer initial requests
			• Very burdensome and expensive
			• Hire experts to produce white papers
			• Assemble data and documents requested by DOJ/FTC:
			  • Detailed supplier and customer information
			  • Internal pricing and strategy analyses related to merger
				• Parties can negotiate **decent decree** (i.e., restructuring or behavioral remedial action) or **go to trial**
				• Companies hire expert economists, engineers, data scientists, accountants, etc. to produce testimony
				  • Cannot be blatant advocacy work – must be grounded in principal or will be thrown out in court
				• Depositions of executives and internal experts take place

The Battleground Depends on the Type of Merger

		Non-horizontal Mergers	
	Horizontal Merger	**Vertical Merger**	**Potential Competition Mergers**
Definition	Consolidation two firms in the same industry or market	Consolidation of two firms in different parts of supply chain	One company buying another that is planning to enter market
Example and Outcome	• Staples/Office Depot (2015) • Merger abandoned	• AT&T/Time Warner (2016) • Unsuccessfully challenged	• Zeneca/Astra (1998) • Restructuring remedy
Actionable Regulatory Battlegrounds	• Define the market • Calculate change in market concentration • Analyze unilateral effects† • Analyze coordinated effects†	• Analyze foreclosure opportunities and incentives • Analyze collusive information exchange • Analyze the elimination of a "maverick"	• Analyze if there is a prevention of increased competition • Analyze if there is an elimination of procompetitive effects

† Unilateral effects are the ability to exercise market power through anticompetitive actions. Coordinated effects are the informal cooperation in the elimination of competition.

Battleground Deep Dive – Horizontal Mergers

Horizontal Merger Guidelines (rev. 2010)

Herfindahl-Hirschman Index (HHI)

- Looked at more in stable markets
- Must first properly **define market** (i.e., product, geography, forward-looking, etc.) – **most debated part of analysis**
- Square and sum each market share – results are between 0 and 10,000
- Agencies classify into three categories:

Market Concentration	HHI Measure	Change Triggering Investigation
Unconcentrated	<1,500	none
Moderately concentrated	1,500<>2,500	>100
Highly concentrated	>2,500	>50

Unilateral Effects

- More powerful merger simulations **using machine learning and complex econometrics with detailed customer-level data**† in large mergers to address actions that firms can take in pro-forma market

Coordinated Effects

- Higher vulnerability of coordinated effects in markets where there is:
  - Price transparency
  - Low friction customers face when switching

† T-Mobile/Sprint economic analysis by Cornerstone Research by Asker, Bresnahan, and Hatzitaskos, "Economic Analysis of the Proposed T-Mobile/Sprint Merger," November 6, 2018, https://ecfsapi.fcc.gov/file/11060648404338/Nov.%206%20Public%20SuppResponse.pdf.

Battleground Deep Dive – Non-horizontal Mergers

Non-horizontal Merger Guidelines (rev. 1984)

Specified in Guidelines

- All mergers analyzed for **horizontal** effects
- Elimination of potential entrants
- Barriers to entry from two-level consolidation
- Vertical integration at the retail level

Other Key Considerations

- Input or customer foreclosure
  - Close access of suppliers or customers to competitors
- Collusive information exchange
  - Retain and misuse access of privileged information on competitors through acquisition

Section 5:

Examples of Agency Enforcements in M&A

AT&T Attempted Acquisition of T-Mobile (2011)

Company Backgrounds

AT&T

- Second largest wireless carrier by subscriber count in US
- By far highest postpaid ARPU of wireless carriers
- Wants to merge to bring faster 4G innovation to market

T-Mobile

- Provider of wireless services
- Fourth largest wireless carrier by subscriber count in US
- Known for serving lower income and minority demographics

Merger Details

- **Horizontal merger**
- Since both companies are telecom, the transaction is reviewed by both DOJ and FCC
- Faced two major enforcement tests (among others):

  1. HHI

  - Debate surrounded market definitions
  - Should wireless carrier markets be defined as nationwide or by cellular defined areas (CDAs)?

  2. Unilateral effects

  - T-Mobile has lower priced plans than AT&T and therefore there could be a disparate impact on customers with new AT&T

Merger Outcome

- **Merger challenged by DOJ and subsequently withdrawn by AT&T**
- DOJ filed a complaint and FCC filed a report outlining similar conclusions that market definitions need not be defined at local areas (i.e., CDAs)
  - Thus, HHI was considered at nationwide level
  - **Increases from 2,651 (already in the Highly Concentrated category) by 741 to 3,356**
- Analysis of unilateral effects demonstrated that AT&T and T-Mobile would have to reduce marginal cost by 11% and 24%, respectively to prevent price increases

Comcast Acquisition of NBC Universal (2011)

Company Backgrounds

Comcast

- Largest cable provider by subscriber count in US
- Largest internet service provider by subscriber count in US
- Deal would give Comcast control of content creation, programming, and distribution

NBC Universal

- Content creator and programmer
- 80% owned by General Electric
- Owns Bravo, CNBC, MSNBC, USA Network, and other networks
- Owns Universal Pictures and Universal Studios
- Founding partner and 32% owner of Hulu

Merger Details

- **Vertical merger**
- Since both companies are telecom, the transaction is reviewed by both DOJ and FCC
- Faced two major enforcement tests (among others):

  1. Input foreclosures

  - Comcast will control a large content creation and programming portfolio – a threat to other distributors

  2. Elimination of entrants

  - Comcast is partaking in this transaction to reduce is loss to cord cutters and will reduce competition of online video distributors

Merger Outcome

- **Merger approved by DOJ**
- FCC filed memorandum foregoing a challenge of the merger but with **behavioral and structural remedies attached**
- DOJ filed a complaint after investigation that supported FCC's conclusions
- Noted in the support of Agencies was the importance to keep the market of online video distributors (e.g., Hulu, Netflix) competitive

Section 6:

AT&T-Time Warner Case Study

Taking a Step Back – Entertainment Value Chain

Content Providers

Create movies and television shows that are purchased by programmers and distributors

Traditional

- **Time Warner**
- 21st Century Fox
- Sony
- Walt Disney
- NBC Universal
- Viacom

Non-traditional

- Netflix Studios
- Amazon Studios

Programmers

Aggregate content into a "feed" that includes movies, television shows, and **advertisements**

Broadcast Networks

- ABC
- NBC
- CBS
- FOX

Cable Networks

- **TBS**
- USA Network

Premium Networks

- **HBO**
- Showtime

Distributors

Distribute programmer content to consumers

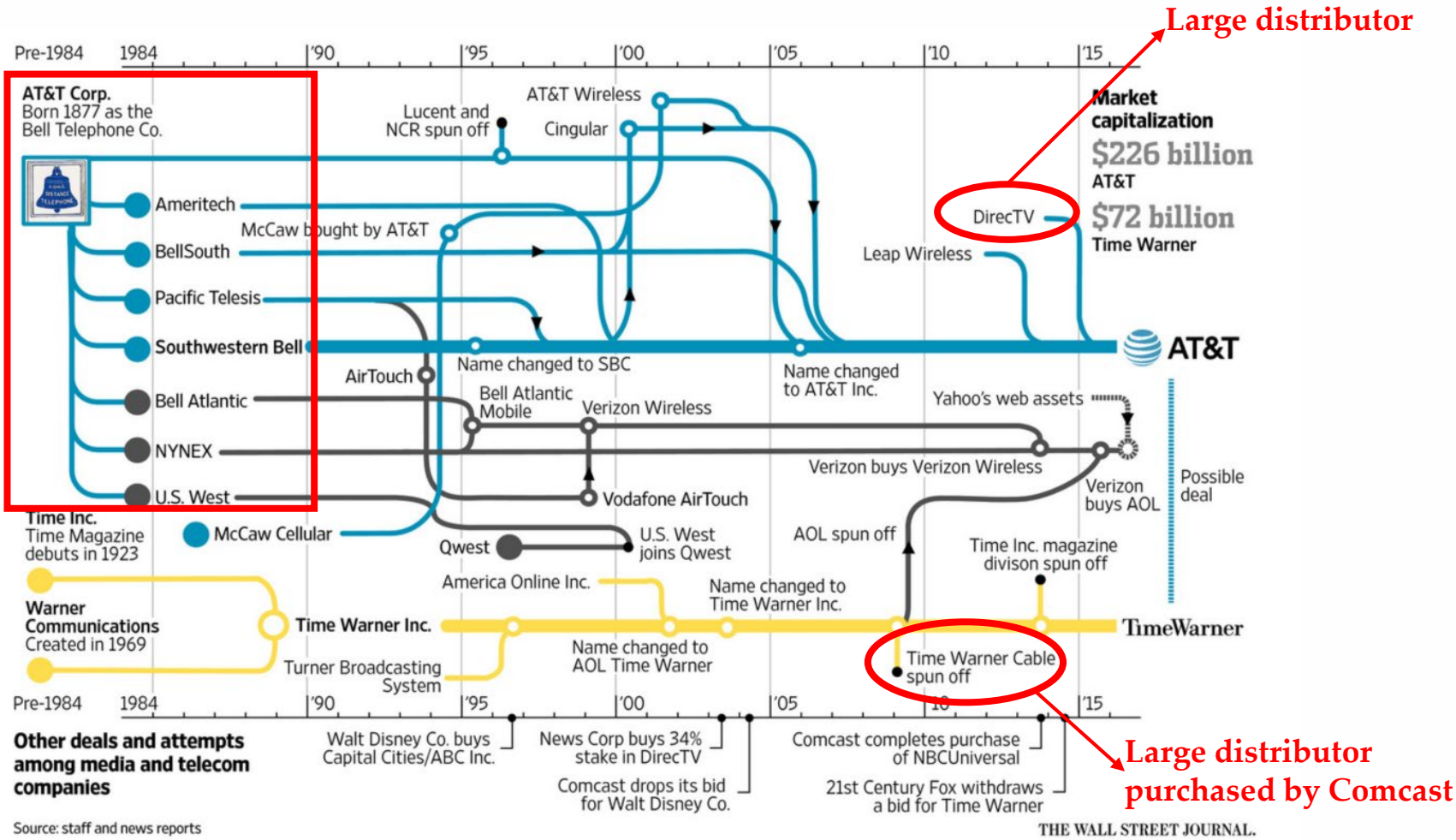
MVPDs

- Cable (Comcast, Charter)
- Satellite (**DirecTV**, DISH)
- Broadband (**AT&T**, Verizon)

Online Distributors (OVDs)

- Netflix
- Amazon Prime
- Hulu
- Sling
- Over-the-top Applications (OTT):
  - **HBO NOW**
  - Showtime

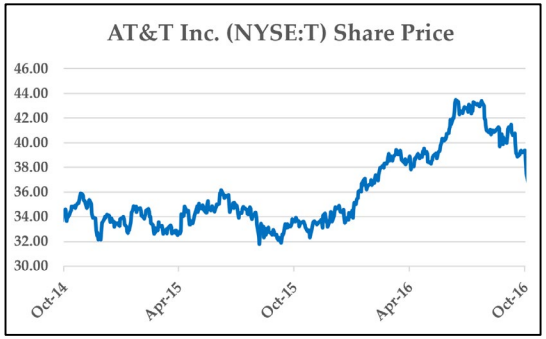
Converging Destinies



AT&T/Time Warner Transaction Overview

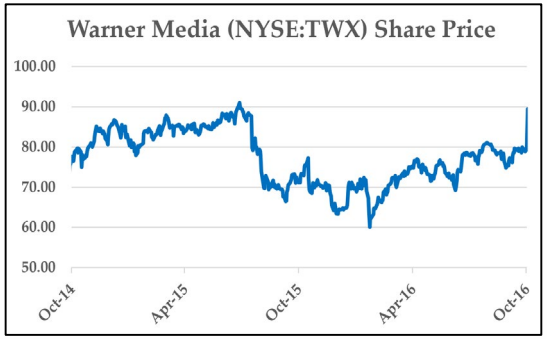
Company Backgrounds

AT&T



- $146.8 billion in revenue in FY2015
  - Business Solutions: 49%
  - Entertainment: 24%
  - Consumer Wireless: 24%
  - International: 3%
- Largest multichannel video programming distributor (MVPD), second largest wireless provider, third largest broadband provider

Time Warner



- $28.1 billion in revenue in FY2015
  - Warner Bros.: 43%
  - TV Networks: 37%
  - HBO: 20%
- Largest film studio, largest premium channel, big-name networks (e.g., CNN, TNT, TBS, Adult Swim)

Merger Details

- **Vertical merger**
- AT&T would be **first** to integrate the entire content value chain:
  - Content creation
  - Programmers (TV networks)
  - Distributors
    - Traditional
    - Virtual
- By combining some of the largest assets of each part of the value chain, AT&T seeks to unlock synergies:
  - Cost synergies
    - Corporate functions
    - Elimination of double-margins
  - Revenue synergies
    - Cross-selling

Transaction Timeline

<10/20/2016	11/4/2016	12/4/2016	12/8/2016	11/20/2017-2/26/2019
Prefiling	**HSR Filing**	**Investigation**	**Second Request**	**Agency Challenge**
• AT&T publicly announced merger with Time Warner	• AT&T and Time Warner submitted their HSR filings to the DOJ	• DOJ followed-up with preliminary investigatory questions as a hold-over to Second Request	• DOJ pursues Second Request • During Second Request gathering, FCC drops from merger review citing that DOJ will review	• **11/20/2017** – DOJ formally announces they are challenging merger • **3/19/2018** – Trial begins in federal courts • **6/12/2018** – Judge Richard Leon rules in favor of merging parties • **7/12/2018** – DOJ files appeal of ruling • **12/5/2018** – Appeal trial begins • **2/26/2019** – Appeal upholds merger decision

Reminder Of The Non-Horizontal Battleground

Vertical Merger Hurdles

Upstream/Downstream Foreclosure

- Consolidating large value chain participants creates anticompetitive incentives to partake in upstream and downstream foreclosure
- Is merger prohibiting access to content downstream?

Elimination of Potential Entrants

- New OVD (e.g., Hulu, Netflix) entrants are moving into same capabilities as MVPDs
- Is merger prohibiting OVDs from entering market?

Precedent Antitrust Approvals

Comcast/NBC Universal (2011)

- Merger approved by DOJ
- Behavioral and structural remedies were required to alleviate foreclosure concerns
- Noted in the support of Agencies was the importance to keep the market of online video distributors (e.g., Hulu, Netflix) competitive
- Ruled by Judge Richard Leon – same judge for AT&T/Time Warner case

AT&T/Time Warner Battlegrounds

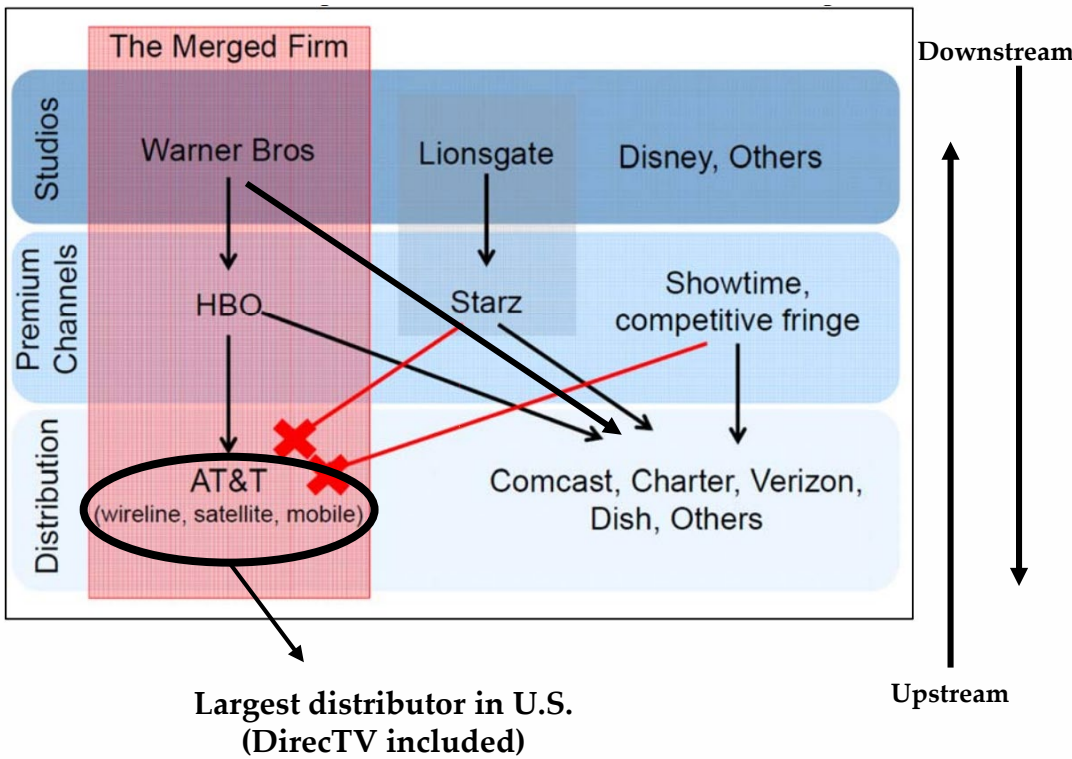
Foreclosure of Upstream Channels

- New AT&T will be able to procure content from the largest content creator and premium channel in market – **why does it need other market players?**
- Closing distribution of other content could be made up with increases in subscribers to current content

Foreclosure of Downstream Channels

- Time Warner will have access to the largest MVPD, second largest wireless provider, third largest broadband provider to distribute content – **dramatically reducing pressure downstream**
- With such access, Time Warner may have an **anticompetitive advantage** compared to other content creators

Effect of Proposed Transaction on Market Relationships†



† Eisenach, Watts, "Effects of the AT&T-Time Warner Transaction on Competition in the Premium Channels Industry," NERA Economic Consulting, July 2017, https://www.washingtonpost.com/blogs/the-switch/files/2017/11/NERA-ATT-TW-Study-Redacted.pdf.

Outcome of Antitrust Review and Litigation

Similar analysis and outcome as Comcast/NBC Universal merger

	DOJ's Arguments	Judge's Ruling

Downstream Foreclosure Battlegrounds	• DOJ economist model showed that Time Warner would gain bargaining power and could increase prices
	• Prices were predicted to increase Time Warner profits by $352 million
		• Negated the DOJ analysis due to of lack of evidence and stated:
		  • Owner of programmer does not affect bargaining process with third party distributors
		  • Profits may not be maximized in New AT&T's own value chain

Elimination of Potential Entrants	• DOJ theory of harm is that AT&T would gain market power that would hurt growth of emerging VMVPDs (e.g., Netflix, Amazon Prime) • AT&T could limit access to Time Warner content to VMVPDs	• Ruled that AT&T would be incentivized to continue relationships with VMVPDs • Ruled out coordination effects between AT&T and Comcast that would harm VMVPDs

Commentary on Vertical Mergers and AT&T/Time Warner

DOJ / FTC

- "Unfortunately, compared to horizontal mergers, **there are also fewer quantitative theoretical models that we can use to attempt to predict outcomes in vertical scenarios**, and the models that exist have a far shorter track record than those used in assessing horizontal mergers"

- "…**firewalls can prevent information sharing, and nondiscrimination clauses can eliminate incentives to disfavor rivals**."

Economist Steven Salop

- "…this opinion may **finally spur the FTC and DOJ to revise the 1984 Vertical Merger Guidelines**, which are hopelessly out of date."

- "Judge Leon …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."

Section 7:

Next-Generation Working Regulatory Frameworks

DOJ / FTC Commentary

- **Technology Task Force**
  - FTC exploring new approaches to competition and consumer protection enforcement on matters involving high-tech markets
  - "…it makes sense for us to closely examine technology markets to ensure consumers benefit from free and fair competition…a crucial step to deepen our understanding of these markets and potential competitive issues."
- **Rethinking vertical mergers**
  - Complex merger simulation capabilities has progressed to show non-horizontal mergers can reduce competition
  - EU updated non-horizontal merger regulations almost 10 years ago
- **Expediting merger review process**
  - DOJ is insisting that merging parties provide detailed information to the government early in the investigation in advance of certifying compliance with Second Requests

Questions?

Thoughts?