OPINION | COMMENTARY

AT&T and the Danger of ‘Vertical Integration’

The old Ma Bell and Time Warner both have histories of using distribution power in anticompetitive ways.

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November 27, 2017

No one should be surprised by the Justice Department’s attempt to block AT&T’s $85 billion bid to acquire Time Warner. Neither economic theory nor recent experience suggests there is anything novel about the antitrust theory underlying the government’s position.

If one company exerts significant control over the means of accessing a particular market, and acquires another company that owns the stuff that goes over or through that distribution system, there is a real danger that independent producers of the same stuff—in this case, what is called “content”—will find life a lot more difficult, to the disadvantage of consumers. Imposing conditions on such a merger or constraints on the behavior of the resulting merged company will likely do little to improve marketplace competition.

Electric utilities use their control over transmission—the wires that bring generated power to market—to make it difficult for independent generators to sell their power. After all, why should a company with its own electricity to sell help a rival generator by moving the competitor’s power to market? Regulators have long struggled to make vertically integrated companies charge only reasonable transmission rates to firms competing with them at other levels of their business. Attempting to control pricing and access terms is a lifelong, tedious and often futile way to preserve competition.

Recall that in 1997 Time Warner tried to protect CNN by refusing to grant Fox News access to its cable system in New York City. New York was crucial to Fox, not only because of the market's size but because many advertising agencies are located in the city. By keeping Fox off its cable system, Time Warner could protect CNN from competition both for viewers and ad revenue. (Fox News and News Corp, which publishes The Wall Street Journal, today share common ownership.)

New York City and state political leaders pleaded with Time Warner to open access to its monopoly franchise system. Only when Fox filed an antitrust action did the cable company relent. The affair proved that Time Warner was right, from the perspective of its own business interests, to use its monopoly at one level of a vertically integrated system to stifle competition at another. Fox was allowed to enter the New York market only because the antitrust laws provided it with a battering ram. Keeping Fox out benefited CNN and disadvantaged consumers, who were left with fewer choices.

Combining AT&T's distribution assets with Time Warner's content would create a merged entity with a strong incentive to stifle competition from new content providers. Whether it would have the legal power to do so is now a question for the courts. The proposed merger comes as the traditional barriers to entry into the content segment of the entertainment industry are breaking down. Alternatives to cable transmission are emerging. Someday those alternatives may make ownership of a cable system by a content provider irrelevant. We'll soon find out if that day has already arrived.

If the Justice Department persuades the judge in this case that the threat to consumer choice is real, it could lead to a deal designed to preserve competition by restricting the merged company's behavior. This wouldn't work and would be a mistake.

When Ma Bell was vertically integrated, it controlled both the wires and the products that could be connected to those wires. Independent manufacturers of communications equipment were in effect prevented from entering the business. The vertically integrated company refused to allow consumers to connect anything not produced by its integrated manufacturer. I once had an AT&T representative demand that I remove a shoulder rest from my office telephone, as it was a "foreign attachment"—meaning any device not manufactured by the AT&T-owned Western Electric.

The Bell system was broken up in 1984, but a consent decree attempting to regulate the behavior of the resulting regional operating companies, the so-called Baby Bells, led to years of judicial control over every aspect of the telecommunications industry. Despite the court's best efforts, it could never do what structural relief eventually accomplished. The consent decree was lifted in 1996, unleashing the creativity of a manufacturing sector no longer smothered by a competitor with sole or preferred access to the message distribution system.

It is just such structural relief that Assistant Attorney General Makan Delrahim, the new head of the Justice Department's antitrust division, says he prefers to a deal requiring regulatory supervision of a merged company for years to come. Such a deal would be especially calamitous for an industry that specializes in the creation of intellectual property and that is undergoing a period of rapid technological change. Judicial supervision would inevitably slow the pace of innovation.

Of course the courts could decide that merging AT&T and Time Warner poses no threat to competition. But if they do, it won't be for lack of historical precedent or because current antitrust theory is too novel to apply.

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Appeared in the November 28, 2017, print edition.