

## VERTICAL INTEGRATION AND THE EVOLUTION OF AUDIOVISUAL SERVICES: ECONOMIC POLICY IMPLICATIONS FOR BRAZIL

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### Abstract

**Purpose** – The purpose of this paper is to describe the salience of economic theories and evidence regarding vertical integration in the multichannel audiovisual industry in Brazil. This is especially important at this time because Brazilian regulators and legislators are wrestling with the appropriate policy approach toward the industry in Brazil in the wake of the merger of AT&T and Time Warner.

**Methodology/approach/design** – The paper develops with several approaches. First, to develop context, the paper provides a high-level introduction to the evolution of the audiovisual industry. Second, the paper turns to a more specific assessment of the economic and legal lessons learned from the discussion and debate regarding the AT&T-Time Warner merger in the United States. This discussion draws on economic and legal theory and evidence, both from the published literature as well as from court proceedings to advance understanding of the issues. These foundational sections, in turn, provide a platform for policy insights. In particular, the paper builds upon earlier research on “results-based regulation” to provide guidance for Brazilian regulatory and legislative measures being considered in Brazil.

**Findings** – The paper concludes that a results-based approach should permit advances in the vertical integration of the audiovisual industry in Brazil. Such an approach necessarily would recognize that the modern evolution towards a more vertically integrated provisioning of audiovisual services is providing numerous consumer benefits while claims of consumer harm have been judged to be speculative. Application of Article 5 of SeAC to the AT&T-TW merger provides no additional consumer protections that are not already part of the merger and would, instead be distinctly anti-consumer.

**Keywords:** Audiovisual Industry. Brazil. Vertical Integration. SeAC. Results-Based Regulation.

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## INTRODUCTION

In October 2016, the merger announcement of AT&T and Time Warner provided an unmistakable signal of a substantial evolution in the market for audiovisual services. In the United States, it also provoked considerable uncertainty about the public policy merits of the emerging industry structure. Now, in 2019 with three additional years of observations and analysis, it is possible to more confidently identify the consequences of the emerging vertical structure in this market. Specifically, in the United States, a robust analysis has produced economic and policy insights that have now allowed the consummation of the AT&T-Time Warner merger. In Brazil, however, limitations on vertical integration between downstream providers of telecommunications services and upstream providers of video content remain a possibility. Consequently, in this Economic Policy Vignette (EPV) I examine the ongoing evolution in the market for audiovisual service to draw economic policy lessons that are applicable to Brazil as it explores the best framework for advancing consumer welfare in this important industry. Of specific importance, these lessons indicate that Brazilian consumers will be well-served by a policy that eschews applying restrictions on vertical integration in the provision of audiovisual service.

The EPV is organized as follows. First, I briefly set the stage by providing a high-level overview of the trajectory of the audiovisual industry. This discussion reveals the emergence of an evolution toward more vertical integration in the provision of audiovisual services both in Brazil and around the world. It also reveals that this vertical integration is having the tangible consequence of improving consumer welfare in a variety of ways. With an understanding of the evolution of the industry in place, the paper next turns to a brief outline of the economic effects of vertical integration in general, and the lessons that can be drawn from the vertical merger of AT&T and Time Warner in particular. Together, the first two sections provide a foundation for a clear-eyed formation of policymaking toward the audiovisual industry in Brazil. In particular, a “results-based” approach toward the industry promises to both complement the positive developments that have been observed in the industry as well as safeguard against any anticompetitive harms that may arise in the future. An important feature of a results-based approach to policy-making that promises improved consumer welfare is the elimination of ex ante regulatory or legislative prohibitions on vertical integration between telecommunications providers and content producers in Brazil.

## THE EVOLUTION OF THE AUDIOVISUAL MARKETPLACE IN BRAZIL

Brazilian consumers have historically accessed multichannel audiovisual services in their homes through subscription to pay-television services. Suppliers have principally included local cable companies or satellite providers. Two features of this industry structure are especially salient: (1) the only companies with direct access to consumers have historically been “retail” distributors; and, (2) the content provided by those distributors has been exclusively determined by those same distributors.

Against this backdrop, the historical separation between upstream content providers and downstream distribution companies has been evolving. As documented in a recent detailed study by management scholar Raul Katz a number of incremental steps in the modern evolution of the audiovisual market have occurred to create the modern industrial structure both in Brazil and around the world.<sup>1</sup> Unquestionably, however, the emergence of the internet and the corollary rise of broadband services have created a disruptive platform for competitively opening the traditional industry structure.

With the emergence of broadband, suppliers of content have identified new pathways for directly reaching customers and satisfying these consumers’ various and myriad demands in Brazil. As identified by Katz, many firms have emerged to competitively vie for the patronage of Brazilian customers.<sup>2</sup> These firms include relatively new business-model innovators such as Netflix and Amazon, as well as traditional content providers, such as Disney, who simply have found a way to more efficiently provide their content to Brazilians. The consequence of this repositioning of firms through vertical integration has heightened competition at the point of consumption.

While the increasingly competitive landscape for providers of audiovisual services in Brazil is eroding traditional distributors’ subscribership and creating significant uncertainty for their future,<sup>3</sup> it is just as surely putting in place a raft of benefits for consumers.

As documented by Katz, these benefits include:

- Expanding the quantity of video content available to Brazilian households

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<sup>1</sup> Raul Katz “Changes in the Global and Brazilian Audiovisual Market: Competitive Dynamics, impact on Consumer Welfare, and Implications for Public Policy and Competition Model,” October 2019.

<sup>2</sup> Id., Table 8, p. 36.

<sup>3</sup> See Katz, id., p. 30 documenting the decline in traditional consumption of pay TV services in Brazil.

- Expanding the quality of video content available to Brazilian households
- Aligning consumer demands for local content with an expanding set of platforms for the delivery of that content
- Improving service quality
- Providing key incentives for investments that will improve the future quality
- Expanding the diversity of content (sport, entertainment, children's programming, etc.)
- Driving prices down
- Enhancing technology to improve viewer experience (e.g., features that make program recommendations)

Collectively, the heightened competition facilitated by the emerging vertically integrated industry structure in the audiovisual industry has created a decidedly positive arc for consumers in Brazil.

### **VERTICAL INTEGRATION: LESSONS FROM THE AT&T -TIME WARNER MERGER**

The announcement in the United States of the AT&T-Time Warner merger in 2016 set in motion a thorough assessment by economists and courts of the likely impacts of the emerging vertical structure in the provision of audiovisual services. This assessment was designed to determine whether the impact of the merger would be pro-competitive or, alternatively, would be likely to substantially lessen competition. Such merger reviews are inherently difficult as they require an accurate forecast of future economic behavior and performance. This necessarily probabilistic assessment is made even more challenging, depending on the type of merger being proposed.

Unlike the more competitively nettlesome case of horizontal mergers between direct competitors, vertical mergers such as the AT&T-Time Warner merger, which do not eliminate competitors, are generally less problematic and necessitate different methods of analysis. In particular, unlike the case of horizontal mergers, simple heuristics of future performance drawn from merger-related changes in market structure are not possible in the case of vertical mergers as such mergers do not immediately alter participants' market shares. Consequently, crafting policy toward vertical mergers is necessarily less

formulaic than for the case of horizontal mergers, and will necessarily center on the more nuanced analysis of the data regarding the economic effects of such mergers.

At the most basic level, two principal economic effects may emerge from vertical mergers. Under specific conditions, such mergers may result in harm to consumers. For instance, in some circumstances, a vertical merger can make it more difficult for competitors of the merging firm to gain access to an important component product or to an important channel of distribution. This problem can occur when the merger creates both the ability and incentive to limit its rivals' access to key inputs or outlets. Alternatively, vertical mergers may create economic efficiencies that will benefit consumers.<sup>4</sup> While numerous specific efficiencies may arise through vertical mergers, two basic efficiencies are most commonly associated with vertical mergers. First, the vertical merger between two firms that formerly operated at separate vertical stages eliminates the transaction costs that the parties necessarily incurred in negotiating the terms under which the output at the upstream stage is transferred to the downstream firm.<sup>5</sup> This reduction in transaction costs associated with vertical integration has been widely recognized since the seminal work of Nobel Laureates Ronald Coase and Oliver Williamson.<sup>6</sup> Second, it is widely known that vertical mergers will act to eliminate price-cost margins that inefficiently compound through the vertical supply chain. This efficiency, known as the elimination of double marginalization, creates benefits that directly flow to consumers of vertically integrated firms.<sup>7</sup>

The theoretical potential for any given vertical merger to either harm competition or to benefit consumers by enhancing efficiencies in the industry provides two immediate cautionary principles for policymakers. First, given the absence of a general theory of anticompetitive harm arising from vertical mergers, the public policy merits of any specific vertical merger must involve a fact-

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<sup>4</sup> Of course, the potential exists for both economic effects to be present in a single vertical merger. The analysis is made even more complicated in this event. For a conceptual framework for considering this situation, see Oliver Williamson "Economies as an Antitrust Defense: The Welfare Tradeoffs," American Economic Review, Vol. 58, March 1968, pp. 18–36.

<sup>5</sup> For a general discussion, see Roger D. Blair and David L. Kaserman Law and Economics of Vertical Integration and Control, Academic Press 1983, pp. 11-18.

<sup>6</sup> See e.g., Ronald Coase "The Nature of the Firm," Economica, Vol. 4, 1937, pp. 386-405; and Oliver Williamson. Markets and Hierarchies: Analysis and Antitrust Implications, New York, Free Press, 1975. For an empirical estimation of such vertical economies, see David L. Kaserman and John W. Mayo "The Measurement of Vertical Economies and the Efficient Structure of the Electric Utility Industry," Journal of Industrial Economics, Vol. 39, Number 5, September 1991, pp. 483-502.

<sup>7</sup> See Joseph J. Spengler "Vertical Integration and Antitrust Policy," Journal of Political Economy, Vol 58, August 1950, pp. 347-352.

specific inquiry.<sup>8</sup> Second, given the potential for specific vertical mergers to benefit consumers by improving economic efficiency in the marketplace, blanket policies against vertical integration are unwarranted.

While general cautionary principles emerge from an examination of the economics and law of vertical mergers and integration, it is also possible to draw lessons from the recently detailed consideration in the United States of the vertical integration of prominent firms in the supply chain that provides audiovisual services to U.S. consumers. In particular, following the merger announcement, both the district court and court of appeals in the United States considered the evidence regarding the economic effects of the vertical integration of a downstream video distribution company (AT&T) and an upstream producer of video content (Time Warner).<sup>9</sup> While a theory of anticompetitive harm was offered, both the district court and the appeals court found that the “real world effects” of the vertical merger did not provide any indication of consequent harm to consumers.<sup>10</sup> Beyond the exculpatory data related to the AT&T-Time Warner merger, the court found compelling real-world evidence from prior instances of vertical integration in the video programming and distribution industry noting that “econometric analysis of real-world data showed that content pricing in prior vertical mergers in the industry had not increased...”<sup>11</sup> While revealing no anticompetitive harm, however, evidence was presented indicating the presence of substantial efficiencies associated with the vertical merger.<sup>12</sup>

Finally, consider the implications of the AT&T-Time Warner merger in Brazil. The general competitive implications of the merger have been considered by the Brazilian competition policy authority, CADE. Its review led it to approve of the merger with an associated set of structural and behavioral conditions. These conditions are explicitly designed to eliminate any potential competitive concerns from the combination of assets of AT&T and Time Warner in Brazil. However, the Brazilian telecommunications regulator ANATEL initiated a review of whether the merger of AT&T and Time Warner are contrary to Article 5 of the Law on Conditional Access Services, also known as the SeAC law. That statute restricts cross-ownership (i.e., vertical integration) between Brazilian

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<sup>8</sup> See *United States v. AT&T, Inc.*, No. 18-5214 (D.C. Cir. 2019) stating that “[t]he government must make a ‘fact-specific’ showing that the proposed merger is ‘likely to be anticompetitive.’” (p. 6)

<sup>9</sup> *United States v. AT&T, Inc.* 310 F. Supp. 3d. (2018), and *United States v. AT&T, Inc.*, No. 18-5214 (D.C. Cir. 2019)

<sup>10</sup> *Id.*

<sup>11</sup> *United States v. AT&T, Inc.*, No. 18-5214 (D.C. Cir. 2019), p. 19.

<sup>12</sup> The court concluded that “Vertical mergers often generate efficiencies and other procompetitive effects....The proposed merger is no exception.” See *United States v. AT&T, Inc.* 310 F. Supp. 3d. (2018), p. 197).

telecommunications providers and producers and programmers of content that are headquartered in Brazil.

It is my understanding that neither of the content providers affected by the AT&T-TW merger in Brazil [Turner/Warner Bros. and HBO Latin American Group (HBO LAG)] is headquartered in Brazil. This would seem as a legal matter to render the constraints identified in Article 5 non-binding for the vertically integrated firm.<sup>13</sup> Independent of any legal interpretation, however, as a matter of economics vertical this constraint on vertical integration is without merit. In particular, because neither upstream entity produces local Brazilian content, neither entity had an incentive prior to the merger – nor after the merger – to act in an anti-competitive exclusionary manner toward Brazilian content providers in Brazil. That is, the merger of AT&T and Time Warner in Brazil provides no incentive or ability for the combined firm to engage in anticompetitive exclusion of local providers of video content. Indeed, the entry and growth of these now-AT&T-affiliated content providers act to create additional demand for local content supply. Thus, far from being exclusionary, the vertical entry and growth of Turner/Warner Bros. international programmers will act to create further consumer benefits for Brazilian consumers.

## CONCLUSION: A RESULTS-BASED APPROACH

In light of the evolution of the audiovisual market in Brazil, it is important to establish a legislative and regulatory framework that acts to further advance the pro-competitive tendencies in this market. Toward this end, it is possible to speculate about the appropriate framework based on an idealized conception of the application of a perfect legislative framework or a perfect regulatory framework. In reality, however, no such perfect regulatory or legislative system for audiovisual services in Brazil has been identified. In such an environment of imperfect market governance approaches, regulatory policies that turn on and evolve as a consequence of emerging, tangible market-based results have been shown to advance consumer welfare.<sup>14</sup> Consequently, a “results-based” approach to iterative policy changes is likely to be very attractive for advancing consumer welfare in Brazil. Such an approach necessarily would recognize that the modern evolution toward a more vertically integrated provisioning of audiovisual services

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<sup>13</sup> My opinion here should not be interpreted as rendering a legal opinion, but rather is simply a non-lawyer’s interpretation of the plain language of Article 5.

<sup>14</sup> For a detailed enunciation of a results-based approach to policymaking in the telecommunications industry, see John W. Mayo, “The Evolution of Regulation: Twentieth Century Lessons and Twenty-First Century Opportunities,” *Federal Communications Law Journal* Vol. 65, 2013, pp. 119-156.

is providing numerous consumer benefits while claims of consumer harm have been judged to be speculative. Application of Article 5 of SeAC to the AT&T-TW merger provides no additional consumer protections that are not already part of the merger and would, instead be distinctly anti-consumer.

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