Final Offer Arbitration (FOA) as a merger remedy

Perspectives of an Economist

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Final Offer Arbitration as a remedy in AT&T / Time Warner

- Shortly after DOJ filed its Complaint, Turner transmitted an “irrevocable” offer of private arbitration to licensees
  - Similar to provisions in the FCC order approving the Comcast / NBCU merger, but not subject to government oversight
- The Turner offer was discussed favorably and at length in the District and Circuit court opinions
- Commentators have noted that this appears to open the door for “self help” remedies to be offered in litigation
  - › “The most surprising aspect of the case … is that the courts credited the parties’ unilaterally offered behavioral fixes, suggesting that such tactics may be quite persuasive in future vertical cases.” (James Keyte, *Antitrust*, Summer 2019)
- But does Final Offer Arbitration actually remedy vertical merger concerns of the sort raised by DOJ in its case?

Some features of the Turner arbitration offer

- No blackout during arbitration, but new terms apply retroactively
- "Baseball style" arbitration:
    - "The arbitrator shall choose the Final Offer of the party which most closely approximates the fair market value of the Turner Networks at issue. The arbitrator may not alter, or request or demand alteration of any terms of either Final Offer."
    - "The decision of the arbitrator shall be binding on the parties."
- Final Offers are complete contracts:
    - "The Final Offers shall be in the form of Carriage Agreement(s) for the Turner Networks requested by Claimant … and shall be for a term of three years unless the parties agree to a different term."
    - Must specify the Turner networks at issue, and "the proposed price, terms, and conditions on which Turner will provide those Turner Networks."
- Claimant must forgo FCC dispute resolution process
- Limits on discovery
- Seven year term

A simple model of final offer arbitration (FOA)

- Game theoretic model of final offer arbitration over price:
  - Risk-neutral Buyer and Seller simultaneously submit final offers B and S to an arbitrator who chooses the offer closest to “fair market value” (FMV)
  - FMV assumed to follow a probability distribution known to buyer and seller and independent of their offers (i.e. no “splitting the difference”)
- Nash equilibrium solution:
  - Median FMV is the expected price
    - B and S each “win” with probability ½
    - B and S are not the same, but are symmetric around the median FMV
  - The spread between B and S is greater when FMV is more uncertain
- Takeaways:
  - Arbitrator’s assessment of FMV drives the outcome
  - Binding FOA is risky when FMV is uncertain
    - The probability that the arbitrator’s decision will match FMV is zero!

What is “fair market value?”

- Definitions
  - Not defined in the Turner offer or in the Comcast / NBCU order
  - Fair market value (FMV) is the price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts. (Internal Revenue Service Pub 561)
  - Other “dictionary” definitions are similar
- Fair Market Value could be anything between the reservation prices of the negotiating parties
  - If those change due to a merger then FMV might change
- Questions for thought:
  - How does an arbitrator assess FMV?
  - Is FMV the price that would have prevailed but for a merger?
  - What does “closest to FMV” mean when the offers are contracts?

FOA in the economics literature

- Binding FOA is widely discussed as a mechanism for resolving private disputes (e.g. labor disputes, salary arbitration)
  - Originally proposed as an alternative to conventional arbitration (CA)
  - Empirically, CA arbitrators tend to “split the difference”
    - Parties likely to take extreme positions
  - Riskiness of FOA encourages settlements
    - Settlement rates are higher under FOA than CA
  - But FOA arbitrators “formulate preferred awards that compromise between the bargainers’ perspectives” (Marburger, 2004)
    - Outcomes reflect private incentives of the parties
- No discussion of broader public interests (e.g. preservation of competitive pricing)
  - No modeling of FOA as a merger remedy

AT&T / Time Warner experts on the Turner offer

- Quotes from Dennis Carlton's reports:
  - "Any threat to withhold Time Warner content from a current licensee is eliminated post-merger. … [P]ost-merger, this threat is lost. As such, any bargaining leverage from this threat is *lost* due to the merger."
  - The "threat" of baseball style arbitration "creates incentives for both sides to be reasonable and reach agreement."
  - The arbitration remedy does "not allow an outcome where 'no deal is reached, resulting in a blackout.'"
- Comments:
  - The threat of baseball style arbitration replaces the threat of a "no deal" blackout
  - Carlton did not say whether bargaining leverage is created by the new threat
  - A blackout could still occur if a licensee chooses to not invoke FOA

DOJ’s experts on the Turner offer

- Quotes from Carl Shapiro’s reports:
  - “Arbitration does not eliminate the incentives created by the merger.”
  - “[A]rbitration changes the *mechanism* through which AT&T’s incentive to raise rivals cost operates.”
  - “[T]he underlying incentives created by the merger … will very likely affect the outcome of any FOA. … [The merger would] give AT&T the incentive to raise the Turner carriage fees that it submits to the arbitrators under FOA.”
  - “[T]he merger causes ‘upward offer pressure’ on the final offer that Turner submits to arbitrators.”
- But Shapiro did not include arbitration in his model of harm:
  - “So it would take a completely different model to model arbitration. It's not something -- the bargaining model is well established in the literature and in the practice, and there is no model that I'm aware of that would be comparable for arbitration so no, I didn't go in that direction.” (Trial transcript 2325)

Conclusions

- There is empirical and theoretical support for the idea that FOA helps parties reach agreement and avoid “no deal” outcomes
- But the goal of a structural merger remedy is different: to negate anticompetitive incentives created by the merger
  - Neither side of AT&T / TW modeled equilibrium pricing with a FOA remedy
    - Defense pointed instead to Comcast / NBCU precedent and elimination of the blackout threat
    - Shapiro recognized that the merger could change FOA offers but did not model a merger with FOA remedy
  - The economics literature does not address whether binding FOA will work as a merger remedy
- FOA as an effective merger remedy probably requires something more than has been offered to date