

BY HAL J. SINGER

If you don't know

who Tim Wu is, listen up. Wu teaches intellectual property law and telecommunications law at the Columbia University Law School, and is temporarily serving as a senior advisor to the Federal Trade Commission. More relevant here, he is a public intellectual with great influence, thanks to his scholarly horsepower, felicitous way with a phrase (he coined the term “Net neutrality”) and journalist’s writing style.

Wu’s most recent book, the best-selling *Master Switch: The Rise and Fall of Information Empires* (Vintage), which has just been released in paperback, offers a fine excuse to consider the potential dangers of “vertical integration” in media industries – that is, control of an entire media supply chain by a single company.

Wu hasn’t convinced me that vertical integration should be banned. But he did give me a new awareness of the very real costs of the rush to media conglomeration. Only two points separate our views. One is his focus on the risks to broadband service, rather than to television. The other is his lack of faith in the capacity of the Federal Communications Commission to enforce its own rules barring discrimination against competing media. Well, check that: I, too, have begun to wonder whether the FCC is up to the task of maintaining a level playing field.

The title of Wu’s book comes from Fred

Friendly, the president of CBS News in the golden age of Edward R. Murrow and company. Friendly believed that the paucity of TV stations created “an autocracy where a very few citizens are more equal than all the others” – one in which the entity that controlled the “master switch” could dictate our thoughts. The theme of *Master Switch* can be summarized in a sentence: modern antitrust law is ill-equipped to contain the “special case” of concentrated power over (and vertical integration of) the creation and delivery of information.

In Wu’s view, antitrust is preoccupied with the impact of business behavior on prices in the near term, in spite of the reality that harm to consumers may manifest itself in other ways. That’s why he argues that Robert Crandall – the Brookings Institution economist who is famously skeptical about the societal value of virtually all antitrust enforcement – erred in concluding that the 1982 AT&T consent decree (breaking up the Ma Bell monopoly) and the 1948 *Paramount* decree (forcing Hollywood to divest its in-house movie theaters) did not serve the interests of consumers.

A little background on that latter decision:

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Paramount, like the other big movie studios, required “block booking” by theaters – that is, it required theaters to buy the dogs in order to get access to the gems. Thus, an antitrust approach that focused too narrowly on price effects, Wu argues, would have ignored the impact on innovation when, as a consequence of this distribution system, independent filmmakers were denied an outlet. By the same token, he argues, the attenuation of innovation today by independents, whether they are writers, TV content producers or Web sites, constitutes a significant cost to society that is largely ignored by economists. “In considering whether government action was worthwhile,” Wu argues, “let us not, particularly where information and culture industries are concerned, fall into the trap of looking to results that only econometrics can reveal.”

Antitrust economists, who are increasingly inclined to err on the side of inaction, take comfort in the belief that most monopolies eventually topple on their own in the face of changing markets and technologies. According to Wu, though, this tendency toward creative destruction cannot overcome the “Cycle” (another catchy Wu-ism) in which a media empire uses its influence to gain special favor from the state, or even becomes a “virtual organ of government.” Thus, the source of failure for an information-industry giant “becomes less a question of market dynamics than of politics.” The consequences, Wu asserts, are felt in the decline of innovation, as well as in the decline of democracy.

He points to the 2004 Supreme Court decision in *Verizon v. Trinko* as the darkest hour of antitrust enforcement. In that case, a majority of the Court held that violations of the Telecom-

munications Act – which, as a condition of selling long-distance service, requires local telephone companies to share their wires with resellers at regulated rates – did not, in fact, create a “duty to deal” under the antitrust laws. After *Trinko*, Wu lost all faith in the antitrust laws’ ability to protect outsiders in their battles with media incumbents.

What’s more, Wu no longer trusts the FCC to enforce its own non-discrimination standards, which should, in theory, cover the gaps in antitrust created by its narrow focus on economic efficiency in telecommunications businesses. This loss of confidence in both antitrust enforcement and in the FCC undergirds his call for a “separations principle” that would divorce control of media content from the metaphoric pipes through which content is delivered and thereby relieve the regulatory agencies of the task of enforcing conduct remedies.



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VERTICAL INTEGRATION – A CLOSER LOOK

Wu offers four problems of vertical integration in media that are allegedly not appreciated in standard antitrust analysis.

Vertical integration creates conflicts of interest within firms, which can lead to reduced supply or quality of content. Digging deep into the history books, Wu uncovers the story of how, during the 1876 Hayes-Tilden presidential contest, Western Union (the “pipes”) was the exclusive carrier of Associated Press news reports (the “content”) – a form of *de facto* vertical integration by contract. Thanks to this less-than-arms-length relationship, he says, Western Union was able to pressure the AP to provide coverage biased in favor of Hayes, its preferred candidate.

Skipping forward a few decades, Wu notes that the Bell telephone network of the 1920s denied use of its long-distance wires to the rivals to its own radio network. Around the same time, he points out, Paramount began requiring block-booking of theaters.

More-recent cases drive home the point. In the 1970s, the old AT&T, which provided both long distance and local calling, engaged in predatory pricing against an upstart rival, the long distance carrier MCI, preventing MCI from connecting its switches to AT&T’s local circuits. AT&T even resorted to sabotage, pulling the plug on MCI’s circuits between Washington and New York.

Wu is certainly right that vertical integration has been used at times to block competition, and thereby to undermine innovation. But he’s wrong that modern economic analysis makes no allowance for the problematic nature of vertical integration. One very relevant example: The FCC and the Justice Department did consider the broader issues in their review of the purchase of NBC-Universal

Studios (a major producer of television content) by the cable giant Comcast; it conditioned the merger on some modest measures reducing the prospect of discrimination against rival content.

Vertical integration leaves firms vulnerable to censorship by a few individuals. Wu cites the 1950s “Hays Code” system of film censorship that Hollywood imposed on itself. This censorship, controlled by the Catholic Legion of Decency, ensured that films of the 1930s, 40s and 50s did not challenge institutions like “marriage, government, the courts or the Church.” He asserts that the *Paramount* decision undermined the code, as the major studios lost control over what theaters showed.

Wu certainly wins here; this problematic aspect of vertical integration is truly outside the realm of traditional antitrust and economic analysis. But the risk of censorship is not just linked to vertical integration. It can also be facilitated by excessive *horizontal* concentration that gives the industry market power. Indeed, Hollywood’s bad deeds may be attributable, at least in part, to the cartelization of the studios, which discouraged independent film production. In general, vertical integration without excessive downstream market power – that is, the ability to foreclose upstream rivals (other producers) – may be innocuous.

Vertical integration leaves firms vulnerable to stagnation and repression of business innovation. Wu explains how, in the early 1880s, farmers pioneered the use of phone lines for broadcasting, long before the advent of over-the-air radio broadcasting in the 1920s. But Bell limited development by requiring the adoption of Bell’s standards to interconnect, along with the use of Bell’s equipment. The company also imposed special fees for use of Bell’s long distance lines – the must-have input monopolized by Bell.

This list of bad behavior goes on. Wu cites Ma Bell's attempts to squelch magnetic recording. The company apparently believed that recording could lead the public to abandon the telephone for fear of being taped. And, in the same vein, it allegedly smothered digital television and electronic-packet networking to protect its monopoly services.

There's another side to this coin, though. AT&T's Bell Labs generated four Nobel prizes in physics, along with a vast body of science that hastened the advance of electronics and telecommunications. And it is far from clear that, had AT&T been forced to operate in a competitive market, it would have invested heavily in basic research in everything from information theory to cosmology, whose fruits could not be directly captured by the company.

Wu applauds FCC regulations that required Bell to allow customers to use non-Bell devices (a form of vertical divestiture), beginning with the *Carterfone* decision in

1968. This opening of the network led to the creation of the first modem, which was necessary to the development of the World Wide Web. The FCC also barred AT&T from data processing and online services, which Wu says opened the door to independent Internet Service Providers.

To be fair to economists here, there's not a lot of evidence (beyond the anecdotal) that innovation by independents is more valuable than innovation by divisions of a vertically integrated firm. That vertically integrated behemoths lose their innovative instincts may be more a function of the growth of internal bureaucracies, suggesting that sheer size and lack of competition created by horizontal concentration is, more than likely, the culprit.

Vertical integration leaves the FCC more vulnerable to regulatory capture. The FCC held a public hearing in 1950 to adjudicate the controversy over the Hush-a-Phone, a plastic cup placed over a telephone that protected the user from eavesdroppers. Old Ma Bell called witnesses who absurdly suggested that the Hush-a-Phone would lead to power surges



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that might electrocute repairmen. The FCC sat on the case for five years, and then decided in favor of AT&T. A year later, the United States Court of Appeals for the District of Columbia, which hears appeals of FCC rulings, overturned the FCC decision. But it was too late for Hush-a-Phone; the little company folded when Bell introduced handsets that were incompatible with its devices.

Wu also recounts instances in which, at the behest of incumbents, the FCC thwarted entry in radio and television – first against rival broadcasters, then against cable operators. The Federal Radio Commission, the precursor to the FCC in the 1920s and early 1930s, had the choice of allowing lots of low-power stations or far fewer high-power ones. It chose to shutter hundreds of small stations to create 40 high-power “clear” channels that could be received at far greater distances, thereby giving two chains, NBC and CBS, domination of the medium.

The FCC also proved susceptible to capture by incumbents in deciding the fate of FM technology. FM could broadcast using less power than AM, making it possible to squeeze more radio signals from a given band of spectrum. But RCA, NBC’s parent, fought FM on behalf of its stations, and delayed the licensing of the first FM station by six years.

Later, the FCC required FM stations to carry the same programming as AM parents. By 1949, 85 percent of the “new” FM station licenses were extended to AM stations – that is, FCC expanded capacity, but discouraged new content and new voices.

Incumbent television networks were afforded similar protection. In response to lobbying by NBC’s David Sarnoff in the 1930s, the FCC (in Wu’s words) “halted television in its tracks” by ruling that mechanical television (TV in which the picture was facilitated

by spinning discs) was inadequate to be marketed to the public. The FCC issued just a handful of licenses and specified they were for experimental purposes only; commercial use was barred. In fact, the commission sanctioned Charles Francis Jenkins, a pioneer in mechanical television, for merely broadcasting an announcement of his invention. By the mid-1950s, the FCC had issued just two television licenses in most communities – by no coincidence, one for NBC and the other for CBS. In 1966, at the urging of the over-the-air broadcasters, the FCC barred cable television from America’s 100 largest cities.

Although Wu suggests that vertical integration was the common denominator to these problems of regulatory capture, a closer look reveals other factors at work. With the exception of the RCA case, the real problem appears to have been excessive horizontal concentration supported by the regulators, along with the Noerr-Pennington doctrine, a legal test following a Supreme Court ruling that the use of political lobbying to reduce competition was not a violation of the anti-trust laws.

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Wu acknowledges that under his prescribed remedy – strict separation of the content from the pipes – some genuine efficiencies might be lost. For example, exclusive contracts (say, an exclusive arrangement between a wireless telecommunications company and a tablet maker) can reduce risk and spur investment. And, from my perspective, it is unclear why these concerns should be given less weight than Wu’s concerns regarding discrimination against outsiders.

Moreover, in a better world, such as the one envisioned by the writers of the Cable Communications Act of 1984, we could have our cake and eat it too. In that world, cable

distributors of video would be allowed to enjoy the fruits of vertical integration by owning program networks, so long as they treated independents in a nondiscriminatory way.

But Wu lost faith in this have-your-cake approach – and understandably so, in light of the FCC’s recent decision in *TCR v. Time Warner*. In that case, the commission reversed its staff findings of discrimination against TCR, a sports network that operates under the more familiar name MASN. The regulators were apparently swayed by Time Warner’s flimsy excuse that it was more profitable to carry MASN on an inferior tier. Never mind the fact that Time Warner never applied that test to its affiliated networks – the very essence of discrimination. Moreover, the FCC buried the appeal for two years, despite a self-imposed requirement to hear it within 60 days.

SO, IS WU RIGHT?

All told, Wu makes a pretty compelling case against vertical integration in media – albeit one marred by some exaggeration and the occasional factual stumble.

He claims that cable companies will soon enjoy an “uncontested monopoly over broadband Internet.” But although cable companies might be up to no good in video programming, there appears to be substantial competition between cable operators and wire-line telephone companies for broadband customers. Indeed, with the implementation of 4G service by wireless carriers, mobile broadband is becoming a viable alternative to cable and wired service.

Wu similarly claims that because the cost of spectrum needed for a national network is “north of \$10 billion,” the “phone market has been effectively closed.” But telephone connections via cable have flourished, with the cable companies tripping over each other in efforts to package phone, Internet and television service. Most of the country enjoys five national wireless providers – AT&T, Verizon, Sprint/Nextel, MetroPCS or Leap (their complementary footprints led to a roaming arrangement



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that effectively creates another national carrier) and T-Mobile (at least for now). Some markets also have a sixth in the form of ambitious multiregion providers like US Cellular or Cellular South. Contrast this with the case of cable programming, where vertical integration is rampant. Comcast owns multiple regional sports networks, along with the Golf Channel, Versus (soon to be renamed the NBC Sports Network), a slice of the Major League Baseball and National Hockey League networks, and now NBC-Universal. Time Warner, for its part, owns TBS, TNT and a regional sports network carrying Los Angeles Lakers games.

Wu later acknowledges that discrimination in media means “charging *similar parties* different prices.” But if this is the real concern with broadband service, why not allow Internet providers to charge content providers for enhanced services, but demand that they make those same services available at the same charges for similarly situated content providers?

Meanwhile, Wu may be a hard-liner on Internet discrimination issues, but is oddly soft on the cable industry. He argues that “cable operators, though not obliged by law to do so, generally carry channels that a cruder calculus would motivate them to block.” Wu is apparently not familiar with the stories of WealthTV, MASN, Tennis Channel or NFL Network, each of which sued Comcast under the program-carriage rules. C-SET, an independent network formed by the NBA’s Charlotte Bobcats, was driven out of business by Time Warner’s refusal to grant broad carriage in North Carolina; Time Warner later scooped up the rights and carried the games on an affiliated network (News 14 Carolina) on the very tier on which it denied C-SET.

When Wu says that vertically integrated

cable operators “generally carry channels,” he doesn’t appreciate the distinction between tiering – that is, the tier on which a network is carried – and carriage at all. He is so fixated on drawing parallels between the old AT&T and the new AT&T that he misses the most obvious form of anticompetitive discrimination in modern media.

By contrast, Wu is a bit hard on the Apple juggernaut, which he claims steers traffic to “Hollywood’s content.” Perhaps Apple only sells profitable items on iTunes, but that does not stop consumers from visiting the Web sites of independent content creators as well as, say, YouTube. By the same token, Wu despised the exclusivity arrangement (now expired) between Apple and AT&T regarding the iPhone. But, as Bob Hahn and I explained in a past issue of the *Review* (1st Quarter, 2010), there were benefits to the iPhone exclusivity. Indeed, the introduction of the wildly popular Droid handset by Motorola was a direct response to the popularity of the iPhone.

Finally, Wu thinks that a broadband network’s charging for enhanced services is the first step on the road to outright blocking of content:

The initial step would be subtle: AT&T would begin offering, for a fee, a “fast line” by which to reach customers, inspiring the cable firms and Verizon to do the same. ... The effects at first would be small. But it doesn’t take a genius to realize that if AT&T and the cable companies exercised broad discretion to speed up the business of some firms and slow down that of others, they would gain the power of life and death over the Internet.

Rather than evaluate the social cost and benefits of allowing tiered broadband services for content providers in isolation, Wu creates a boogeyman whose costs are infinite but would never materialize. Suppose Sony Online Entertainment asks AT&T for special handling of its online video game, EverQuest.

AT&T agrees, and the two firms enter into a voluntary contract. Should this be permitted? The FCC's Open Internet Order, which enshrined Wu's Net neutrality into law, considers such a contract "presumptively illegal." And surprisingly (at least to me), the majority of law school students to whom I've posed this question share the FCC's view.

To ensure that AT&T does not favor Sony on the basis of affiliation, I asked the students to assume that the contract was non-exclusive, that AT&T had no direct financial stake in Sony, and that AT&T would be compelled to extend the same offer to all similarly situated purveyors of Internet content. Not good enough, the students said: the contract violated their sense of fairness. Perhaps some up-

start gaming site that seeks to compete with Sony could afford the "toll" imposed by AT&T.

But Sony could distinguish its service from the new kid on the block by investing in a host of expensive things, I countered, hiring better programmers and graphics artists and buying better music. Why should we prevent Sony from differentiating its service in just one aspect (broadband speed and reliability)? Because it is the Internet, the students insisted and the Internet is special.

Vertical integration in media is, as Wu says, a troubling trend. But while his singular emphasis on the impact on the Internet has clearly tapped into the zeitgeist, I see it as a diversion from the real show. **M**

