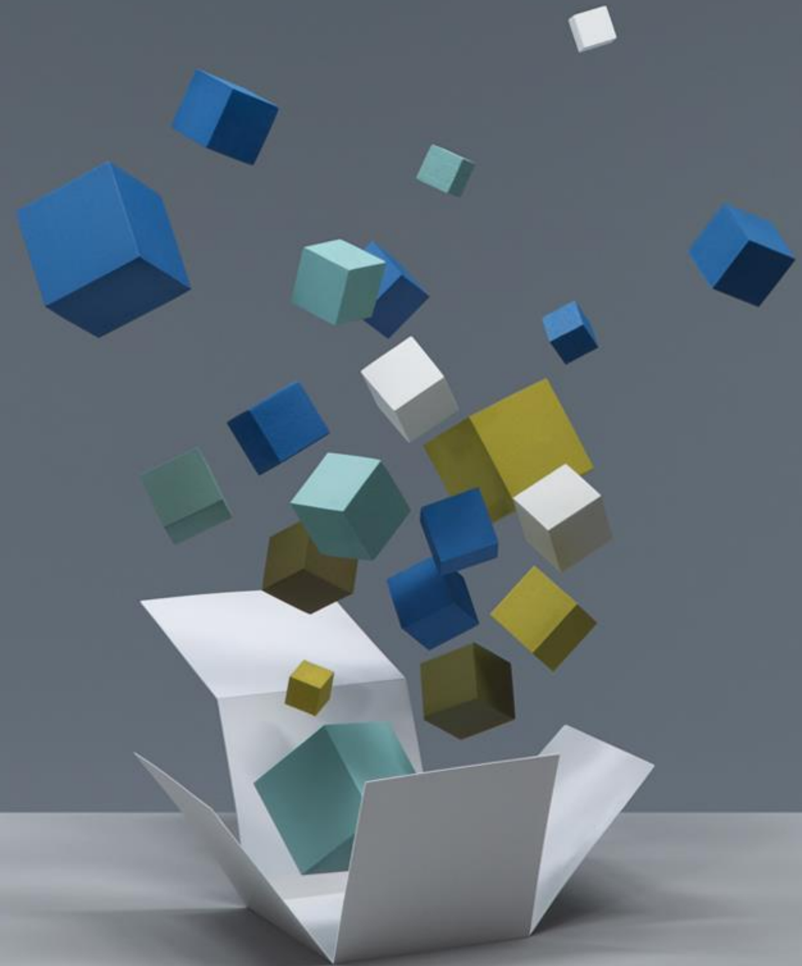
Universal/EMI

Economic analysis and insights



Hans Zenger

CRA Charles River Associates

Outline

1. **Introduction**
   - Context and main economic questions raised by the case
2. **The Commission's main theory of harm**
   - Big is bad
3. **Empirical Analysis**
   - The Commission's methodology and its limitations
4. **Conclusion**

Introduction

Citigroup sold:

- EMI's publishing rights to Sony (transaction cleared on 19 April 2012 with conditions)
- EMI's recorded music rights to Universal (transaction cleared with conditions on 21 Sept. 2012 after an in-depth investigation).

Almunia: "*one of the most difficult cases*" (Speech of Sept. 21)

Market evolutions

- Global music sales declined from US$23.3 billion in 2003 to US$15.9 billion in 2010 (a decline of 32%).
- Physical sales declined 55%
- Digital sales accounted from US$4.6 billion in 2010.

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Sony BMG II	Universal EMI
Majors reduced from 5 to 4	Majors reduced from 4 to 3
Investigation focused on:	
- Coordinated effects	- Unilateral effects
- Physical sales	- Digital sales
- Price transparency	- Bargaining power
Phase II clearance (unconditional)	Phase II clearance with remedies

Interesting issues

- Role of piracy
- Buyer power (e.g. iTunes)
- Closeness of competition between the parties
- Role and evolution of Indies
- Development and promotion of artists
- Impact of the transaction on the development of new digital services
- Control shares
- Impact of the transaction on the merged entity's bargaining power vis-à-vis internet platforms

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The Commission's main theory of harm

In initial exchanges, the Commission was mainly concerned about

- high market shares and
- the "must have" nature of Universal and EMI's repertoires for digital platforms (allegedly giving rise to pre-merger market power)

However, a number of industry-specific factors made it doubtful that the Commission's arguments give rise to a credible competition concern:

- The substitutability between individual songs is considered to be very low. Unilateral effects could therefore plausibly only arise at the level of entire repertoires
- The Commission's insistence on Universal and (to a lesser extent) EMI being "must have" providers for platforms suggests that portfolios are complements, rather than substitutes

The Commission's main theory of harm

It is intuitively plausible that digital platforms, such as iTunes, must carry the songs of all majors to be attractive to final consumers.

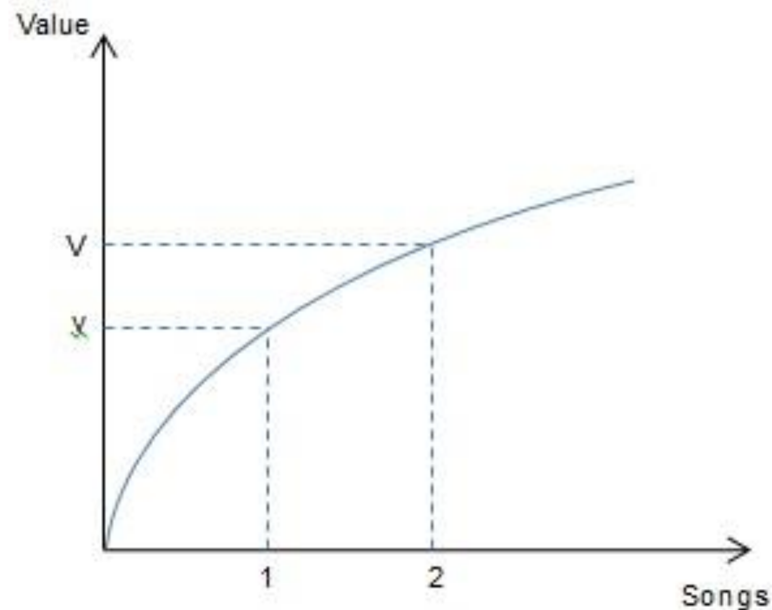
But in that case, a merger between two "must have" providers would normally not increase the bargaining power of each firm:

Post-merger, prices would not increase, precisely because portfolios are not interchangeable (so no competitive constraint is removed).

When the Commission was pointed to this contradiction in its argument, it developed the following theory of harm, which was supposed to underpin the substitutability of repertoires.

The Commission’s main theory of harm

Allegedly, digital platforms obtain decreasing marginal benefits from adding additional repertoire to their platform.



The Commission's theory of harm

I.e., if a platform already offers the repertoires of several majors, adding another major to its portfolio will create under-proportional value.

In that case, platforms would be in a strong bargaining position, because the threat of losing each individual major is not much of a concern.

A merger may then increase the parties' bargaining power, because it would become more difficult to substitute the loss of repertoire of a larger firm.

This theory of harm was based on an academic article of the Commission's Chief Economist on labor markets (adding new workers under-proportionally increases output as there are decreasing returns to scale when capital is fixed).

The Commission's theory of harm

Note that implicitly, this is a portfolio theory (but without claim of exclusion).

Given the facts of the recorded music industry, however, it appeared implausible that the Commission's theory of harm was applicable:

- Other than labor markets, digital platforms exhibit increasing returns to scale (high fixed costs, low marginal costs).
- Other than in labor markets, inputs for platforms (songs) are not easily substitutable (platforms have to offer the *specific* inputs that are desired by consumers, otherwise they will face commercial difficulties).

This strongly suggests that the value of a platform is more than sum of its parts (not less, as the Commission suggests).

The Commission's theory of harm

Specifically, the Commission's theory of harm implies that platforms with only one major (say EMI) will make the highest profits per song (from that major) if no other majors are represented on that platform.

This seems highly implausible: there is a reason why platforms aspire full coverage and no such "EMI only" platform exists.

When the Reply to the SO confronted the Commission with these arguments, the Commission de-emphasized its labor market mechanism.

Essentially, the Commission argued that whether or not platforms have decreasing marginal benefits from additional portfolios is an empirical question.

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Differentiated products

How does one normally assess competition in differentiated product markets?

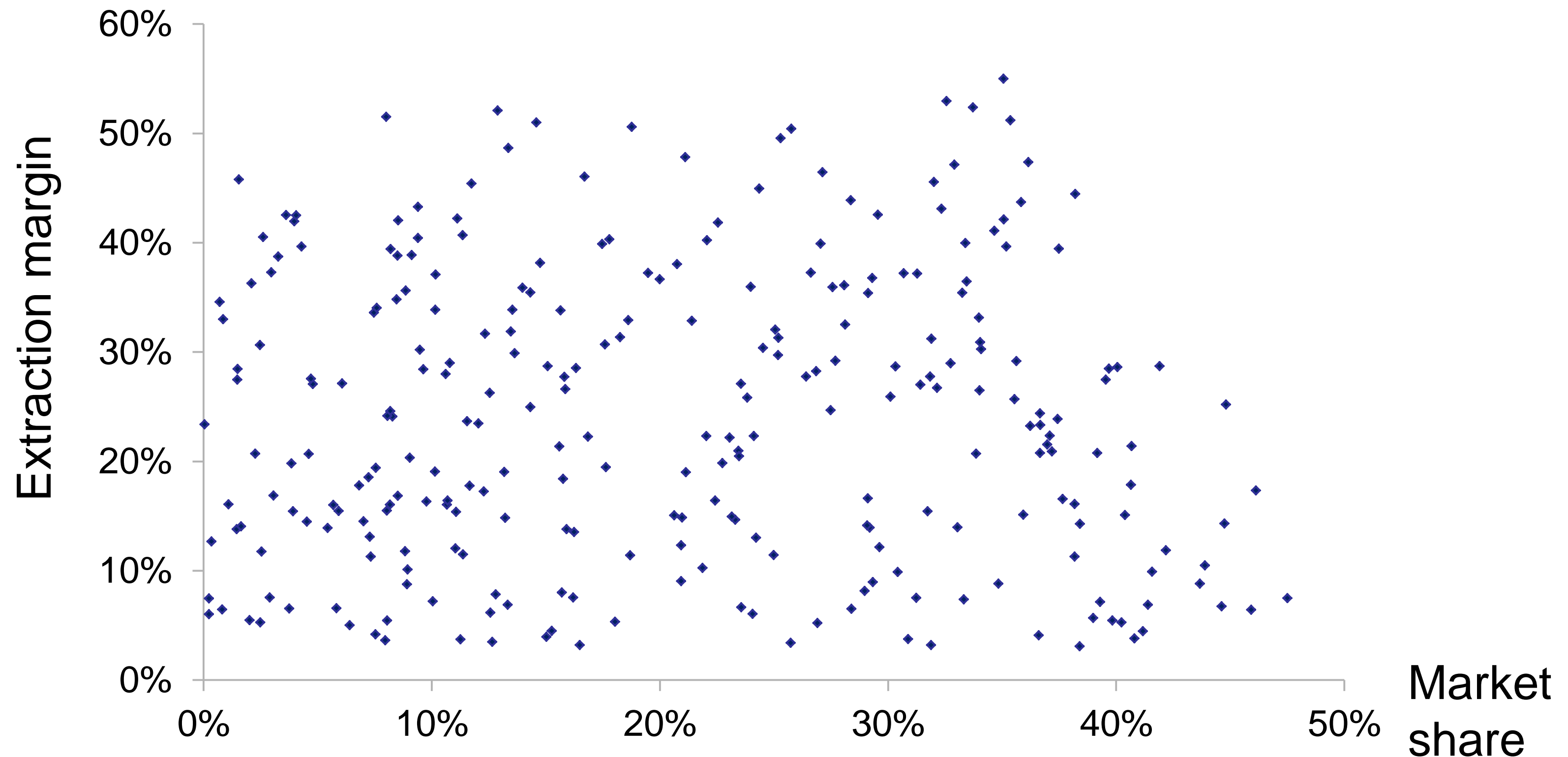
- Standard closeness of competition analysis:
  - Qualitative (e.g. focus on new releases and back catalogue)
  - Quantitative (e.g. diversion ratios/cross-elasticity)

In this case:

- No evidence of substitution at the song/album level (each song is unique)
- Substitution at the level of portfolios? (essentially the Commission's theory)
- Check whether the size of a record company's is associated with better terms (so-called extraction margins and prices)

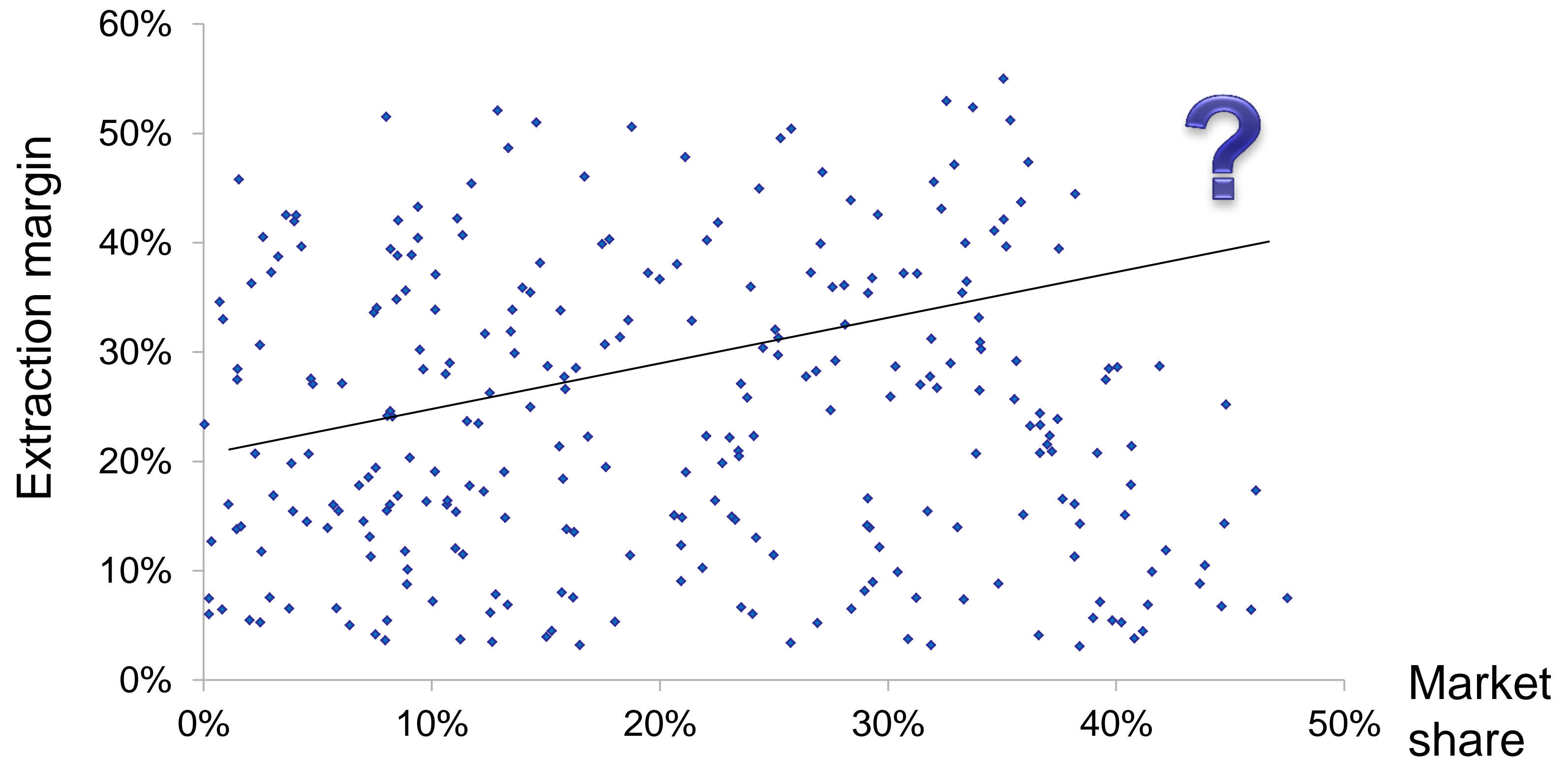
Commission's analysis

Econometric relationship between size and extraction margin (randomly generated data for illustration purposes)



Commission’s analysis

Econometric relationship between size and extraction margin (randomly generated data for illustration purposes)



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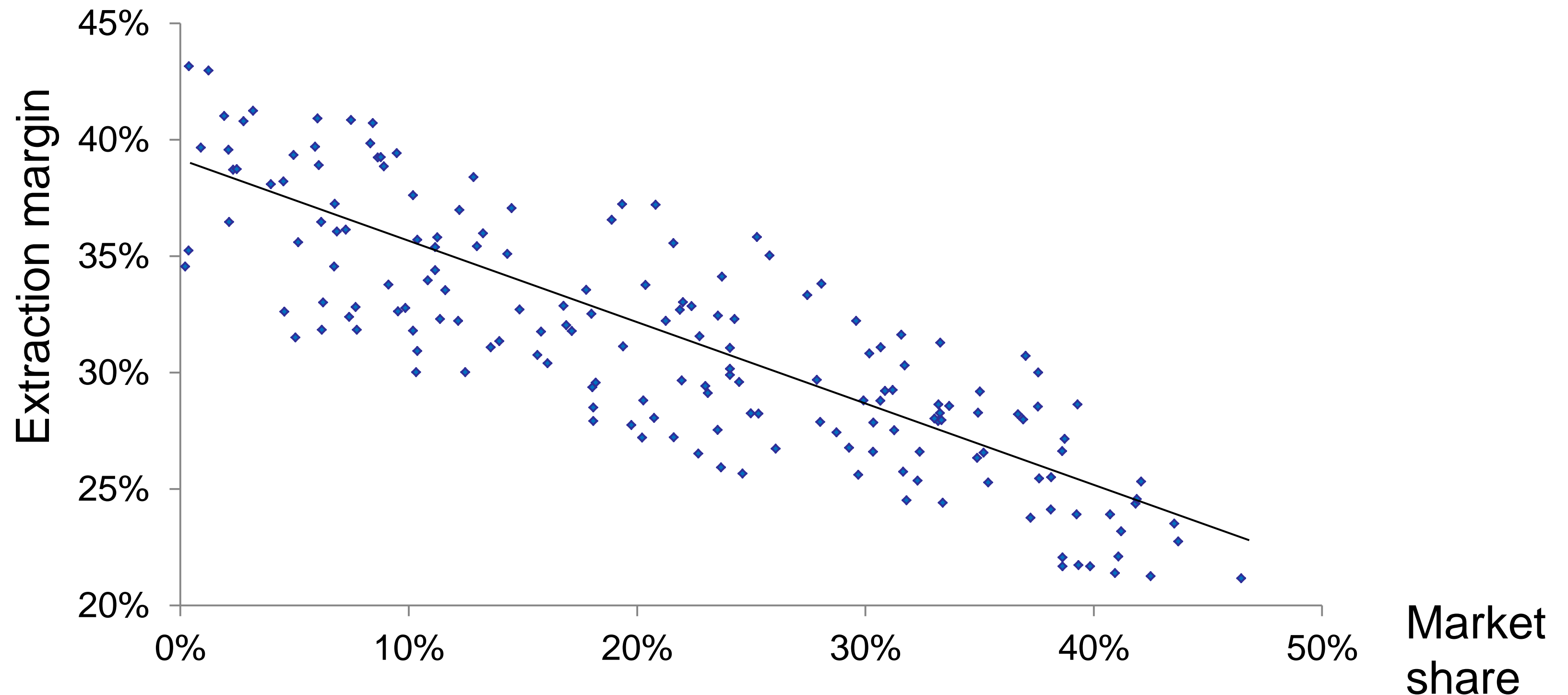
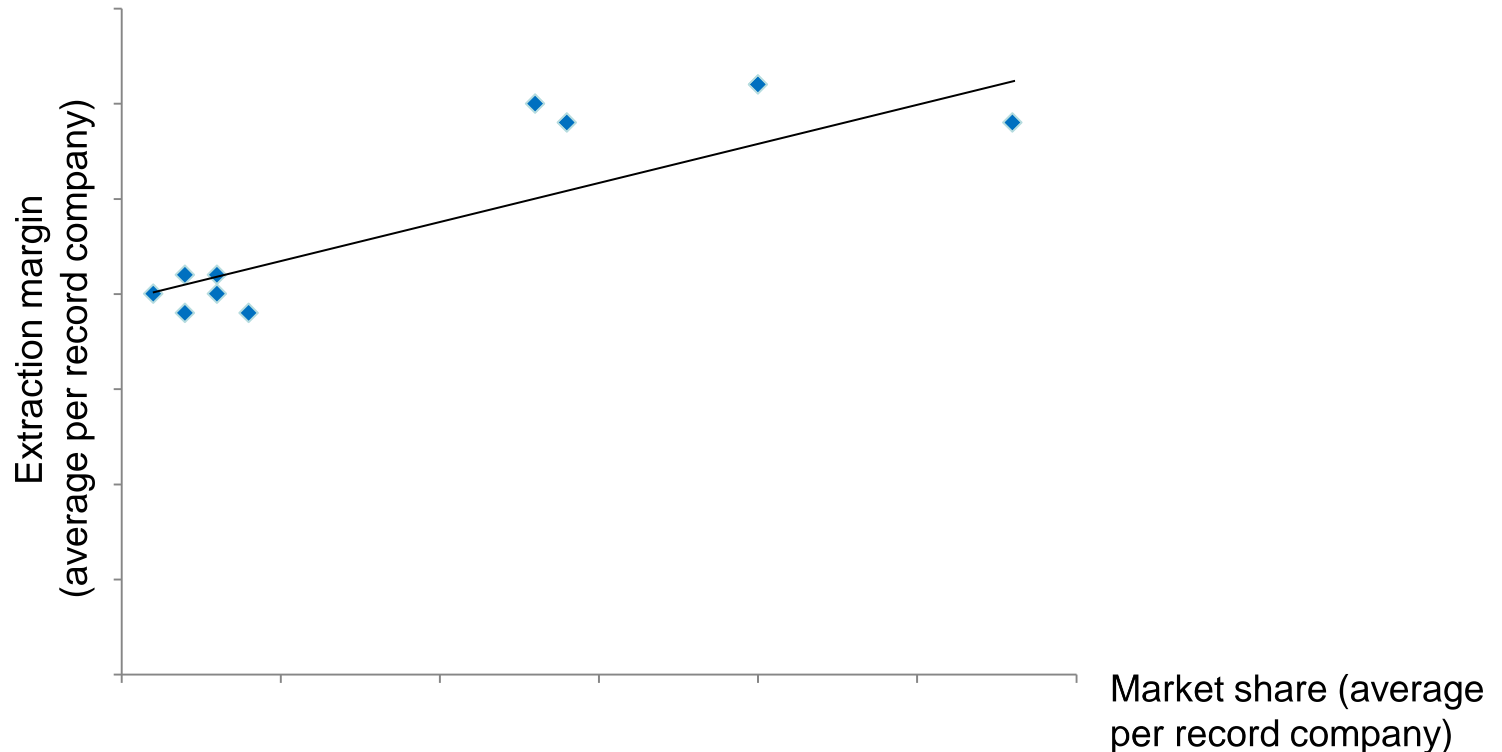
Some comments

- Regressions performed poorly and not robust
- The Commission's empirical framework is not good: uses monthly data at the country level, which is not linked to contract negotiations
- In fact, the Commission's results come from cross-sectional differences between record companies (for which the Commission did not include any control in its regressions)
- In any case, this exercise does not tell whether Universal is likely to increase prices post-merger:
  - Effect partly estimated from differences between majors and Indies
  - Results do not hold on a comparison of Universal/EMI data
  - Results do not hold for majors independently

Universal does not get better terms when it is bigger (randomly generated data for illustration purposes)



But the Commission still considers that larger companies get better terms on average… (data generated arbitrarily for illustration purposes)



Other interesting issues

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Conclusion

- The Commission's new bargaining theory of harm (big is bad) is at odds with the market characteristics of the music industry: not only songs do not appear as substitutes for each other at the consumer level, but also music portfolios at the platform level.
- Such a theory of harm may however be more relevant in other industries (if supported by empirical evidence).
- In such cases, it is important to understand the sources of variation in contract terms (e.g. size versus quality, companies leading to the identification of the results).
- Importance of a full review of the Commission's economic work and data in the context of a data room.
- What about consumer harm?

FTC:

1) "*Universal is very strong in popular new releases, but EMI – the smallest of the Majors – has a portfolio much more heavily weighted toward older titles*."

2) *"Commission staff found considerable evidence that each leading interactive streaming service must carry the music of each Major to be competitive. Because each Major currently controls recorded music necessary for these streaming services, the music is more complementary than substitutable in this context, leading to limited direct competition between Universal and EMI. In the end, insufficient evidence existed showing that Universal and EMI offer products that could be viewed by streaming services as direct substitutes. »*

London
Tel +44 (0)20 7664 3700
Fax +44 (0)20 7664 3998
99 Bishopsgate
London EC2M 3XD
United Kingdom

Brussels
Tel +32 (0)2 627 1400
81 Avenue Louise
Brussels B-1050
Belgium

Paris
Tel +33 (0)1 70 38 52 78
27 Avenue de l'Opéra
75001 Paris
France

www.crai.com/ecp