March 2016

RBB Brief 51

RBB | Economics

Better together? Commission adds a new tune to its repertoire on music rights mergers

Introduction

In October 2015, following a phase II investigation, the Commission published its decision to approve a joint venture ("JV") between three of the largest music publishing collecting societies in Europe, PRSfM, GEMA and STIM.[1]

As in other recent music industry mergers, the Commission investigated whether the combination of the parties' repertoires would enhance their negotiating power when licensing digital service providers ("DSPs"), such as iTunes, Spotify, Deezer and Google Play that commercialise music.[2] The Commission's conclusion in this case, that larger repertoires are not able to command higher royalties, is in marked contrast to its conclusions in Universal/BMG, Sony/Mubadala/EMI Music Publishing, and Universal/EMI.[3] The Commission's assessment raises several interesting points that have important implications for other cases involving patent pools, airline alliances, sports media rights, gaming, and other combinations of portfolios of different products or services.

Background – CMOs' activities

Platforms that distribute music, such as radio stations, require licences relating to the authors' and composers' underlying musical works (broadly, music publishing copyrights).[4] Authors and composers, or their music publishers, have historically assigned the administration of their music publishing rights to mainly national collective management organisations ("CMOs", also known as collecting societies) because it would be impractical for them to license their copyrights individually. CMOs then manage those copyrights, negotiate and grant licences to users, monitor the use of licensed rights, and collect and distribute royalties due to the relevant rightsholders of the music works.

CMOs have historically operated on a national basis. For example the UK CMO, the PRSfM, licenses BBC radio stations for their broadcasts of music in the UK.[5] However, with the advent of truly multi-territorial services in the online world, such as iTunes and Spotify, CMOs have started to grant multi-territorial licences to their own repertoires for online services.[6] By way of example, the PRSfM has granted multi-territorial licences to some DSPs, for the EEA-wide, or even global, exploitation of its repertoire.

Repertoire aggregation and bargainings

This transaction involved the CMOs in each of the UK (PRSfM), Sweden (STIM) and Germany (GEMA), and one of the purposes of the JV was to aggregate the three parties' repertoires to offer a single multi-territorial licence to relevant DSPs.[7] In three previous mergers in the music industry the Commission felt that the repertoires of different licensors operating in a particular country were competing with one another, and so required significant divestments – a standard analysis of horizontal substitutes.[8] The critical question facing the Commission was whether or not the aggregation and joint licensing of the repertoires of three of the largest CMOs in Europe would be likely to enhance their bargaining power when negotiating licences with DSPs.[9]

1. M.6800-PRSfM/ STIM/ GEMA/ JV.

2. The Commission also separately investigated concerns that the JV might affect copyright administration services provided to the music publishers. The parties ultimately agreed behavioural commitments to address these concerns.

3. M.4404 – Universal/BMG Music Publishing, M.6459 - Sony/Mubadala Development/ EMI Music Publishing, M.6458 - Universal Music Group/EMI Music.

4. Platforms would typically also require licences to performing artists' and producers' works (broadly, recorded music rights), although this case only considered music publishing rights.

5. CMOs have historically operated through a network of reciprocal representation agreements by which each local national CMO offered a national blanket licence covering the "world repertoire" (the aggregation of all CMOs' repertoires).

6. Separately, following the Commission's 2005 Recommendation (2005/737/EC), several music publishers have withdrawn their relevant music publishing rights from the CMO network, to undertake direct licensing to DSPs on a pan-European basis.

7. This repertoire aggregation is consistent with a framework set out by the European Union in the CRM Directive (2014/26/EU).

8. See footnote 3.

9. The Commission observed several additional constraints on a CMO's ability to negotiate royalty rates with DSPs, see paragraph 272.

The framework of the theory of harm explored by the Commission was drawn from labour market economics, considering negotiations over wages and employment between labour unions and firms. In stylized labour markets, where every worker performs the same task, they have more bargaining power when they negotiate collectively through a union than when they negotiate individually.[10] Importantly, this result assumes that workers are substitutable. When workers are substitutable there are, at least after a certain point, decreasing benefits to hiring each additional worker (i.e. an additional employee adds less value than the previous employee). Viewed within the context of bargaining over wages, the average damage to a company from losing each worker then increases as more workers threaten to stop working (e.g. through strike action, collectively as part of a union).[11]

However, if the starting assumption of worker substitutability is reversed, and if workers were instead complementary, then the result would also be reversed, and the aggregation of workers would result in less bargaining power and lower wages (prices). To continue the labour markets illustration, different types of workers might be complementary if a firm needed both plumbers and electricians to operate a plant. In that case, there are increasing benefits to hiring an electrician after having hired a plumber (since only by hiring both can the firm operate). For a firm that has hired a plumber and is negotiating with an electrician, this means that the marginal benefit of the electrician is higher than the average value of the two workers together.[12] In this situation a union made up of plumbers and electricians would have less bargaining power than the electrician alone.

A similar intuition lies behind the standard antitrust analysis of horizontal mergers between suppliers of substitute versus complementary products. With substitutes, the intuition behind unilateral effects analysis in mergers is clear – if a price rise by one merging party was not profitable pre-merger, it may well be profitable post-merger, as some of the sales lost would be recaptured by the second merging party. By contrast, a merger between suppliers of complements may lead to a fall in prices, reversing the logic in the case of substitutes.[13]

Asking the question

Applying this negotiation framework to music publishing repertoires, the question then is whether different repertoires are substitutable. If they are, then an aggregation of repertoires may lead to an increase in the CMOs' bargaining power (and possibly prices). Alternatively, if the Parties' repertoires were considered to be complements (for example because each was already important to a given DSP) then under the bargaining framework adopted by the Commission, an aggregation of repertoires may instead lead to pro-competitive incentives to license more readily, and a decrease in royalty rates.[14]

It might seem intuitive that two different music repertoires are likely to be substitutes: both operate at the same horizontal level of the supply chain, and are licensed by the same types of entities (CMOs) to the same DSPs. It might seem plausible that a customer could credibly tell one CMO that if its repertoire were too expensive then it could walk away from the negotiating table, and rather stock the repertoires of several other CMOs. However, the Commission concluded that there is no theoretical reason to consider that two large music repertoires are either substitutes or complements. This is important but not unprecedented. In Universal/EMI the US FTC accepted that different recorded music repertoires were complementary, each already being important for a successful platform, rather than being substitutable alternatives, which might have been the case if platforms did not require a wide range of music to compete effectively.[15] Accordingly, the Commission considered that it was appropriate to carry out an empirical analysis to assist in addressing this question.[16]

10. Agents, as a union, bargain collectively over their average contribution to a platform, whereas agents would individually bargain over their marginal contribution. If the agents are substitutes, the agents' average contribution is higher than their marginal contribution because an additional agent is worth less to the platform than the previous agent. The assumption of bargaining "at the margin" (i.e. each worker assumes that the firm will negotiate with other workers first and considers itself a "marginal worker") is an important part of the analytical framework applied by the Commission.

11. These results are not novel. See, for example, Horn H, and Wolinsky, A., 1988, "Worker Substitutability and Patterns of Unionisation", Economic Journal, vol. 98 (391), pages 484-497. While other bargaining dynamics have been developed in the economic literature, including "efficient bargaining" models in which the labour union and the firm negotiate to achieve more efficient outcomes than under "monopoly union models" (which underlies the Commission's framework), these questions are not considered further in this Brief.

12. The order in which the complementary workers are hired does not affected the overall result.

13. A similar logic applies in removing "double marginalisation" in vertical or conglomerate mergers.

14. A merger of horizontal complements that led to a reduction in royalty rates might raise questions about the rationale for the JV, but in this case collective bargaining was an integral part of the overall JV's objective to pursue efficiencies across the full range of its activities. This rationale has also been recognised in other settings. See Chipty and Snyder (1999): The role of Firm Size in

The empirical assessment

Given its concern that the repertoire aggregation that would result from the JV could lead to stronger bargaining power and, accordingly, higher royalty rates, the Commission tried to assess whether large repertoires achieved higher royalty rates than smaller repertoires. The Commission used two approaches: looking at contractually agreed royalty rates, and using data on actual royalties paid by DSPs to CMOs, which were calculated as a proportion of the DSPs' retail revenues related to each CMO's repertoire.

While the Commission found no indication that larger CMOs had negotiated more favourable terms than those with smaller repertoires, there are a number of challenges that affect the reliability of this type of analysis. In particular, the calculated royalty rate paid by the DSP to different CMOs might reflect differences in the popularity or commercial appeal of different repertoires, as well as the DSPs' independent retail pricing decisions.[17] If these effects were material, it would be wrong to simply look for causation from repertoire size to effective royalty rates, when an apparent relationship (or lack of one) might have been driven by factors far removed from the bargaining power of the CMOs. The Commission acknowledged some of the challenges in this empirical exercise, and may build on this experience in future investigations.

Licensing and stocking behaviour

Having found no signs of substitutability through these empirical exercises, the Commission then investigated other features of the market in order to corroborate this finding.

Pre-merger, the Parties' repertoires were widely considered to be individually important repertoires for DSPs wishing to operate successfully in Europe. Consistent with this, the Commission observed that DSPs typically licensed all repertoires, not merely a selection of repertoires as might be expected if repertoires were substitutes (as in the case of different brands of milk in a supermarket, where it is not necessary to stock every single brand in order to have a credible offering as a supermarket).

However, the implications of the DSPs' decision to stock all repertoires, while intuitive in this case, might need to be more carefully considered in other contexts. It cannot be presumed that where a supplier chooses to stock all (or even a large selection of) brands this is proof that those brands are complementary. For example, if an online retailer choses to stock 10 brands of USB stick for sale, this would not mean that those brands of USB stick were complementary. Rather, this might reflect the low incremental costs of stocking additional brands online, and while an online retail offering might be more credible by offering 10 brands, there may be many candidate brands that could contribute to that level of credibility. In each case it will be necessary to consider the relevance and balance of these different effects.

In the case of the music industry, the decision to license all significant repertoires appears to have been substantially driven by the fact that, individually, these repertoires were each already important for the DSPs rather than substitutes for each other.

The Commission also sought to distinguish the case of CMO repertoires from earlier cases involving the aggregation of music publisher or recorded music company repertoires. It noted that as national CMOs the parties offered distinct types of repertoires, in particular focussing on different linguistic and cultural areas, and that, unlike publishers, who represent relatively homogenous, popular Anglo-American authors, CMOs' licences contain shares in almost every musical work registered in a CMO home country.

Bilateral Bargaining: A Study of the Cable Television Industry, The Review of Economics and Statistics, May 1999, 81(2): 326-340. In any event, this discussion relies on the assumption that the bargaining framework applied by the Commission indeed accurately captures the bargaining dynamics in the online licensing industry.

15. See http://www.ftc.gov/os/closings/comm/120921emifeinsteinstatement.pdf, "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."

16. Commission Decision paragraph 263.

17. Royalty rates are often calculated as a proportion of DSPs' retail prices, and may be further complicated by minima per stream or per download, or periodic lump sum payments; DSPs might choose to discount or promote certain repertoires more intensively than others, and such initiatives might even be part of their contractual negotiations with rightsholders.

However, it is difficult to see why these observations would affect the conclusion of substitutability, given that the Commission's other findings would likely also apply to the case of a large publisher or record company repertoires – any large music rights repertoire is also already likely to be important to large DSPs.

The Commission's broader assessment of licensing behaviour confirmed the results of its empirical assessment, that control over a larger repertoire would be unlikely to allow the JV to extract better licensing terms from DSPs.

Conclusion

Despite the outward appearance of a merger that involved a significant horizontal overlap, the Commission's decision clearly states that the aggregation of three large repertoires of media rights is not presumptively anti-competitive. This was attributable to the complementary nature of the Parties' repertoires, which in turn provided a clear pro-competitive incentive for a JV that would allow them to license those rights more effectively and efficiently.

The Commission's preparedness to assess any hypothetical theory of harm against the available evidence must be welcomed. In doing so, it acknowledged the challenges in some of the empirical assessments of evidence that were undertaken. If intuitive, high-level empirical exercises are significantly confounded by complicating factors, then it is necessary to properly account for these factors in order to achieve a reliable assessment. The Commission sensibly considered a wide range of factual evidence in its assessment, looking not only at direct evidence of differences in royalty rates, but also the testable predictions of its model, such as licensing behaviour by DSPs and CMOs.

The Commission's ultimate conclusion in this case, that the combination of three large repertoires would not lead to any increase in negotiating power, is in contrast to those in its recent investigations in this sector, and raises important questions regarding potential concentrations in other sectors which share similar economic features.