12 Views of the major record companies

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Introduction

12.1. In this chapter, we summarize the views of the five major record companies, BMG, EMI, PolyGram, Sony and Warner (together referred to in this chapter as `the companies').

12.2. In a letter dated 26 November 1993, we informed the companies of our provisional finding that they (and their subsidiaries in the UK) were members of a complex monopoly group, within the meaning of the Fair Trading Act, which engaged in one or more of the following practices:

(a) adopting similar pricing policies to each other for the various formats (CD, music cassette and vinyl) of `full-price' albums and singles;

(b) declining to license imports of some sound recordings in which the company holds the copyright and licensing others only on payment of a fee under the MCPS/BPI import scheme; and

(c) entering into contracts with artists which include terms that restrict the artists' ability to exploit their talent fully and restrict competition in the supply of recorded music (eg in clauses relating to the extent of copyright acquired, length of contract, exclusivity, options, obligations to exploit recordings, royalty rates, packaging and other deductions from royalties, and/or arrangements for accounting for and auditing royalties).

12.3. We invited the companies to comment on our provisional finding, and on a number of issues arising out of that finding. A summary of their views is set out below.

The competitiveness of the UK recorded music industry

12.4. All the companies maintained that the recorded music industry in the UK was both highly successful and very competitive.

12.5. BMG said that the industry was a British success story in international terms, with about one-sixth of albums sold world-wide coming from the UK. In 1992 the industry had domestic earnings of about £1.2 billion at retail level and overseas earnings of around £800 million. Given fair conditions of international competition, the industry would continue to prosper to the benefit of the British economy as a whole.

12.6. At the same time, it was a complex and finely balanced industry and externally imposed changes could easily upset that delicate balance. In particular, artists and record companies were in partnership together, but their relationship could only flourish with a fair allocation between them of the risks and rewards involved in developing, making and selling records. Thus, for example, if restrictions were imposed on record companies in the UK as to the terms on which they could contract with their artists, such that they could no longer expect a fair return on their investments, recording contracts in future would simply by signed elsewhere in the world, most notably in the USA.

12.7. BMG stressed the importance of copyright, which it said was the foundation upon which the music industry was built. It was essential that the value of its copyrights was preserved. Intellectual property rights protected both the industry and consumers from the distortions which resulted from piracy and home taping, and would become even more important to the health of the industry in the future in the new environment of multimedia and with the spread of digitalization which offered new means to deliver music.

12.8. As to the price of recordings, consumers were buying the experience of the music, not a commodity. Therefore, the process of pricing a record was determined by its perceived value to the public, not by the cost of the plastic. The price of a particular recording reflected what people were willing to pay for that perceived value in relation to the prices of substitute forms of entertainment. It was significant that there had been a considerable growth in the unit sales of CDs since 1988. The prices of records to consumers were, however, fixed by retailers not by record companies.

12.9. EMI said that record companies operated in a highly competitive environment, with intense competition on signing and retaining artists, on price, on marketing and promotion and on obtaining shelf-space for their recordings. They faced a constant threat from new entrants and were squeezed between powerful suppliers, in the shape of artists, supported by expert managers and lawyers, and powerful buyers, in the form of large retail chains. They had responded to this competitive pressure by offering consumers choice, quality and innovation at reasonable prices.

12.10. As a consequence of the competitive nature of the market, and in view of the considerable investment in the music industry, UK prices for recorded music were not high, either in absolute terms or by comparison with those in many other countries.

12.11. EMI maintained that the UK recorded music industry served its customers in the UK extremely well and that the high quality and popularity of UK artists contributed to the UK's relatively large share of the world market. Regulatory intervention in this market was unnecessary and could both damage the interests of consumers and undermine the UK's position as a leading exporter. The market forces which operated so powerfully in the industry today should be allowed free play.

12.12. PolyGram said it was strange that, given the success of the record industry and its contribution to the national economy, it should have become such a focus of concern in recent years. It was an industry in which internationally the UK had absolute and comparative competitor strength. The UK domestic market accounted for some 7 per cent of world sales. The industry's international success could be measured by comparing this domestic base with UK penetration of world sales; these were currently around 18 per cent, according to the BPI.

12.13. The industry was competitive, according to the usual criteria by which competitiveness was assessed. First, profitability was modest. Secondly, concentration in the market was also modest, particularly by comparison with the USA or France. Thirdly, all the evidence pointed to relatively low barriers to market entry; there was a vibrant and dynamic independent record sector which competed actively and very successfully with the major record companies.

12.14. PolyGram also stressed the importance of copyright protection in the operation of the UK market for recorded music. The scope of copyright protection (both temporal and in terms of the rights which it gave) in the general operation of the market for recorded music was designed to encourage efficient investment and overall economic efficiency. The consequence was that innovation had to be priced higher than at its short-run marginal costs. The copyright legislation had rightly recognized that limiting imitation and encouraging investment was in the best long-term interests of consumers.

12.15. Sony said that a number of factors were important in understanding the nature of competition in the UK market for recorded music. There was the investment required in new artists, a highly risky business since artists failed more often than they succeeded. Only by having the security of long-term contracts with artists were Sony and the other record companies able to take a long-term view of their investment in an artist. The imposition of shorter-term contracts would only benefit the small number of existing successful artists while aspiring new artists and independent record companies would suffer and the industry overall would risk stagnation from lack of investment in new artists and new music genres.

12.16. The record companies needed an adequate incentive in the form of prospective revenue to enable them to continue to take the risks inherent in investing in new artists. Sony's profits from the sale of copyrighted works did result in significant investments in the creation of new artistic works. Whether the market as a whole achieved the socially optimal level of investment was less easy to determine. But it would be dangerous to tamper with the current balance between risk and reward without clear evidence of excessive investment and rewards in the industry.

12.17. Sony said that the activities of the UK record companies in investing in new artists not only provided a cultural platform for the UK abroad but also generated employment and the development of skills and expertise in the UK in the extensive infrastructure of recording studios, musicians, sound engineers, producers, designers, managers and promoters who were involved in the UK record industry.

12.18. Warner pointed to benefits which the record buying public enjoyed as a result of the way in which the UK record industry currently operated; among these were the wide range of recordings placed on the market by the record companies and their signing of UK songwriters and artists; the continued technological development of the recordings supplied by the record companies, of which the MiniDisc and the DCC were the latest examples; the strength of competition in the industry, which had ensured that prices were reasonable in relation to the costs of the record companies and to prices elsewhere in Europe; and the international success of the industry, with the licensing of copyrights of UK-originated product overseas providing a substantial flow of income into the UK.

12.19. Certain aspects of the industry had been, and were, essential, Warner said, if these benefits were to continue. They were the maintenance of current levels of profitability, which were currently entirely reasonable; the continued protection of record company copyrights which were exercised reasonably and responsibly by record companies of all sizes; the maintenance of a balanced relationship with the other parties involved in the production of the recording, in particular the artist; and the continued existence of a wide range of retail outlets stocking a variety of music and formats.

The complex monopoly situations

12.20. BMG, EMI, PolyGram and Warner challenged the jurisdictional basis of the MMC's provisional finding of a complex monopoly in favour only of the five major record companies. They maintained that there was no material difference between the conduct of the majors in relation to the three grounds identified by the MMC and the conduct of record companies of whatever size. First, there was no evidence to support a contention that the prices charged by the independent record companies were significantly different from those of the majors. Secondly, the members of the BPI who operated the import licensing scheme included not only the majors but a large number of smaller record companies as well, who derived particular benefit from the practice in question; moreover, the same royalty terms applied to them as applied to the majors. Thirdly, many of the features of artist recording contracts referred to by the MMC were also likely to be found in the contracts offered to artists by independent record companies.

12.21. BMG said that it seemed wholly arbitrary for the MMC to have provisionally found that, with a market share in 1992 of 5.4 per cent by value and 5.1 per cent by volume, it was part of a complex monopoly while not coming to the same provisional finding with respect to MCA, a company which also engaged in the three specified practices and which had a market share in the same year of 4.1 per cent. EMI added that a number of companies not in this complex monopoly group were subsidiaries of large, amply resourced corporations, based in the UK or overseas, for example MCA (Matsushita); Echo (Chrysalis 75 per cent and Fujisankei 25 per cent); and Pickwick (Carlton).

12.22. EMI also said that, so far as it could see, the only feature which distinguished the companies identified as group members from other record companies was that the five engaged in record distribution in the UK and in many other territories. This fact appeared to EMI to be wholly irrelevant in the context of the reference, in particular given the nature of the practices that were provisionally found to give rise to a complex monopoly situation.

12.23. BMG, PolyGram and Warner took the view that the MMC were required by the terms of the Fair Trading Act 1973 to determine `in favour of what person or persons that monopoly situation exists'. That required the MMC to determine *all* those persons in whose favour the monopoly situation existed. It was not, in their view, open to the MMC arbitrarily to select certain persons in whose favour they believed the monopoly practice might or might not exist and omit others without a fully reasoned analysis demonstrating how the complex monopoly group was distinguished from other members of the industry; on the contrary, there must be a rational, objective and fully verified basis upon which to conclude that they had identified all those parties that operated some or all of the identified practices.

12.24. PolyGram said that it distinguished the provisional finding of the complex monopoly situation in this case from that identified by the MMC in the Ecando case. In that case, in recognizing that only the hall owners and their tied contractors constituted participants in the complex monopoly, the MMC were rightly distinguishing between two separately identifiable groups, which carried on different functions. But the MMC had not identified any proper reason for distinguishing the activity or conduct of the majors from the other record companies in the case of recorded music. Warner said that it did not interpret the Ecando judgment as giving the MMC a general discretion as to which of the companies to include as persons in whose favour the complex monopoly situation existed.

12.25. The MMC had apparently limited the group to the five majors on the grounds that those companies held some 72 per cent of the UK market and that they also had a significant market share at the international level. This, the MMC had said, had led them to the view that `the practices of the five companies effectively determine the practices of the UK industry as a whole'. In the companies' submission, this was an irrelevant consideration upon which to base a provisional finding and had not been substantiated by any evidence presented to the companies. Moreover, it represented a significant and unwarranted departure from previous MMC practice. In their previous reports on the supply of petrol, beer and motor cars, the MMC had included in the respective complex monopoly groups not only the largest players whose market shares accounted for the greater part of the market in question, but also smaller suppliers. Those smaller suppliers had also been found to be persons `in whose favour' the monopoly situation existed and the MMC had not thought it relevant in that regard to consider whether their conduct was influenced or dictated by the conduct of the major players.

12.26. EMI said that the commercial reality of the music industry was that the persons whom the MMC had excluded from the group, and who had accounted over a 20-year period for 30 to 40 per cent of the market, were a significant factor in the overall competitive equation. Only those companies which had not been in existence for an appreciable time when the inquiry started or who had not been active in the market could properly be omitted on the grounds of commercial reality. EMI also said that it did not understand what the MMC meant when they said that the companies `effectively determined' the practices of the industry as a whole. The latter was driven by competitive forces, not by the companies.

Prices

The pricing practice

12.27. The companies said that the provisional finding that they adopted similar pricing policies to each other for the various formats (CD, music cassette and vinyl) of full-price albums and singles could not be sustained, however the alleged practice was interpreted.

12.28. BMG said that so far as the relative prices charged for different formats as between the companies was concerned, CDs were now the standard carrier for audio products, and offered, through the quality of their reproduction, their extended playing time and their virtually indestructible format, considerable value to consumers. Consumers were not willing to pay the same price for the older analogue formats which did not offer the same value. As a result, record companies had no choice but to price CDs at a higher level than their vinyl and cassette equivalents.

12.29. But having a piece of music available in two or three formats at different prices was, if anything, pro-competitive; and it was likely that, if the price differential between the digital and analogue formats were to be eroded completely, prices for analogue formats would increase, while those for CDs might only be reduced only a little, if at all. Once the analogue formats no longer had a price advantage over CDs, they would be likely to disappear quite quickly, depriving consumers of choice.

12.30. EMI said that it was certainly a common feature of pricing by record companies generally, and not just by the majors, that where a new popular title was released on CD and also on cassette (or cassette and vinyl), the CD would generally (although there were many exceptions) be marketed at a higher price than the cassette (and vinyl, if any). This feature was not confined to full-price lines and EMI did not understand why the MMC had so confined the alleged practice.

12.31. EMI said it strongly resisted any conclusion that a higher price of CDs relative to other formats prevented, restricted or distorted competition, or was a manifestation of any lack of competition. On the contrary, this was the normal response by record companies to free market forces and, in particular, to the differing price elasticities of demand for CDs, on the one hand, and cassettes and vinyl, on the other. The record companies were operating in an environment in which various forces-competition from industry competitors, competition from new entrants, the bargaining power of suppliers (in the shape of artists) and of buyers (particularly the large retailers), and the threat from substitute products-forced them to make the right judgment about the price of CDs relative to other formats. If the price of CDs was set too high relative to those formats, that left room for competitors, including new entrants, to obtain greater sales and a higher return by setting a lower differential. Recent successful new entrants who had done just that included Naxos and other budget classical labels.

12.32. EMI noted that CDs were generally priced higher than cassettes in all markets around the world (where both were available), despite the different market structures and demand conditions.

12.33. EMI said that the structure of costs in the industry was also very important. The industry incurred appreciable fixed costs in producing the first copy of a new title, and the marginal cost of production was therefore very much less than the average cost. If prices were set equal to marginal cost, record companies would make a loss and go out of business. Marginal cost pricing was therefore unrealistic. Any interference with the ability of the record companies to price above marginal cost would lead them initially to reduce the number of titles they produced, with a view to reducing average costs, and later to their losing money and quitting the business. This would reduce consumer choice and competition

and operate against the public interest. EMI also pointed out that its average percentage margin on CDs was very similar to that on cassettes.

12.34. Moreover, since record companies did not make excess profits, any forced reduction in the absolute or relative price of CDs might result in a rise in the price of cassettes, all other things being equal. This might well have the effect of reducing the range of titles and prices of recorded music available to consumers.

12.35. PolyGram said that the MMC's own data suggested that there was significant variation in the list prices pursued by the major record companies for their full-price products of all formats, and therefore the provisional finding that the companies all had the same differential for their full-price CDs, cassettes and vinyl products could not be sustained. On the contrary, each record company appeared to be pursuing its own pricing policy according to the precise marketing mix which it wished to follow for its individual products.

12.36. Not only were there considerable differences in the individual price categories between individual companies, but also differences in these companies' discount structures. It was highly unlikely that discounts and returns offered by the majors on full-priced formats would be similar. Indeed, it would be an extraordinary outcome, given the wide variety of discounts made available by PolyGram and other record companies, and the highly competitive nature of discounts offered by the record companies in this regard.

12.37. Sony said that, by focusing on the relationship between dealer list prices for CDs and cassettes, the MMC had disregarded a significant number of other factors which, both individually and collectively, had considerably greater impact on the level of competition between the record companies. Sony concentrated its efforts on competing with other record companies through the promotional campaigns and dealer-specific discounting that it offered to retailers. Any assessment of the impact of record companies' pricing policies on competition should therefore take into account the effect of these promotional arrangements and discounts.

12.38. The pricing policies which Sony adopted were a response to the competition that it faced from the records of other record companies, to the strong purchasing power of the retailers and to the control that retailers exercised over the price to the consumer. It was therefore inappropriate to reach a conclusion about the effect of a particular element of a record company's pricing policy on competition without taking into account how that element formed part of the wider pricing policy and looking at the overall effect of that policy.

12.39. Warner said that the MMC had not identified the way in which the practice was alleged to prevent, restrict or distort competition or how levels of prices would be different in the absence of any such practice. Warner's published dealer price for CDs had been significantly lower than that of any other major record company from mid-1988 until September 1990. In introducing this price reduction, the purpose of which had been to bring its records into a lower retail price band and thus securing it a considerable competitive advantage at the retail level, Warner had clearly not adopted a pricing policy similar to that of the other majors. It was clear from the MMC's reports on *Flour and Bread*[1] and *Insulated Electric Wire and Cables*[2] that the MMC had to look at realized prices after the discount had been given, and not simply at the PPD, when considering whether there was really a coincidence of pricing.

12.40. The price of cassettes was strongly influenced by the fact that the customer had the opportunity to create an almost identical product for himself from a blank cassette at a fraction of the price. This had artificially deflated the price of pre-recorded cassettes over the years and was a factor felt equally by all the record companies.

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[1] *Flour and Bread: a report on the supply in the United Kingdom of wheat flour and of bread made from wheat flour*, HC 412, July 1977.

[2] *Insulated Electric Wires and Cables: a report on the supply in the United Kingdom and the export from the United Kingdom of insulated electric wire and cables*, HC 243, March 1979.

12.41. Warner said that the MMC's assertion that the difference in price between CDs and cassettes for full-price albums and singles bore no relationship to the costs of producing the different formats was of doubtful validity, at least in its case. Warner did not allocate costs to different formats; the actual costs of manufacture made up only a small element in the overall costs of the business and the major elements of costs in terms of A&R spend or marketing and publicity were not format- related. One could not therefore expect the difference in price to be attributable to an identifiable difference in cost.

Whether the alleged pricing practice results in higher prices than would otherwise be the case

12.42. We asked the companies whether the alleged practices (set out in paragraph 12.2) resulted in higher prices for recorded music in the UK than would otherwise be the case. The compan s said that none of the practices had this effect. In respect of the pricing practice, their reasons are set out below. (Their responses in relation to the other two practices are summarized in paragraphs 12.70 and 12.96 respectively.)

12.43. With respect first to the pricing practice, the companies said that the use of multiple formats at different price levels was characteristic of record companies generally (and companies in other industries), both in the UK and world-wide, and was a rational, economic response to ownership of intellectual property rights.

12.44. BMG said that, so far as dealer prices were concerned, it was clear from the MMC's market information that the dealer list prices charged by each of the companies for different formats varied quite widely; realized prices probably differed to an even greater extent. The only pricing policy which the companies had in common was that, for full-price albums and singles, prices for CDs were higher than prices for other formats, and that was simply a reflection of the greater value offered to consumers by CDs as compared with other formats.

12.45. EMI said that price differentiation by format resulted in greater sales, lower costs and lower prices and/or greater variety for the consumer, for the reasons given in paragraphs 12.30 to 12.32. This alleged practice did not affect the choice of price band or the price within a band at which records were marketed or the incidence of shifting albums from one price band into a lower band in the course of their life. The alleged practice had not prevented a massive growth in the sale of CDs in the UK and world-wide, nor had it inhibited EMI from releasing a large number of records at mid-price or budget price. Moreover, the alleged practice had not prevented CDs from rapidly gaining market share from other formats, nor had it prevented a large fall in the real average realized dealer price of CDs over the past decade.

12.46. PolyGram stressed that the initial full-price release was invariably the critical release, for unless the record was successful at this stage, its chances of achieving success later were limited. For this reason, most of PolyGram's promotional spend went on new releases. A copyright owner had to be able to anticipate receiving a sufficient return on his investment within the often short-term commercial life of the innovation and that implied that he should be allowed to price the innovative copyright work higher than its short-run marginal cost. At the same time, retailer power (as a result of which increasingly high discounts were negotiated by retailers) accompanied by the increasing levels of concentration at the retail level, ensured that there was no scope for record companies to charge higher prices for recorded music than would otherwise be possible.

12.47. Sony said that a number of factors affected its pricing decisions. First, variations existed even between the list prices of the companies' full-price albums and these variations were greater if mid-price and budget price records were taken into account. The differences would be greater still if record companies' realized prices were compared. Secondly, at retail level, prices were set by the retailers and record companies had little opportunity to price records individually. Thirdly, Sony had a limited number of pricing points for new releases, in respect of which it sought to achieve sales through dealer-specific discounts and promotional campaigns. Fourthly, the importance of chart success to the overall sales success of a record, and the fact that retailers and consumers tended to view records in the charts almost as commodity items, meant that there was little or no opportunity to premium price chart successes. Fifthly,

any attempt to promote new records through a low-price strategy needed to be combined with a wider campaign involving retailers in order to overcome the consumer perception of low-price products as low-quality products and to ensure that retailers passed on the lower price to consumers. Finally, although the opportunities for pricing strategies to be implemented at the time of release were limited, there were opportunities, which Sony used, to implement price strategies later in the life-cycle of a recording in order to promote sales.

12.48. Warner said that it had at all times pursued its own pricing policy, which was designed to maximize the range and volume of its recordings stocked and displayed by retail outlets and to enable the retailers to offer the consumer particular promotional deals both on new releases and on back catalogue material. It was also clear that the pricing policies of the record companies were not the only factor affecting the price at which recorded mucic was sold in the UK. In Warner's experience, the decisions of the retailers as to the appropriate retail margin were more important in determining the level of prices than either the dealer price or the level of discounts and rebates offered by the record company. Thus the willingness of the retail side of the industry to respond to the introduction by the record companies of mid-price and budget categories, and the popularity among retailers of offering shorter-term price reductions and special offers, had to be set against the effects of price banding by retailers and the reluctance, particularly on the part of the specialist chains of retailers, to pass on overall price reductions by the record companies.

Relative prices charged for CDs, cassettes and vinyl records

12.49. As to the question whether they were exploiting the monopoly situation by the relative prices they charged for CDs, cassettes and vinyl records, the companies said that their pricing policies were exactly what would be expected in a competitive market. The use of multiple formats at different price levels was a rational economic response to the structure and development of the market for recorded music, the structure of demand for that music and the ownership of intellectual property rights in that market. The enormous success of the CD format in the last few years demonstrated clearly that consumers valued the qualities which it offered, and were prepared to pay a higher price for it than for the cassette or vinyl record formats. There were many examples of consumers paying different prices for what was essentially the `same' product with somewhat different characteristics: for example, hardback and paperback editions of the same book; business and economy class tickets for the same flight; and differently-priced seats for the same concert. Similarly, differential pricing in the case of recordings was beneficial to consumers, artists and record companies alike, since it widened the range of goods available in the market-place, increased the volume of goods sold and was evidence of a competitive market. By contrast with other sectors dominated by intellectual property, such as books and films, music formats were not marketed by withholding one format now and releasing another at a later stage. Record companies did, however, charge different prices for those formats which they considered were of the highest quality and for which consumers were prepared to pay.

12.50. Quite apart from differently-priced formats for the same recording, within each format different recordings were available at a huge range of different prices, as was shown by the MMC's own market information. Moreover, mid- and budget-priced recordings were taking up an increased share of album sales. As for the price of CDs, these had followed the usual pattern with new technologies, and there had been a significant reduction in the real price of CDs over the period 1983 to 1992 as they had become the most popular format. Any pricing which aimed to decrease the differential between cassettes and CDs in order to encourage the sale of CDs would risk destroying the market for cassettes without causing a corresponding shift of purchases to CDs. All these factors created a situation which was wholly inconsistent with the notion that the companies collectively were following any particular policy with regard to the relative prices of the different formats or that a monopoly situation was being exploited.

Price differences between the UK and other countries

12.51. We asked the companies what was the extent of the price differences between the UK and other countries and the explanation for these differences. In responding to these questions, the companies referred to the survey of retail prices commissioned by us and carried out by BMRB and to individual dealer price company surveys which they themselves had carried out in the course of the inquiry.

12.52. BMG said that it was not in a position to comment in detail on the extent of the price differences between the UK and other countries. It noted with interest, however, the findings of the BMRB survey of international retail prices, which had found that the USA was the cheapest, no matter what the genre or format or whether with or without tax, and that Britain and Germany were generally the next cheapest for both CDs and cassettes, with France and then Denmark as the most expensive. That survey also showed that the average price differential was very much smaller than was popularly supposed, being only 11.7 per cent without tax for a full-price CD; with actual differentials ranging between 3.1 and 18.6 per cent.

12.53. It was also very important, BMG said, to note that the BMRB survey covered only full-price recordings and did not deal with budget or mid-price product. It pointed to research by BIS Strategic Decisions which showed that on the basis of a weighted average across the price range, prices in the UK ($12.6) were in fact lower than prices in the USA ($13.9), and substantially lower than elsewhere in Europe where they ranged from $21.4 in Denmark to $15.6 in Switzerland.

12.54. Both of these studies had been based on an examination of retail prices. BMG said that decisions on the level of retail prices in the UK were made by the retailers and not by the record companies. An examination of overall dealer prices from data supplied by the BPI and Record Industry Association of America showed the average differential between the UK and the USA to be very much smaller than the average differential in retail prices, ie only 2.5 per cent.

12.55. Commenting on the principal conclusions to be drawn from the BMRB survey of retail price comparisons, EMI said it broadly accepted the MMC's finding that full-price pop records in the USA were priced between 10 and 12 per cent higher in the UK than in the USA at an exchange rate of £1:$1.54. However, EMI had a number of reservations about the BMRB survey, the main one being that the sample was restricted to only 14 titles. The survey was therefore statistically insignificant.

12.56. EMI had conducted its own study to investigate the extent of EMI dealer, rather than retail, price differences between the UK and other countries. That study was designed to strip out the effects of local retail conditions. It had involved three price comparisons: gross dealer price comparisons for 100 titles across nine countries; gross dealer price comparisons between the UK and USA for 200 titles; and average realized price comparisons across seven countries. The study had shown that price differences as between the UK and other countries surveyed were generally in favour of the UK consumer. UK prices compared favourably with those in countries such as Japan, Germany, France and most of the rest of Western Europe, and only in the USA could prices sometimes be said to be lower. In particular, while the results of the UK/US gross dealer price comparisons varied from an unfavourable to a favourable outcome, depending on the exchange rate used to translate dollars into sterling, the results of the CD average realized dealer price comparison did not; the UK was cheaper than the USA regardless of which exchange rate was used. If classical recordings were separated out from EMI's sample survey of gross and realized dealer prices, the differential between UK and US prices, at an exchange rate of $1.49, was in the range of 2.5 to 10.5 per cent in favour of the USA.

12.57. PolyGram said that, for its own products, the average wholesale price for all CDs was lower in the UK than in any country other than Sweden. When all CD albums were considered together, the average realized price was lower in the UK even than the USA. Therefore, while both the BMRB's retail survey and PolyGram's assessment of its own dealer prices confirmed that full-price albums were cheaper in the USA, when mid-price and budget albums were also considered, average prices were lower in the UK. So far as the average wholesale prices for all PolyGram classical CDs were concerned, its analysis showed that the UK ranked eighth in terms of cheap classical CDs, some 10 per cent cheaper than the USA but marginally more expensive than Northern Europe and Scandinavia, Australia and Canada.

12.58. At retail level, the BMRB survey confirmed PolyGram's belief that UK prices for full-priced products were lower than in most other European countries. PolyGram was also pleased to note that the survey confirmed higher levels of availability in the UK than in most other EC countries. While the survey also confirmed that prices in the USA were lower than in the UK, this differential did not exceed 10.5 per cent. PolyGram said, however, that it had a number of reservations about the methodology of the BMRB study which made it difficult to draw definitive conclusions from the results.

12.59. Sony said that it was necessary to consider separately the price at which record companies supplied their customers (dealer or wholesale price) and the retail price. As to the prices charged by record companies, a comparison of Sony's own dealer prices after average discounts for a range of formats in the UK, Germany, France, the Netherlands and Denmark showed prices in April 1993 in the UK being the lowest across the range of formats. Differences in price, however, depended to a great extent on the exchange rate used. The dramatic effect of exchange rate fluctuations on relative prices between markets could be seen from a comparison of Sony's average net wholesale price for CDs in 1992 with those of its US counterpart. Based on an exchange rate for 1992 of £1:$1.754, the UK price was 79p higher than in the USA. In the first six months of 1993, when the exchange rate averaged a lower £1:$1.509, the UK price was 91p lower than that in the USA.

12.60. Turning to retail price differences, Sony said that it had not undertaken any detailed analysis of retail prices in Europe. The BMRB survey, however, although limited in the number of titles and therefore not wholly representative, indicated that retail prices in the UK were generally below those in other European countries.

12.61. As for retail price differences between the UK and USA, Sony said that it had carried out its own survey in these countries, covering a wide range of titles from its current UK catalogue, 85 in all, and including chart, non-chart and a range of specialist records. The same 85 titles were used in the US survey. Mid-price as well as full-price records were chosen. Sony said that the results of its survey showed pre-tax price differences which were significantly less than those found by the MMC. Non-classical CDs in the UK were on average only 58p more expensive than in the USA; for cassettes, the difference was 77p. For classical CDs, it was more difficult to obtain comparable titles in both countries, but for CDs where 15 titles could be compared, the UK prices were 73p higher on average than in the USA; and for eight comparable titles on cassette, the difference was 95p.

12.62. Sony said that its own survey, because of its broader coverage and Sony's additional information on sales, provided some additional insights into the nature of price competition in the two markets. First, the selection of popular titles had a strong influence on the results of any price comparison. In the Sony survey, five titles alone made up over 55 per cent of sales in the samples in both countries. The pre-tax price differences on these titles varied considerably from title to title and prices were heavily discounted in both countries. Secondly, there was a high frequency of titles for which the UK price was lower than the US price-19 in the non-classical survey. Thirdly, the Sony survey showed that in the UK there was a greater dispersion of prices across titles than in the USA; the maximum price was always higher in the UK but the minimum price was often lower. Fourthly, there appeared to be as much variation in the pre-tax prices within the USA as between the UK and USA; widely differing retail prices could therefore occur within a single market.

12.63. Warner said that the BMRB study broadly confirmed its view that the prices in the UK were lower than elsewhere in Europe but higher than those in the USA. Warner considered, however, that far from disclosing `some very strong and consistent patterns' in the prices of pre-selected recordings in the different territories, the BMRB report had in fact demonstrated very little consistency in the relativities between the different countries. Warner took the view, therefore, that had a different range of albums been selected for the survey, a very different picture might have emerged. A further factor suggesting that there was in fact no strong or consistent pattern in pricing across the countries surveyed was the difference in price relativities between CDs and cassettes. For example, while France had consistently the highest prices for CDs without tax across all titles, this was not the case for cassettes, where in two cases it was cheaper even than the USA; and while Denmark had the highest cassette prices both before and after tax, for CDs it lay in fourth place in the pre-tax prices. Warner added that it was important to recognize that the process of averaging the prices charged in the BMRB survey masked the practice of retailers of setting their own retail

prices in clearly defined bands, for example £8.99, £10.99 or £13.99 for CDs and £4.99, £5.99 and £7.99 for cassettes.

12.64. In the companies' view, there were a number of reasons for variations in gross and realized dealer prices as between different countries, including the size and competitiveness of the local market, differing manufacturing and distribution costs, the degree of retail power and concentration, the role of intermediaries, different legal regimes, the local cost of living, differences in musical tastes and the local levels of disposable income.

12.65. So far as differences specifically between the UK and USA were concerned, `structural' differences, including higher sales tax and property costs and lower labour productivity and economies of scale in the UK, were also likely to be key drivers of higher retail prices here. Factors particularly affecting different dealer prices in the two countries were: the huge disparity in the sizes of the two markets; the different distribution patterns; the higher level of retail concentration in the UK which gave record companies' customers considerable power in negotiating discounts and other favourable terms; the longer manufacturing runs in the USA which led to substantial savings in manufacturing costs in that country; and the lower per unit cost of the A&R departments in the USA because of the size of that market in terms of volume sales. This volume difference meant that in the USA the costs and risks were allocated over a wider base, resulting in a lower unit cost and hence lower prices. The policy of originating a wide range of different kinds of music was a much less risky policy in the USA than the UK since a record was likely to generate the number of sales needed to recover the costs even if it was not a major hit. Accordingly, a higher proportion of albums released in the USA was profitable compared with the UK.

12.66. Another important difference between the two markets which affected the relative costs and risks was the higher level of advances and royalties paid to UK artists than US artists. Record companies in the USA paid lower average artist royalties than their counterparts in the UK and, as a result, lower advances. Another factor which helped to keep US advances below the level of those in the UK was that the competition for finding and signing new talent was less fierce in the USA than the UK, since the wider geographical dispersal of potential artists in the USA meant that US A&R departments were less likely than those in the UK to be bidding against rival record companies in particular cases.

12.67. EMI said that the UK/US differential was typical of the generality of other goods and services at present rates of exchange, but had hitherto been exaggerated by partial (in both senses of the word) investigations that had told more about exchange rates than about competition or lack of it in the UK music industry.

12.68. Sony believed that the general perception among the public of retail price differences in the USA and the UK might well be distorted by a failure to take account of US sales tax. Whereas VAT in the UK was incorporated into the shelf price of a record, US sales tax was not, and its effect on the price of a record only became apparent at the store cash till. Further, Sony thought that public perception had been affected by a lack of awareness of the dramatic differences between the levels of US sales tax and VAT.

12.69. PolyGram added that willingness to pay was certainly higher in the UK than the USA, despite higher US incomes. This might be due to the greater range of leisure activities available to US customers and to the lower prices of these other leisure activities. All in all, the US consumer had more alternatives competing for a share of leisure spend and the prices of these alternatives were relatively low, so it was not surprising that UK consumers were willing to pay more than their US counterparts for recorded music.

MCPS/BPI Import Licensing Scheme

The import practice

12.70. The companies emphasized the fact that the right to decline the licensing of imports derived not from the MCPS/BPI Import Licensing Scheme (the Scheme), but from UK law (section 27(3) of the 1988 Copyright Act). They also pointed out that this position under UK domestic law was consistent with the EC's Rental Directive, which had to be incorporated into the laws of all member states by 1 July 1994. Their policy on licensing was accordingly a normal and legitimate exercise of their intellectual property

rights, and it was well settled under both EC and UK competition law that a party did not prevent, restrict or distort competition simply because it declined to license third parties to use its property. It was also relevant to note that UK copyright law was an integral part of an international network of historical and current Conventions, which were recognized internationally as providing an appropriate balance between the interests of consumers, creators and risk-takers.

12.71. Far from acting as an impediment to importation, the Scheme facilitated imports and thus enhanced competition in the UK. Without the Scheme, such importation would be largely impracticable because of administrative problems associated with the obtaining and granting of licences from and by the rights-owner concerned. In any case, the companies said that they exercised their ability under the Scheme to stop imports of particular records very sparingly, and only for legitimate marketing reasons or for the prevention of piracy.

12.72. EMI said that there was no reason to suppose that abolition of the Scheme would by itself make importing any easier. Indeed, many independent record companies were not members of the Scheme and it was very difficult, if not impossible, to get permission to import their records. By contrast, members of the Scheme operated a liberal regime whereby there was a general open licence subject to a right to withdraw that licence. The right had been exercised infrequently by EMI, although it was likely that independent record companies belonging to the Scheme exercised such rights rather more frequently. It therefore appeared paradoxical to single out the Scheme and the majors participating in it for criticism, whilst ignoring the conduct of those who were responsible for the majority of licence withdrawal under the Scheme, or of those who did not participate in it. Any distortion of competition would seem to be due rather to those latter groups.

12.73. Referring to the licensing of imports only on payment of a fee under the Scheme, EMI said that if the alleged practice at issue was the charging of a royalty in itself, rather than the level of that royalty, then it was not open to the MMC to make a provisional finding, since again, EMI was simply exercising a property right derived from UK and EC law. If on the other hand it was the level of the royalty rates that was considered to prevent, restrict or distort competition, then EMI did not know what lower rates could be thought not to do so. The present royalty rates had been held constant in money terms for six years, ie since the introduction of the Scheme in 1988, and had therefore fallen in real terms by over a quarter. The royalties were shared between the record company and the music publisher. EMI's total annual receipts under the Scheme had been economically insignificant. If the Scheme were brought to an end, the royalty rates that EMI would itself charge, were it willing individually to administer import licences, would certainly be no less and would almost certainly be greater than its half share of the Scheme royalties.

12.74. PolyGram said that it had no specific corporate policy in relation to the licensing of parallel imports and each individual case was considered on its own merits. Sony said that the only `conduct' in which it had engaged had been to permit imports through the Scheme except in what the MMC had itself admitted was a limited number of cases each year. Warner said that it understood from the BPI that in 1992 a total of 95 import bans had been issued under the Scheme, 45 of those by the majors and 40 by independent record companies. Warner itself had not issued any bans in that year.

12.75. Warner said that the levying of a fee under the Scheme could not amount to conduct of a kind contemplated by section 6 of the Fair Trading Act. It could not be suggested that a complex monopoly existed in any industry where the suppliers all chose to charge for their product instead of giving it away free. The Scheme obviated the need for the importer to negotiate a licence fee for each particular recording; a flat rate was applied to all recordings, regardless of the status of the artist. This enabled the importer to know the level of fee in advance and to determine on that basis whether importing was commercially attractive.

Effect on prices of the Scheme

12.76. Turning to the effect on prices of the alleged practice regarding the Scheme, BMG said that it was clear from the MMC's own research on international retail prices that the ability to control imports had no effect on prices. That research showed that the lowest prices for recorded music were generally to be found in the UK and the USA, and that the highest prices were generally to be found in France and Denmark. In both the UK and the USA copyright owners had the right to control imports; in France and Denmark they did not. It was also highly questionable whether imported products were necessarily cheaper than domestically-produced ones, once the costs of importation were taken into account. In fact, it was not uncommon to find that imported recordings were more expensive. There was the further consideration that if controls on imports were removed unilaterally by the UK, other countries, particularly the USA, might retaliate; this was a danger which even the NHC had recognised.

12.77. Referring to the question whether the statutory rights conferred by the 1988 Copyright Act, rather than the Scheme itself, resulted in higher prices than would otherwise prevail, EMI said that the answer was complicated. In the absence of such rights, parallel importers could bring in non-pirate recordings from any third country without paying any royalty. However, the opportunities for profitable importing were limited and even where they arose, the main benefit might accrue to the importer rather than to the consumer. Moreover, EMI said that there appeared to be no correlation between the general level of prices for records in a country and the degree of protection, if any, against parallel importation enjoyed by rightsholders in that country; for example, the USA, which excluded parallel imports, was a relatively low price territory, whereas Denmark and the Netherlands, which had not so far afforded protection against parallel imports, were relatively high-price territories. It was therefore to be doubted whether, if unrestricted parallel importation were possible, it would appreciably affect the price level in the UK.

12.78. To the extent that abolition of the rights in question were to lead to any significant increase in parallel imports from third countries, the titles likely to be affected would be the `best-sellers'-certainly, the evidence from other countries with lower levels of protection from parallel importation suggested that that would be so. But it was precisely those titles that were most likely to be the subject of split rights, so that there would be no certainty of the UK rightsholder's loss being compensated for by a gain on the part of one of its overseas associates. The overseas supplier and the export-import agency would therefore be in the classic position of free-riders. Even in the absence of split rights, parallel importation of large numbers of best-selling records would play havoc with the UK rightsholder's marketing, promotion and manufacturing plans and consequently with its financial results.

12.79. PolyGram said that its own research on cross-country comparisons showed that there was no evidence that licensing controls led to higher prices; or that removing controls on parallel imports led to lower prices to the consumer. Parallel importation was a free-rider activity which involved no local investment or commitment to productive activity in the UK. The continued existence of copyright protection against imports safeguarded both record companies and artists; its removal would have a number of adverse consequences, including a decline in investment in new artists, who would be more likely to sign overseas where record companies retained the means and incentive to invest; an increase in the extent to which existing catalogue was recycled; an increase in investment in broken, established artists, resulting in less innovative music; and an increase in the amount of US (and other foreign) music in UK record shops.

12.80. Sony said that for parallel imports to lead to lower prices for recorded music in the UK, a number of conditions had to be met. First, the wholesale price for the product had to be sufficiently lower in other major markets than in the UK to cover the transport and other costs involved in importing into the UK and supplying retailers and wholesalers. However, at least so far as Sony was concerned, comparison of the average wholesale prices in the UK and the USA for 1992 and the first six months of 1993 did not indicate significant differences at present. In these conditions, the necessary price differential for parallel imports to occur was only likely to arise where there were further significant exchange rate fluctuations-and here, imports were likely to be opportunistic imports of large quantities-or where the importer was able to achieve significant discounts off the average US wholesale price by placing individual large orders for a single title.

12.81. Secondly, the parallel imports had to be available at a time and in quantities to meet UK retailers' and wholesalers' requirements. Because retailers received a number of service benefits from the distribution operations of UK record companies (for example, rapid delivery of small orders, promotional support) which parallel importers would be unable or unwilling to match, parallel importing would not occur across the full range of titles currently supplied by the UK record companies. Consequently, Sony believed that, even if the existing legislation were changed, imports would only occur in two circumstances, namely niche demand for records not available from UK record companies and volume imports of selected titles, typically major stars and chart successes.

12.82. The third condition necessary for parallel imports to lead to lower prices was that retailers had to pass on the lower wholesale prices to the consumer. In the case of niche recordings, there was no incentive for the retailer to pass any cost savings on to the consumer, while in the case of volume imports, there was no guarantee that retailers would do so. As to chart successes, these tended currently to be sold at lower prices by retailers. It was therefore doubtful whether they would be prepared to offer further discounts if they parallel imported this material.

12.83. Warner considered that, in so far as the Scheme had any effect on prices, it operated to reduce the level of prices in the UK. The charging of the current fee of £1.25 for a CD could not possibly be regarded as excessive; it was not designed to bring the price of the imported product up to the price of the locally-marketed product, nor did it do so in practice. It would not be in the public interest to deprive the record companies of their right to license their copyright for a fee. In any case, half of the £1.25 fee was given to the MCPS for distribution to its members and the record company therefore only received 62.5p. The public interest lay not simply in obtaining cheap product but in ensuring that the creative skill of the record company and the holders of the other copyrights in the record were adequately rewarded.

12.84. The operation of a flat fee for all recordings also served to reduce the price level of the product, because it encouraged importers to take advantage of any price discrepancies that existed across the whole repertoire of the record companies. Whether or not consumers received the benefit of the lower prices charged to the retailers by the importers of product would depend on the pricing decisions of those retail outlets. Warner's experience of the industry did not lead it to believe that cost savings made by retailers from buying in imported product would necessarily be passed on to the consumer. Warner noted that the MMC's survey of prices in different countries had shown that Denmark's before-tax prices were generally much higher than those in the UK, despite the absence of any national provisions restricting parallel imports into Denmark.

Contribution of the Scheme to the prevention or detection of piracy and to the success of the UK recorded music industry

12.85. We asked the companies whether the right to control imports and the operation of the Scheme contributed to the control of piracy and to the success of the UK industry.

12.86. The companies said that record piracy was a complex, global problem which had been increasing dramatically in recent years. The right to control imports and the existence of the Scheme undoubtedly contributed both to the prevention and the detection of piracy. By having a scheme in place which controlled flows of imports from countries outside the European Union by the fixing of stickers on to incoming commercial product, illegitimate products were the more readily detectable, whether pirated or unauthorized imports. It was often extremely difficult to distinguish pirated from legitimate product and to do so required co-operation not only within the recorded music industry under the Scheme, but also from UK Trading Standards Officers and Customs and Excise. The Scheme also fostered co-operation between importers and the record industry, and importers were regularly able to provide information about suspected pirate imports.

12.87. If imports could take place free of copyright restrictions, the industry would then have much less involvement in imports by third parties, and it would be much more difficult for customs officials on their own to distinguish between a pirate recording and a legitimate one. There appeared to be a link between levels of sales of pirate records and the ability to use local laws to control importation of copyright-protected products. The UK had one of the lowest levels of piracy in the world, and one of the highest

levels of piracy seizures in the European Union, while levels of piracy in countries with significantly lower levels of protection against imports appeared to be higher. The IFPI, for example, reported in its 1992 Review that pirated product was estimated to account for 9 per cent of total unit sales in the Netherlands.

12.88. Turning to the question of the contribution which the right to control imports and the Scheme made to the success of the UK record industry, the companies said that the right to control the distribution and exploitation of a copyright work was vital to such success. In and of itself, the Scheme was of no great significance and generated only a tiny income for the record companies. Nevertheless, it was a manifestation of the rights of copyright owners and embodied principles which ensured that competition between the UK and its international competitors was fair. Effective copyright protection was at the very heart of the success of the UK music industry.

12.89. The right to control imports protected record companies' ability to earn a return on the small percentage of releases which were successful, and which were vital to record companies' profitability. The evidence from other markets with lower levels of protection against imports was that it was precisely those titles on which parallel traders were most likely to concentrate their activities. It was also those titles which were most likely to be the subject of split territory deals, particularly in the case of independent record companies but also very frequently in the case of the majors. If record companies lost the right to control imports from North America of those albums to which they held only non-North American rights, their own UK sales of those albums would be reduced, perhaps significantly. That in turn would affect their ability to reinvest in new repertoire, and would also impinge on the artists' rights to grant copyrights for individual territories as he or she thought fit. Over time, the UK's continuing position as a major source of international and domestic repertoire would undoubtedly be affected by a withdrawal of the right to control imports, with serious consequences for all elements of the industry.

12.90. Parallel imports into the UK effectively `free-rode' on the marketing and promotion expenditure of UK record companies and loss of revenue from units it would otherwise have sold would further prejudice the UK record companies' capacity to invest in new artists; such investment was vital to the UK as one of the two major sources of international repertoire. Artists, too, would be damaged by unrestricted importation, as it would be more difficult for the artist to track royalties and ensure proper payment; moreover, exports would increase from countries in which the artists' royalty was lower than in the country of importation. Music publishers also had a major interest in protecting their investment in the relevant UK rights in sound recordings.

12.91. More immediately, the ability of record companies to place a ban on recordings, particularly from the USA, before the record was released in the UK was a vital element in securing the effectiveness of a UK record company's launch campaign. The infiltration of products from the USA in such circumstances would undermine the impact of the promotional campaign and diminish the chances of the recording achieving a chart position on the basis of the initial sales figures. It was also likely to be more difficult to persuade retailers both to stock and promote the recording. Ultimately, the possibility of imports reaching the UK market ahead of the UK release date might result in reduced total UK sales of the recording, to the detriment of record companies, artists and writers.

12.92. BMG noted that the Australian Government had recently reversed its decision to accept a recommendation by the PSA that copyright restrictions on parallel imports into that country be removed. A report which it had commissioned on the implications for the industry of such a move showed that there was disquiet and loss of confidence within the Australian record industry at the prospect of the removal of protection, which was thought likely to have a major adverse effect on investment, to lead to an increase in the level of piracy in Australia, and to act as a constraint on the industry's capacity to grow and develop.

Independent record companies and the Scheme

12.93. We asked the companies whether certain independent record companies, in particular those represented by Umbrella, were being excluded from the Scheme in order to restrict their ability to compete in the UK.

12.94. The companies said that the only reason why an independent record company was excluded from the Scheme was because it was not a member of the BPI. There was nothing to prevent any member of Umbrella joining the BPI and the fee was nominal. By joining the BPI, an independent could then benefit from the Scheme, as well as all the other services offered by that body. PolyGram said it noted that Umbrella's Memorandum of Association specifically prohibited any major record company from joining that organization.

12.95. In any case, it was difficult to see on what possible basis an independent record company's ability to compete could be jeopardized by the operation of the Scheme, since it was open to any such company simply to allow importation of recorded works of which they were copyright owners in the UK or, alternatively, to exercise their rights to refuse to license such importation. Moreover, the core business of many of these companies was making records in the UK for sale in the UK and although in a few cases overseas rights might be licensed, this occurred on a very limited scale for the kind of companies represented by Umbrella. EMI suggested to us that it would be possible to design an industry-wide import scheme open to all record companies.

Artists' contracts

The practice

12.96. The companies said that all recording companies-majors and independents alike-included, to a greater or lesser extent, terms such as the MMC had identified in their contracts with artists (the term of the copyright, the length of the contract, options, obligations to exploit recordings, royalty rates, packaging and other deductions from royalties, and/or arrangements for accounting for and auditing royalties). It was hard to see how there could be a recording contract at all if it did not deal with such matters or how record companies could carry on their business without such contracts. Nor did these contracts constitute a general practice which restricted either party, since both parties were creating new rights and were assuming obligations which they did not previously have.

12.97. There was no such thing as a `standard form' recording contract. All recording contracts were actively negotiated on an individual basis, often in circumstances where a number of companies were competing fiercely with each other to sign a particular artist. The negotiating process could take anything from six weeks to three months. Artists were almost invariably represented in the negotiations by lawyers and managers whose job it was to ensure that the terms finally agreed were the best that could be obtained. Not only were there very wide variations in the terms offered by each company, but each of them might well have a very different approach to the relationship with its artists. Moreover, it was quite wrong to suggest that the companies regarded many of their terms as non-negotiable; record companies were responsive to requests to renegotiate contracts, particularly, but by no means exclusively, in the case of successful artists.

12.98. PolyGram added that there might be circumstances where the enforcement of (but not the entering into) a contract might operate in restraint of trade and it was precisely for that reason that the common law doctrine of restraint of trade had developed. However, in reaching any determination as to whether enforcement of such a contract did operate in restraint of trade, there was no hard and fast rule and it depended ultimately on the facts of each case, taking into account a number of relatively general legal principles.

12.99. The companies said that contracts with artists accomplished a variety of pro-competitive rather than anti-competitive goals. They operated to enable the record companies to maximize sales, to increase product quality, to enhance productive efficiency and to take the very significant risks in investing in new artists. Without such recording contracts, another company would be able to sign an artist after the first company had heavily invested in the development and promotion of that artist and would thus be able to free-ride on that development and promotion. If that occurred, record companies would find it considerably less attractive to invest in new artists. They had to be able to count on artists who succeeded to cover the costs of those who failed, thereby spreading their risk across many artists. It was only by concluding contracts which embodied such terms as retention of copyright, exclusivity and a reasonable length of contract term that the companies could reap the necessary long-term benefits for those few artists who succeeded and that the artists who succeeded could reap the long-term benefits in their development and career.

Exploitation of the monopoly situation

12.100. We asked the companies whether the terms of their contracts with artists amounted to an exploitation of the monopoly situation.

12.101. The companies said that the contracts they had with artists did not reflect any lack of competition between record companies to secure and retain those artists' services; although there were similarities in the legal structure of contracts, the key terms, including advances, royalties and term, were all vigorously negotiated in each case. There was nothing to suggest that the potential rewards were insufficient to attract an adequate supply of recording artists and indeed the size of advances and royalties had increased substantially in recent years, reflecting a shift in the balance of power in favour of the artist at the expense of the record company. In this sense, therefore, there was no market failure. At any one time, there was active competition for the services not only of new artists but also of established and superstar artists. The terms of artists' contracts did not, therefore, present an obstacle to expansion by established record companies or to new entry by companies currently outside the industry. While it was true that the opportunities for buying-in established and superstar artists would be enhanced if the duration of artists' contracts were shortened, such a development would result in a shift by established companies from their well-tried policy of developing their own artists. Moreover, only the larger record companies with deep pockets would be able to take advantage of such opportunities.

12.102. As to retention of copyright, there was no benefit to the public interest in a successful artist acquiring control of the copyright in his recordings. An artist's only avenue for protecting and exploiting his copyright was to license it to a record company and this was achieved by auctioning it to the highest bidder. The consumer did not benefit because he was primarily interested in the artist and only to a limited extent in the particular label on which the recordings were released. There was a public interest in freedom of contract as well as in freedom of trade and in so far as the artist accepted contractual obligations, he or she received consideration for so doing in the shape of greater remuneration or remuneration on a more attractive basis than if those obligations had not been accepted. Where freedom of contract was abused, the law provided redress. But the expenditure by a record company on an artist represented an investment risk which would benefit both the artist and the record company if the risk paid off; if it did not, the record company would lose its money, whereas the artist would not only lose nothing but would also have received substantial advances on royalties which he or she would be under no obligation to repay to the record company. Investment in nine out of ten artists was not fully recouped.

12.103. Far from restricting artists' ability to exploit their talent fully, artists' recording contracts were precisely the means by which they were able to exploit that talent. A recording contract gave an artist not merely the opportunity of a recording career, but also the chance to earn significant income from touring, publishing, merchandising deals and public appearances. The artist could also exploit his or her talent by taking on session work, producing, remixing and soundtracks; the record company received no income from these activities, yet without the initial investment by the record company, these opportunities would not become available. If material modifications were made to the key provisions in recording contracts, dealing in particular with the extent of copyright acquired by the record company, the length of the contract and the exclusivity provisions imposed on the artist, then the companies would be forced to take a much

more short-term view of their relationship with artists, which would not only be detrimental to the long-term development of those artists, but which would inevitably mean that the companies would not be able to invest as widely in new UK artists as they did at present. This would have the wider effect of reducing the numbers of artists who signed with UK record companies, to the detriment of UK artists and the industry alike. PolyGram added that the record industry could not be viewed in pure risk reward terms because, first, the services supplied by artists were not homogeneous and the industry was characterized by extremely high rewards for a few stars; secondly, the star artist was in an extremely strong bargaining position; and thirdly, other than in relation to star artists, there was an endemic oversupply of talent in the industry.

Effect on prices of the companies' contracts with artists

12.104. So far as the effect on prices of the terms of the companies' contracts with artists was concerned, the companies took the view that those contract terms generally operated to keep prices down. Record companies took very considerable risks in signing new artists. They were able to continue to justify investment in new artists at present levels only because they were able to generate sufficient sales revenue (both in the UK and from overseas sales) from those artists that were successful to offset the losses that they made on the majority of their signings. Changes to recording contracts which had the effect of materially limiting the companies' ability to benefit from their initial investment would, on the basis of current levels of profitability, mean either that record prices would have to rise or that investment in new artists would have to be curtailed, all other things being equal.

12.105. By having contracts which lasted for a reasonable period of time, the companies were able to take a longer-term view of the likely returns. By exercising a limited number of options to continue the term of the contract, record companies had the opportunity to reinvest in situations where the commercial potential had not been fully realized. Exclusivity served to protect the investment made by a record company in a particular artist; in the absence of exclusivity, other record companies could free-ride on that company's investment; the resulting impact on its ability to earn profits from its successful albums could only lead to increased prices at the time of release. Further, the removal of exclusivity would result in a greater proportion of the record companies' budgets being devoted to bidding for the `stars', to the detriment of new artists with minority appeal. If contract terms were shortened, the record company would seek to earn a return over a shorter period of time. Again, this would be likely to result in higher prices. The same considerations would apply to any enforced curtailment of the companies' interest in copyright.

Producers' rights

12.106. We asked the companies whether they were exploiting the monopoly situation by not recognizing any rights of producers as first holders of copyright in the sound recordings they produced.

12.107. The companies said that the role of the record producer varied considerably so far as his or her involvement in the production of a sound recording was concerned. Although often making a significant creative contribution, the producer by no means always did so. A very small number of record producers, such as Pete Waterman, took the risks in funding and undertaking all the arrangements for records they produced; but in most cases, the producer took no risk. In practice, the role of the record company was closer to that of a film producer in relation to the making of a sound recording: the film producer took a financial risk, obtained the rights in the work to be filmed, arranged the financing, supervised the making of the film and delivered it to the distributor.

12.108. It was clear that, in drafting the relevant provisions of the 1988 Copyright Act dealing with the grant of copyright in sound recordings, Parliament had intended that the record company should be the holder of that right, since it was the record company which generally made the necessary arrangements for the making of the recording, including the provision of the necessary finance. There was authority as to the meaning of `the person by whom the arrangements ... are undertaken' in relation to films. The courts had held that the word `undertake' meant `be responsible for', especially in the financial sense but also generally. It could therefore be assumed that in using the same formula for sound recordings as for films in the 1988 Copyright Act, Parliament had intended that copyright should vest in the person who had

undertaken the financial responsibility for making the recording. The ownership of that copyright was the reward for the risk they had undertaken. The 1988 Copyright Act was entirely consistent with the Rental Directive, which made it clear that the producer of a film or record was intended to refer to the person by virtue of whose investment a recording or film came into being. There was no question, therefore, of record companies `not recognising any rights of producers as first holders of copyright in the sound recordings they produce' as had been suggested by some producers. Rather, those rights did not subsist at all.

12.109. The companies considered that record producers operated in a highly competitive market and were already more than adequately remunerated (often in the shape of a sizeable advance and a share of royalties), especially considering that they did not contribute to the investment in an artist made by the record company or bear any part of the risk inherent in making a new recording. Moreover, where the producer was entitled to royalties on the sale of the record, he generally received payment more quickly than the artist because only the advance had to be recouped. But in any case, in the companies' submission, this was not an issue which raised any public interest concerns.

Effect of the terms of artists' contracts on competition

12.110. We asked the companies whether competition between them, or between them and independent companies (including BBC AI), was adversely affected by the terms of artists' contracts.

12.111. The companies said that, for the reasons already given above, artists' contracts did not adversely affect competition between them and other record companies, of whatever size. As between themselves, contract terms varied significantly and artists could and did move from one company to another. Competition between the companies to sign artists was intense.

12.112. Competition between the companies and independents was also intense. All record companies were able to offer packages which would appeal to different artists. Competition for artists had tended to increase the level of advances offered to new artists, but there was no evidence that this had put new artists beyond the reach of smaller, independent companies. There were a number of reasons why artists might prefer to sign with an independent company: for example, such companies were often specialists in a particular musical genre and could offer expertise in that area; they were often prepared to be more flexible and innovative in their approach because of the smaller scale of their operations; they could often give more individual attention to artists in a business where personal contact was crucial; and they were often `closer to the ground' than larger companies and were in a position to offer a contract to an unknown artist before he or she had come to the attention of such companies. The existing commercial arrangements assisted the smaller record companies by giving them the security of being able to retain their successful stars rather than losing them to the larger companies in more frequent bidding wars or, if they wished, by `selling' their stars to larger record companies for significantly large sums of money. Independent companies needed their copyrights and a reasonable length of contract in order to be able to secure licensing agreements to exploit their artists' recordings overseas. They would find it difficult to recover their investment in a successful artist if that artist were able to take the copyright and transfer it to one of the major record companies as soon as he achieved success.

12.113. As for BBC AI, the companies maintained that it could not be equated with ordinary independent record companies. Indeed, it was in a unique position, possessing an archive of recordings of famous classical artists originally made by the BBC for the purpose of broadcasting only, at a time when it had a monopoly of broadcasting in the UK and when the artists in question were under exclusive recording contracts with a number of record companies. The artists concerned knew very well the contractual basis upon which permission to broadcast was granted at the time they contracted with the BBC and both parties had until now always accepted the conditions involved. It might be that the consequences of the operation of artist and title exclusivity and the terms of the Broadcasting Permission were not now commercially convenient for the BBC. But artist and title exclusivity were no more than was reasonably necessary to protect the legitimate commercial interests of all record companies to ensure a reasonable return on their significant investments in classical (and indeed other) repertoire; many classical recordings were unsuccessful and many more could take many years to recoup the initial investment undertaken. The classical repertoire was of very considerable cultural and public interest and if the BBC were allowed to free-ride on the back of that investment to release public performances which were made on the basis of a

clear recognition of the record companies' need to protect their investment, the continuation of such investment in classical artists by record companies would be seriously undermined.

12.114. PolyGram added the following points. First, it was the wish of artists that recordings of performances made for broadcast purposes should not be issued to the public otherwise than by broadcast, so that the artistic integrity of the work and its reputation for quality might be preserved. Secondly, artist exclusivity was also essential to enable a record company to identify itself with the totality of an artist's work and thereby to provide and maintain a nexus between the reputation of the artist at a particular point in his or her career and the image and reputation which attached to the particular record company. Thirdly, in addition to artist exclusivity, the object of title exclusivity was to prevent record companies' investment in an artist being undermined by that artist recording, a relatively short time after the expiry of a contract with another record company, the same work as had been recorded by that artist with that record company. Fourthly, BBC Enterprises Limited, of which BBC AI was a subsidiary, was a major economic operator in, *inter alia*, the market for recorded music. It was not correct for BBC AI to maintain that it represented the first attempt by the BBC to enter the record industry; BBC Enterprises had consistently released a wide variety of sound recordings of the BBC's broadcast activities and indeed the BBC had figured prominently in the BPI's own table of record industry market shares over the past ten years; fifthly, the issues identified in relation to BBC AI applied equally in the field of pop music and to all broadcasters of pop music, whether on radio or television, and artist and title exclusivity equally protected the record companies' investments against release of those archive recordings. Finally, if the MMC were to limit the scope of, or prohibit altogether, title and artist exclusivity, this would put the UK out of line with practice in the rest of the world and place all the record companies at a significant competitive disadvantage.

Profitability

12.115. We asked the companies whether their underlying profitability was excessive in relation to sales and capital employed. We also asked them to comment on the suggestion that their profitability was effectively understated as a result of the present accounting treatment of their investment in A&R and copyright material. On this second point, we had commissioned a study into the business valuation of the companies by KPMG Peat Marwick (KPMG), and a summary of this report is at Appendix 8.2. Thirdly, we asked them whether they were choosing the formats on which they released recordings in a way which was designed to increase their profits rather than meet consumers' requirements.

Levels of profitability

12.116. The companies maintained that levels of profitability in the UK market for recorded music over the past five years had been low, particularly within the context of the high degree of risk to which record companies were exposed and the volatile return on investment in this market. The companies did not consider that ROCE was a meaningful measure of profitability for the recorded music industry which had a large service element and a small requirement for capital; return on sales, although it had certain limitations as a measure of profitability, was the more appropriate. If returns were compared with those achieved in various other sectors which had certain characteristics in common with the recorded music industry, such as the leisure industry, the pharmaceutical industry, publishing, broadcasting and software companies, it was clear that the underlying profitability of the companies was in line with profitability in those comparable sectors and that it was not excessive in relation to sales. In any case, profitability did not provide a reliable guide to the nature or extent of effective competition in the market for recorded music.

Accounting treatment of A&R and copyrights

12.117. The companies said that their accounts were prepared fully in accordance with UK accounting standards and the profits shown in those accounts were fairly stated. Their policy was also consistent with the fundamental accounting concept of prudence, which dictated that A&R costs should be provided for as they were incurred unless there was a reasonable expectation of recoupment from future revenues. It was

common practice among UK companies not to include on their balance sheets the value of their intangible assets and the companies were following UK accounting practice in this respect.

12.118. BMG said that the part of its A&R investment which represented prepayment of royalties to artists was recoverable only from artists' future royalty earnings. Because there was a risk of non-recovery in respect of those advances, dependent upon the success or otherwise of the individual artists, provisions were made as appropriate on an artist by artist basis to reflect this risk and to reduce the value of the `investments' to recoverable amounts. The level of such provisions was reviewed on an annual basis, and as it was applied consistently year-on-year, there should be no material impact on profitability.

12.119. Internally generated copyrights, such as rights to exploit future recordings by artists under contract to BMG, were not carried as intangible assets on BMG's balance sheet, because the carrying of internally-generated intangibles on the balance sheet did not comply with either UK accounting standards or group accounting policy and because of the high degree of subjectivity involved in their valuation, as a result of which the values ascribed to copyright might vary significantly year-on-year. Any impact of internally generated copyrights on the company's balance sheet would only occur when the value of those copyrights was realized on a sale.

12.120. Commenting on the KPMG report, BMG said that it disagreed fundamentally with the methodology adopted, the data used in preparing the analysis and the usefulness of the results obtained. In its view, the methodology was so flawed as to provide no useful insight even at the aggregated level. The turnover multiple was used because it was the least flawed of the methods considered and because a discounted cash flow analysis was not feasible. However, even the least flawed method was insufficient to produce a useful contribution and the number of key unjustified assumptions fatally undermined the results of this analysis. While valuations of individual companies would clearly be necessary in a bid situation, and could be generated with sufficient understanding and expert knowledge of the value of the different assets of the company (tangible and intangible), KPMG had not demonstrated the expertise to provide a sensible valuation for the industry as a whole.

12.121. BMG accepted that the valuation of a target company's catalogue was a major factor in mergers and acquisitions transactions in the music industry; but it was only one among many key factors in assessing the attractiveness of a target, and was as difficult to estimate in money terms as the quality of management. This problem had become worse as the markets had fragmented and consumer tastes were changing at an increasing rate. Any estimate would be a guess based on knowledge of the catalogue and the market. The uncertainty of the business meant that the valuation would be a high-risk endeavour, and would often be determined by the broader range of factors.

12.122. EMI said that the proper way to arrive at an economic return, as opposed to an accounting return, was to value the intangible assets and include the increase or decrease in the overall return. However, it was very difficult to measure either the value of the additions to the intangibles during the year or the changes (upwards or downwards) in the value of the existing intangibles. Even if it were possible to arrive at reasonable estimates of value, based on projections of future revenues, the circularity involved would render them of no use to the MMC in considering whether or not excessive profits were being made. The KPMG exercise had not overcome these difficulties and consequently EMI did not believe it was helpful in considering whether or not excessive profits were being made. EMI also had a number of more specific concerns about the KPMG turnover methodology. For example, EMI did not believe that a standard multiple applied to turnover could produce an accurate valuation of intangibles, since it took no account of differences in profit margins between companies. Moreover, use of acquisition values to estimate the multiple could be misleading because in some cases copyright had represented the main value to the acquirer, while in others potential cost savings had been the main benefit.

12.123. The stock market rating of THORN EMI suggested that EMI's intangibles did have a substantial value but did not suggest that the market considered that THORN EMI's accounting practices understated its underlying economic profitability to a greater extent than other public companies. The evidence from the acquisitions by THORN EMI of Chrysalis and Virgin suggested that the greater part of the acquisition prices was based on EMI's ability to achieve cost savings and the lesser part on the value of the intangibles in Chrysalis and Virgin. In both cases, the current artist roster was considered by THORN EMI to be more important than the back catalogue.

12.124. PolyGram said that it was generally accepted accounting practice in the UK that assets should only be carried at a valuation if the value could be measured with reasonable certainty. The uncertainties and subjectivity inherent in endeavouring to project future earnings on albums not yet released or even recorded, and the general problems of valuing artists who had unique economic and commercial characteristics and potential, were such that any valuation of back catalogue or its artists' roster would not be verifiable under the accounting guidelines. While recognizing that value had been created in the back catalogue and artists' roster through A&R activities, this value only became quantifiable with reasonable certainty on disposal.

12.125. PolyGram said that it had asked Ernst & Young to explore alternative means by which measurements of ROCE could be achieved to include the company's intangible assets. Ernst & Young had concluded that if the artists' roster and back catalogue were recalculated and restated at an independently determined valuation, any such valuation would normally be based on a forecast of net earnings from the artist and back catalogue using a normal ROCE. The result would be entirely circular, since actual earnings were likely to be different from forecast earnings. Therefore, any differences in actual ROCE from the `normal' ROCE would merely reflect the inaccuracy of the original forecast earnings and, as a consequence, the inaccuracy of the valuation.

12.126. If, alternatively, a revised capital base were calculated by restating the balance sheet and profit and loss account as if A&R investment had been capitalized and amortized rather than written off in accordance with current policy, the only difference with PolyGram's current accounting policies would be one of timing. Under the capitalization method, expenditure would be spread over the estimated economic life of the catalogue, say 10 or 20 years. Under the method used by PolyGram, costs were written off against royalties recouped or written off as soon as non-recoupment was foreseen. The capitalization method produced a `mismatch' between the 10 or 20 years over which the advance was written off as against the actual time when an advance would be recouped which, in the case of a successful artist, was likely to be much more quickly through royalties. The net assets on the balance sheet therefore merely represented historical costs that had been capitalized and amortized in an arbitrary manner, reflecting neither the value of the catalogue and artists to the business, nor accepted accounting policies. An ROCE based on a capitalization method was accordingly flawed, potentially misleading and largely meaningless.

12.127. Sony said that its accounting policy for A&R costs, which had been adopted consistently over recent years, was to capitalize only significant advances where it was reasonably certain that they would be recouped from future royalties. In practice that meant that only advances to established artists were capitalized. Most advance payments were written off, a practice which simply reflected the nature of the business: the vast majority of releases were not successful and hence most advances were not recovered. Where a recording did not sell immediately after its release, it was highly unlikely to fare any better in subsequent years.

12.128. It was possible to consider alternative accounting treatments of A&R costs. Even if these were acceptable in terms of the fundamental accounting concepts of prudence and matching, their adoption would not affect the long-term profitability of Sony's UK business. This was because, in a mature business, changing the accounting policy would tend to have a one-off effect on the profit of the company, with a permanent adjustment on the balance sheet.

12.129. Commenting on the KPMG report, Sony said that there were a number of flaws in the methodology adopted which undermined the validity of the 1.2 turnover multiple used in KPMG's calculations and made it inappropriate for the MMC to rely on the KPMG calculations. In particular, they had failed to give proper weight to a number of factors which significantly affected the purchase price paid for a business and had also failed to take proper account of the differences between the various transactions considered. For example, the value of a trade mark of a record company had been taken to represent of the order of 10 per cent of the purchase price required to acquire the company, yet no explanation had been given of the basis for that figure. A blanket 10 per cent deduction gave insufficient weight to the large number of factors other than the copyright valuation that affected the price paid for a record company, and failed to take adequate account of the differences between the various businesses acquired and the differing factors affecting the price paid in each case, such as the infrastructure of the business and the current management team. Other factors which KPMG failed to take into account were, for example, the fact that almost all the acquired businesses considered by KPMG included a range of business activities, not just core record company activities; the businesses covered ranged from purely national concerns to

multinational operations; no allowance was made for macroeconomic factors over the period during which the transactions took place; no allowance was made for the price being driven up by competitive factors; and no allowance was made for the effect on price of potential synergies and cost savings which the purchaser could achieve. In addition, Sony questioned the validity of applying a turnover multiple of 1.2 to the major record companies' figures when it was apparent from the KPMG study that there was very considerable price variation in the turnover multiples calculated in the various individual transactions and that 1.2 was merely a simple average.

12.130. Warner said that it believed its accounting treatment of A&R spend and copyright material was the most appropriate in accordance with prudent accounting practice, taking into account the risks inherent in the recorded music industry.

12.131. Warner had asked Ernst & Young to review the KPMG study. Ernst & Young took the view that the methodology did not lead to useful measures of economic profitability, for the following reasons. First, there was inevitably a problem of circularity associated with market-based valuations of intangible assets, although KPMG had overcome this difficulty to some extent by focusing on changes in the value of intangibles during the period in question. However, secondly, if the resulting rate of return measures were to have any useful meaning, increases in asset valuations should be attributed to the appropriate period in which the expectation of higher future earnings, and hence the notional increase in the `value' of the back catalogue, first arose; the KPMG method seemed unlikely to do this. Thirdly, the KPMG method made little or no allowance for the success or lack of success of individual record companies in creating intangible assets with an enduring earning power. Fourthly, an economic profit approach could increase the profit attributed within a finite period but it could not increase the overall quantum of profit. And finally, even if it were applicable to the global operations of a record company, the KPMG method could not yield a realistic measure of the capital employed by a UK record company with significant income derived from the international licensing of repertoire.

Profitability in relation to record formats

12.132. We asked the companies whether the formats on which they chose to release recordings were designed to increase their profits rather than meet the requirements of consumers, thus reducing consumer choice.

12.133. The companies said that the formats on which they released their recordings were determined by consumer demand; in that way, they maximized their profits by anticipating and meeting consumers' needs at the prices consumers were willing to pay. Purchasers of recorded music had a far wider choice than was offered to consumers in other sectors in which intellectual property rights were fundamental, such as books and films. In the case of books, for example, publishers generally issued the more expensive hardback version of a book first and the cheaper paperback version some considerable time later. The companies continued to offer all three formats-vinyl records, cassettes and CDs-to their customers at the time the recording was released on to the market, notwithstanding the decline in demand for the vinyl record format.

12.134. The trend among consumers was towards the newer formats at the expense of vinyl records. Consumers who were prepared to pay more for a higher-quality product had increasingly chosen CDs over both vinyl records and cassettes. There had been increased CD player penetration over the past ten years and CD prices had fallen in real terms over the period from 1983 to 1992. At the lower end of the market, consumers had increasingly chosen cassette over vinyl because of its greater durability, convenience and flexibility. Moreover, retailers had shown an increasing reluctance to stock the vinyl record because, although it sold at the same price as cassette, it was heavier, more fragile and required more shelf space than cassette or CD and was therefore a less attractive format for retailers to stock.

12.135. BMG said that it had continued to release a significant number of titles on vinyl until 1991, by which time there had been a dramatic collapse in demand, and it still offered the vinyl format in areas where demand was still strong, namely dance music, pop singles and `alternative' albums.

12.136. EMI said that it still released virtually all new pop records-ie both singles and albums-on CD, cassette and vinyl, even though sales of vinyl pop albums now accounted for only 5 per cent of total UK album sales. Demand for classical music on vinyl had now fallen away and although EMI had continued to supply classical recordings on vinyl until 1991, it had now generally discontinued doing so. EMI considered that the days of vinyl records were numbered and their decline would soon reach the point at which any remaining demand would be too small to enable them to be marketed at commercially acceptable prices, except perhaps in the case of pop singles.

12.137. PolyGram said that, far from being limited in the choice of formats with respect to its recordings, consumers were able to obtain these in all formats, including vinyl, even though demand for vinyl had fallen to very low levels, particularly since 1990. It was PolyGram's policy, however, to continue to release recordings on vinyl and to continue to market this format and make it available for distribution for as long as this was commercially possible, and although this was usually at a considerable loss to the company.

12.138. Until 1991 Sony had released all albums on cassette, CD and vinyl. Vinyl had been manufactured at its own pressing plant at Aylesbury. In 1991 Sony had decided that the plant was no longer commercially viable and was closed; vinyl was now manufactured for Sony by a sister company in the Netherlands. Sony said that it usually released singles on 12" vinyl, cassette and CD; although it continued to release vinyl albums, sales had continued to decline sharply.

12.139. Warner said that at present most of its singles were released on vinyl, cassette and CD; so far as its albums were concerned, they were released at least on CD, and the decision whether to release on vinyl (or DCC, MiniDisc etc) was taken in relation to every recording. In any case, since many retailers (for example, W H Smith) had now stopped stocking vinyl, there was little point in the record companies continuing to produce it.

Phonographic Performance Limited

12.140. We asked the companies whether they were taking steps to maintain or exploit the monopoly situation by the way in which they controlled PPL so that *(a)* some independent record companies did not receive a fair share of PPL's income and *(b)* no part of PPL's income was paid to producers.

12.141. The companies denied that they in any way controlled PPL. PPL had a broad membership of some 1,440 member companies which controlled over 5,000 labels between them. Any person who owned or was entitled to the performing right in a sound recording was eligible to become a member and there was no fee or charge for membership. The companies could in no sense be said to dominate the committee structure of PPL and indeed, of the three PPL Distribution Committee members, two were from independent record companies and the third was from EMI. The rules which governed PPL were entirely transparent and non-discriminatory and did not confer any benefit on the companies as against the independent record sector.

12.142. PPL's three main revenue sources were the BBC, Independent Local Radio (ILR) and public performance. Distribution of BBC revenue was in accordance with returns from virtually every service of the BBC and independent record companies received their right and proper share of this revenue. PPL was currently in the process of improving the distribution system for ILR revenue by increasing the number of local radio stations used as the basis for returns; this would benefit smaller companies whose specialist repertoire was played by specialist stations which did not at present analyse the playing of records in detail. The most difficult area was public performance, since full or even large sample returns were not practicable from more than 100,000 different locations. PPL was, however, understood to be considering proposals for a substantial change of approach here aimed at more accurately measuring actual usage.

12.143. To the extent that there were imperfections in the current distribution arrangements, these were not attributable to any action on the part of the companies, nor were they likely to discriminate against independents and favour the companies. The companies fully supported the moves being taken to improve the system. Any remaining unfairness would be the result of operational and administrative difficulties, and there was a balance to be struck between the amounts of money involved in improving usage measurement

and the complexity of the analysis of fair play returns required for splitting the income equitably. The companies believed PPL had largely succeeded in achieving a fair system.

12.144. As to the question of any part of PPL's income being paid to producers, the companies said that since producers had no copyright interest in the sound recordings which they produced, they correspondingly had no performance rights in those sound recordings (see paragraphs 12.106 to 12.109). There was therefore no reason why record producers should expect to receive any part of PPL income.

Video Performance Limited

12.145. We asked the companies whether collective negotiation through VPL of licence fees for the broadcasting of music videos was justified or whether it constituted a step taken for the purpose of exploiting the monopoly situation.

12.146. The companies said that although music videos were part of the package of methods used to promote certain artists and types of music, they were also now primarily products in their own right, involving considerable creative effort and expenditure on the part of the record company. They were offered for sale as an additional format in which consumers could enjoy the music of a particular artist. Music videos had now become an important source of programming for an increasing number of broadcasters. Broadcasting organizations also benefited from the availability of music videos by increasing their advertising revenue and enhancing their market position.

12.147. VPL had been set up in 1984 in order to facilitate the grant of licences in music videos. The MMC's 1988 report on *Collective Licensing* had set out very clearly the rationale and justification for such a body as VPL which, like any other collective licensing body, carried out a range of functions, including licensing the use of copyright, determining tariffs for that use, collecting royalties, distributing the revenue, monitoring the collective use of copyright material and enforcing copyright. Its convenience both to users and rights owners was particularly applicable to music videos, which were short, song-length pieces, each of which might be licensed to a number of different broadcasters and shown several times in a single day and many times during a week. In practice, all VPL's activities were interrelated, so that if it were to be prevented from negotiating royalties with broadcasters, it would cease to play any part at all in relation to those particular licences. This would significantly undermine its value to members.

12.148. VPL currently had around 390 members, the vast majority of whom were independent of the companies. Revenue received from users was distributed strictly in accordance with the use made of each member's videos. If VPL were to be prevented from negotiating on a collective basis, then it was likely that most broadcasters would only wish to negotiate on an individual basis with the major groups. The smaller companies would then find that their videos were not played at all or that they were played without payment. Very few of the smaller companies would have the resources to negotiate effectively with major broadcasting organizations, and the very considerable power which such organizations already enjoyed would be further enhanced. Nor would smaller companies have the resources to take action individually to control unlicensed use of their videos. The benefits of collective licensing through VPL also included a reduction in the number of transactions that would otherwise be necessary, the maximization of music video broadcasting output, and the avoidance of duplication in such matters as negotiation, monitoring of use, granting licences, collecting fees and enforcing rights. It therefore avoided the need for broadcasters to seek separate licences in each jurisdiction in which it operated.

12.149. If the royalties required by VPL were unreasonable, it was open to a broadcaster under the 1988 Copyright Act to refer the issue to the Copyright Tribunal for determination. It was notable that MTVE, which had alleged that the companies were abusing their monopoly position in relation to VPL, had not chosen to put its case to the Copyright Tribunal on the question of royalty rates.

12.150. PolyGram made a number of additional points in response to the complaints made by MTVE to the MMC. First, it was incorrect for MTVE to state that it could not negotiate directly for UK rights. The rights in the relevant music videos which members of VPL had assigned to VPL were terminable on six months' notice and it had therefore always been open to PolyGram to seek to license MTVE direct; indeed, PolyGram had undertaken extensive negotiations with MTVE prior to the expiry of the original five-year

agreement between VPL and MTVE. Secondly, MTVE had failed to note in its submission to the MMC that it was the only dedicated 24-hour broadcaster of music videos and that it was therefore in the position of a monopsonist in its negotiations with VPL. Thirdly, MTVE's bare assertions of the record companies' anti-competitive intentions were untenable; they implied certain motivations and intentions on the part of PolyGram and the other majors acting through VPL but had produced absolutely no evidence in support of any of those assertions. Fourthly, MTVE had chosen to ignore all of the benefits offered by the VPL/IFPI collective licensing arrangements because it wished to seek a change in the UK market structure with the sole, unrealistic objective of reducing the royalty payments to VPL to a level which it considered to be appropriate in order to further boost its already substantial profits. PolyGram submitted that in any event, individual licensing would result in higher and not lower royalty payments by MTVE. Fifthly, MTVE appeared to be arguing that copyright owners such as PolyGram must market their copyrights in a form convenient to MTVE. In order to achieve this, MTVE was seeking to substitute the market conditions in the EC by those prevailing in the USA. But the legal, cultural and historical background to the licensing of music videos in the UK and the EC was fundamentally different to that prevailing in the USA. Record companies were entitled to seek fair and reasonable remuneration in respect of their intellectual property rights in music videos and it was quite wrong for MTVE to consider that such videos should be provided free of charge `in consideration of their promotional value'. The record companies provided MTVE with cheap programming with a proven appeal to consumers and advertisers for which they were entitled to reasonable remuneration. Finally, PolyGram pointed out that the various benefits to MTVE, to the copyright owners and to consumers offered by collective licensing in general applied even more to the IFPI/VPL pan-European licensing arrangements. The pan-European licensing arrangement offered the only legal and practical means of obtaining a pan-European licence, given the different legal positions prevailing in EC member states and the legal position in EC law following the judgment of the Court of Justice in *Coditel v Ciné-Vog*.[1] Moreover, the benefits of collective negotiations through a `one-stop shop' had recently been recognized by the European Commission.

Independent record companies

12.151. We put to the companies a number of issues relating to various aspects of their relationship with independent record companies; these covered the music charts, the companies' spending on promotion and marketing and the role of the BPI.

The music charts

12.152. We asked the companies whether they were seeking to exploit the record charts in a way that restricted or distorted competition with independent record companies, eg by the inclusion in the `independent chart' of records released by the companies in which they had an interest or with which they had a business relationship.

12.153. The companies said that this issue appeared to reflect a basic misunderstanding of the operation of the independent charts. These were intended to reflect the success of a particular genre of music, loosely described as `alternative' music. The original criterion for inclusion in these charts had been independent distribution, but in 1992 a second criterion was added, namely that the record must be within the `indie' music genre; the purpose of this second criterion was to eliminate from the independent chart any mainstream artists who were independently distributed but whose music was not part of the `indie' music scene. The genre criterion was, however, subsequently abandoned and the independent charts reverted to a single rule, namely independent distribution through music specialist panel stores.

12.154. The companies said that, to the extent that the independent charts operated unfairly, they did so in respect of them rather than the independents. The application of the distribution criterion had the effect of excluding from the independent charts some recordings which consumers would consider `indie' music even though it was distributed by one of the majors. By the same token, some `indie' recordings of the independent record companies were excluded from these charts because they chose to have their product distributed by one of the companies. The current arrangements also operated to the companies'

[1]Case 262/81 [1982] ECR 3381.

disadvantage because they acted as a disincentive to independent record companies to enter into distribution agreements with them, even though the independents and the record-buying public might be better served by the lower prices and greater efficiency of such arrangements.

12.155. But in any event, the companies denied that the practice of having a small number of releases distributed by independent, and often more costly, distributors could be thought to restrict or distort competition. On the contrary, it was a feature of the intense competition and the wide range of choice available to consumers. If the chart compilers thought it was somehow wrong for these releases to be eligible for the independent charts, it was open to them to redraw the qualification criteria to exclude them.

Promotion and marketing

12.156. We asked the companies whether the practices of spending large sums on promotion and marketing and supplying free copies to retailers constituted uncompetitive practices which had the effect of restricting actual or potential competition with independent record companies and/or reducing the amount of the royalties paid to artists.

12.157. The companies said that the UK recorded music market was highly competitive, being driven by the availability of substitutes, the power of retailers, the power of artists and media costs. In those circumstances, it was inevitable that companies would be forced to invest heavily in promotion and marketing in order to differentiate their products from their competitors', to develop a distinct identity for their artists and to introduce consumers to new music which they might otherwise be unwilling to buy. Promotional expenditure was in addition to and not a substitute for price competition, as evidenced by the size and the nature of discounts. Although the independent record companies did not always have the resources to match the marketing and promotional expenditure of the companies, this did not mean that actual or potential competition from independents was restricted. Independents simply competed in different ways, for example by concentrating on niche products, exploiting their flexibility, speed of response and proximity to customers, taking advantage of a generally lower cost base, obtaining additional funding by licensing overseas rights or selling out contracts with particular artists, and entering into strategic alliances with the majors in order to take advantage of the wider range of skills which they possessed. Moreover, the most important promotional medium, radio, was free and open to access by all record companies. The specialist press was not only also free but tended to prefer featuring independent artists.

12.158. It was in any event difficult to see how the normal commercial activity of spending large sums on promotion and marketing could, in and of itself, amount to an uncompetitive practice. In a market where loyalty was shown to the artist rather than to the record label, small record companies were at no disadvantage in marketing and promotional terms. Nor was there any evidence that independents were being squeezed out of the market; their historically stable share of the market overall, their ability to break new artists and the inroads which had been made by niche specialists in classical music proved that they were competing fairly and effectively.

12.159. In general, the level of promotional and marketing spend did not reduce the amount of royalty paid to the artist since such expenditure was not treated as recoupable against royalties. On the contrary, the aim of such expenditure was to increase the volume of sales, from which the artist derived benefit by virtue of the increased accrual of royalties. Artists and their managers tended therefore to press for more marketing and promotional spend rather than less in order to boost record sales and, consequently, royalties received. It was true that the costs of some marketing and promotional activities, particularly television advertising, were treated as wholly or partially recoupable. However, such arrangements were made to reflect the high cost of television advertising and the mutual benefit it brought to artist and record company alike.

12.160. As for free copies, these were primarily new releases of singles and were provided largely to independent retailers as part of the normal promotional discount terms to this retail sector. The practice was intended to encourage independent retail outlets to display larger quantities of the particular recording in order to encourage sales and help the record to achieve chart success, and it appeared to be just as widespread, if not more common, among the independent record companies. The success of independent

record companies in the singles chart indicated that the practice did not have the effect of excluding them from the charts.

12.161. With regard to the effect of free goods on the royalties payable to artists, artists' royalties were paid on sales, so the artist would benefit in the longer term from the larger overall volumes of sales of that recording generated by the free issues. Since the majority of artists were in any case unrecouped, it was irrelevant that those artists did not receive royalties on free goods.

The BPI

12.162. The companies were asked whether they were exercising effective control over the BPI in a way that distorted competition with independent record companies.

12.163. The companies denied that they exercised actual or effective control over the BPI. They pointed to the fact that the BPI currently had 147 members, of whom 102 were fully independent and 18 were associate members. The balance of 27 comprised the companies and entities connected to the companies; in voting terms the companies held only 21 per cent of the votes and did not, therefore, hold actual control. Of the 14 elected members of the Council, six were representatives of the companies. The companies had no influence over the activities of the BPI outside of the votes which could be cast at general meetings.

12.164. The BPI operated through its Council and any full member or employee of a full member was eligible for election to the Council. The various BPI committees operated in a fully transparent fashion and frequently included representatives from independent record companies. In a recent instance where there was a divergence of views between the companies and some of the independent record companies over the independent charts, the Council put in place the decision which these independents favoured, notwithstanding the opposition of the companies and many other independents. Subscriptions were based on turnover, so that the companies paid considerably more than the independents. The independent BPI members nevertheless derived the same benefits from membership, for example over measures to combat piracy, in lobbying over copyright matters, in collective dealings with broadcasters and in many other ways. To the extent that staff from the companies took an active role in BPI affairs, they did so on behalf of the industry as a whole.

Complaints from third parties

12.165. We had put to the companies for comment, by way of an annex to the issues letter, a number of complaints from individual members of the public, CA, industry bodies and other interested parties. We have recorded the companies' response to many of these points in the course of dealing with the issues set out above. Summaries of the companies' comments on some of the complaints from consumers are set out below.

12.166. EMI said that it was not true, as alleged, that small retailers experienced difficulties in obtaining supplies from the large record companies and were forced to purchase through distributors. EMI maintained a much more liberal policy with regard to the size of customer accounts than did, for instance, its US sister company. As a result of its UK policy, EMI's distributor costs represented a higher percentage of its turnover than the equivalent costs in the USA. PolyGram too said that this criticism was unfounded. It was very much in PolyGram's interest that small, independent retailers had full access to the totality of PolyGram's repertoire, and indeed independent retailers had a pivotal role to play in the competitive process. The development of new electronic ordering systems such as EROS was clear evidence that record companies wished to improve and develop facilities for direct ordering by all record retailers from record companies in order to maximize sales, rather than the reverse. Warner too stressed that it did not discriminate against small retailers in any way and in fact provided an excellent service to all sizes whatever their requirements. Its distribution centre currently serviced over 2,200 retail accounts, of which over half were accounts with small retailers which were not part of a national chain. The centre had no minimum order requirement in respect of new releases and, as far as product already released was concerned, made a charge of £3 only if the order value was less than £50.

12.167. In response to the criticism that many CDs ran for only 50 or 60 minutes, Warner said that the criticism ignored the fact that a recording was a creative work and any attempt by a record company to require extra tracks to extend the length of an album would be viewed by the artist as an unjustified interference with his or her artistic control over the album. Most CDs stated the playing time of the different tracks or the total playing time on the back of the CD. EMI added that it had no policy of marketing CDs as offering any particular playing time. PolyGram said that the economics of the record industry were such that it was inappropriate and not economically rational for record companies to charge a different price according to the running time of a particular product. Sony said that no one had forced consumers to purchase CDs; they did so because they wanted the higher quality which CDs offered and record companies had simply responded to the demand.

12.168. As regarded the criticism that all CDs were priced more or less the same, despite the different production costs which must be attached to different kinds of recording, EMI said that the impact of production costs on total unit cost was highly dependent on the length of the production run. There was no direct relationship between the cost of a recording and its dealer price; this was because demand, and hence unit cost, was almost impossible to forecast, particularly with new releases. Overall, EMI attempted to price its recordings so as to sustain its business. PolyGram said that, as with all high-risk, research-intensive industries, the record industry must look at its total costs of production and must take into account its overall total risk in deciding how to price its products. The use of multiple formats at different price levels was the rational economic response to the structure and development of the market for recorded music, the structure of demand in that music and the role and importance of ownership of intellectual property rights in that music. Warner pointed to the enormous range of prices for classical CDs and to the availability of different versions at widely differing prices. The production costs for a full-length opera were indeed significantly greater than those for a solo piano recital and this was reflected in the dealer price of the two types of recording.

12.169. With respect to the price of CD sets, EMI said that it had a vast range of recordings at different prices. It was possible to buy two-CD sets for less than the price of a full-price individual CD. PolyGram said that its earlier comments about production costs applied equally here. Warner said that the economies of production, packaging and retailing for multiple sets of CDs were in fact minimal; since each disc in the pack did, of course, contain different music, there was no particular saving in producing the discs; and although there was some saving in the packing, many boxed sets had a higher standard of insert with more substantial booklets, some, for example, containing an opera libretto or programme notes, which counterbalanced that saving.

12.170. In response to the allegation that consumers were subsidizing, through high prices for CDs, the investment being made in new music carriers such as DCC and MiniDisc, which moreover they did not want, having only just spent large sums on acquiring a CD collection, the companies said that in the first place CD prices were not too high, as explained elsewhere in their responses. But the bulk of investment on DCC and MiniDisc had been incurred by the hardware manufacturers. Such investment could hardly be recouped by record companies raising CD prices, since the benefit would then go to the record companies rather than the hardware manufacturers. There was no evidence that CD prices had been affected by these new formats. EMI said that its own investment in releasing music on these new formats had been modest to date. It was clear that consumers were not rushing to acquire the new hardware necessary to play these formats and that was their prerogative. But for those consumers who had, or were intending to acquire, such systems, it was helpful to have a range of titles available to play on their systems. PolyGram and Sony said that consumer sovereignty would prevail and if new delivery systems were not wanted by consumers, this would be reflected in the lack of demand for those formats. Warner noted that one unusual feature of the music industry had been the ability of different formats at different prices to maintain their place in the market at the same time, although lower-quality formats did in time become obsolete.

The retail sector

12.171. We invited the companies to comment on the retailing of recorded music in the light of the provisional retailers' complex monopoly practice which we had identified, namely that W H Smith, Our Price, HMV and Woolworths (in association with EUK) (the retailers) were securing discounts and

promotional support from suppliers of recorded music that were larger than those made available to other retailers. The companies' comments are briefly summarized below.

12.172. Commenting on the role of the retailers in the supply chain, BMG said that the price which the consumer finally paid for a record was a function of the retailer's margin, which the retailer was able to take as a result of the concentration of retail power in the market-place. BMG said that its own published dealer prices had dropped substantially in real terms, particularly for full-price CDs, and in terms of its realized prices, over the past four years. At the same time, its marketing costs had risen considerably during that period and a significant part of those costs was represented by co-operative and marketing support with retailers. This trend of increased marketing and promotional spend had developed during the 1980s and had led to a heavier cost base than BMG considered appropriate. In BMG's view, this situation had resulted from retailer power and was now irreversible.

12.173. BMG thought that the retail market was competitive. It took the view that Our Price had adopted the strategy in the late 1980s of spreading geographically throughout the country and setting up in the smaller high street locations close to independent retailers, with a view to competing directly against them. The strategy had achieved considerable success.

12.174. BMG also said that the pricing points at which records were sold by retailers were determined by the retailers. As a record company, BMG had found that there was little point in pricing below one of these price points because the retailer simply priced at the higher price point and took the difference in extra margin.

12.175. EMI said that increased concentration was a common feature of retailing of a wide range of goods and services in the UK and abroad. As with the trend towards larger stores, it appeared to be driven by a broad range of factors and to be quite independent of the level of discounts or promotions. EMI pointed to the Robinson-Patman Act in the USA which severely restricted the granting of volume-related discounts, yet in that country retailer concentration in many sectors, including music, was proceeding apace. EMI believed that there would always be a place for the independent retailing sector, although it might be smaller than in the past. Such diminished importance would not represent a threat to the UK music industry since artist and record labels, whether large or small, would find a way of launching releases and breaking acts. In this connection, EMI stressed the important role which HMV played, as well as the independent sector. It was generally accepted that barriers to entry in retailing of music were very low, as evidenced by the huge increase in outlets which now stocked music in the UK.

12.176. PolyGram said that each retailer sought and negotiated its own discounts and promotional mix according to its own business requirements. Quantity-related discounts obtained by large buyers were part and parcel of competitive selling terms and were a natural part of the buying power of large customers. Over the past five years, there had been, first, a significant increase in the level of discounts and other financial support given to major retailers, and secondly, a consolidation in ownership which had been accompanied by an increase in the general level of retail margins. PolyGram had found that levels of retail concentration and retail margins were higher in the UK than in the other countries under consideration by the MMC; that average independent retailers' CD prices were shown by the MMC's study to be lower than prices for the equivalent products both in multiples and specialists; and that it was not common for retailers to pass a dealer price decrease to consumers. The major record retailers had a degree of countervailing market power which could be used to their advantage in securing discounts from PolyGram and other record companies.

12.177. PolyGram had no evidence to suggest that, other than in terms of the diminution in numbers of retailers as a result of increasing concentration, there had been any reduction in choice for consumers in the availability of recorded music. If the increasing discounts offered by PolyGram and, it was assumed, the other record companies were passed on to consumers by all retailers, independent and multiple alike, consumers should benefit from lower retail prices. However, this did not appear to be happening in practice and the BMRB analysis strongly suggested that average retail prices were lower amongst independent retailers than the large multiples.

12.178. Sony said that it could not rely on retailers to pass on to the consumer the benefits which they had received from Sony in the shape of reduced dealer prices. The large retailers had considerable power to extract large discounts, together with the marketing and promotional expenditure required to launch new

releases. Sony also expressed concern about increased concentration in the retail market and the effect which that might have on the continuing development of talent in the UK. Sony said that six customers now accounted for 85 per cent of retail sales, and that put Sony in a vulnerable position, since retailers such as W H Smith and Woolworths might not continue to sell recorded music indefinitely. To them, it was just another product, whereas to the independent specialist, it was their sole livelihood. It was true that the large specialists such as HMV, Virgin and Tower had expanded their floor and shelf space so that they were able to accommodate both music and the other forms of entertainment such as video games. In these specialist multiples, Sony considered that its catalogue was still very well represented; but in the general retailers, it was under-represented. Sony did not think that there was much room for further concentration at the retail level. In the meantime, it was doing what it could to encourage and increase the strength of the independent retailers, which were willing to stock a much larger range of singles than the multiples and large specialists (who tended only to stock chart successes) and which were therefore needed to break new artists.

12.179. Warner said that it believed the continued survival of the independent record stores was important for the health of the industry, and to this end it sought to offer them special deals and promotional help so far as their limited floor space and low volume of sales permitted. These shops had an important role to play in breaking new talent, given the increasingly conservative stocking policies operated by the multiples. Although Warner wished to continue to produce a broad range of music going beyond the mainstream hits, it was reliant on the retailers to provide an outlet for these recordings. In the absence of a significant number of record shops prepared to offer a more adventurous range of music, there was little point in the record companies investing in signing and promoting those artists who, despite great musical talent, were unlikely ever to reach or appeal to a mass audience.