9 Other views

Contents

9.1. In this chapter we summarize the views of those listed above.

9.2. Many other companies, not further mentioned here, provided factual information about their own activities (which has been taken into account, to the extent appropriate, in earlier chapters), while not expressing any views on the issues raised in the course of the inquiry.

Hardware manufacturers

Atari Corp (UK) Ltd

9.3. Atari Corp (UK) Ltd, a wholly-owned subsidiary of the Atari Corporation of California, said that demand for games machines was determined by what was currently in fashion. This could override other factors such as price. All Atari's European activity had been centralized in the Netherlands and sales were no longer invoiced by the UK company. It was thought that UK sales had declined from £32.7 million in 1990 to about £1.6 million in 1993.

Commodore Business Machines (UK) Ltd

9.4. Commodore Business Machines (UK) Ltd (Commodore UK) said that its annual turnover was £75 million. Commodore UK manufactured Amiga hardware but not software; it did, however, package software with its hardware, which was then distributed to multiple retailers such as Comet, Dixons and Rumbelows, and to two main distributors, SDL and ZCL, which supplied independent computer specialists. During our inquiry it was announced that Commodore UK's parent company had become insolvent.

Philips Interactive Media International Ltd

9.5. Philips Interactive Media International Ltd (Philips) said that it was established in 1991 to produce and publish software principally for the interactive CD system (CD-i) developed by Philips. The CD-i system was a world-wide standard for which the technical specifications were contained in a manual known as the *Green Book*. This could be purchased for a one-off lifetime licence fee of $5,000. Once a developer had bought it, he was in a position to develop titles, have them manufactured in any CD manufacturing plant, and have them published without any further payment to the licensors. It was not necessary for publishers to acquire the *Green Book*. The CD-i system was not conceived as a dedicated games platform and the products developed for it catered for a wide range of interests and markets. About a third of the 110 titles available in March 1994 fell into the games category; however, later in 1994 a more games-orientated version of the CD-i was launched. Costs of production for individual titles were estimated to range from under £50,000 to over £200,000.

Software publishers and developers

Acclaim Entertainment Ltd

9.6. Acclaim Entertainment Ltd (Acclaim UK), a UK subsidiary of the US corporation Acclaim Entertainment Inc, had a turnover in 1992/93 of £32 million. Acclaim UK said that the market was becoming increasingly price sensitive, though quality had also grown in importance as consumers became more discerning. There had been a tendency towards price escalation in the UK over the last three years as a consequence of adverse currency fluctuations and consumer demand for higher memory configuration products. The level of marketing support was an influential factor in determining market position, which was also affected by the market share of the hardware system. CD-ROM was the medium of the future, but the present installed base was low. Competition at retail level was intense and highly effective.

9.7. Acclaim's output was in the proportions two-thirds Nintendo to one-third Sega. Acclaim believed in concentrating its resources in this way, since by licensing only to these two companies which distributed the software on cartridge format, a medium which was very difficult to copy, Acclaim's product enjoyed the benefit of this additional protection from piracy, within an industry which was otherwise fraught with piracy problems. Acclaim UK did not think it was easier to acquire a licence from Nintendo than from Sega, or vice versa. Both companies were keen to demonstrate their support across as many publishers as possible.

9.8. Since the end of 1993 Acclaim UK's policy had been not to express trade prices in terms of discounts on RRPs but to have a base dealer price, with discounts for co-operative marketing arrangements and according to volume ordered. Acclaim UK denied the suggestions that had been made (see paragraphs 9.95 and 9.116) that it withheld supplies of a title from retailers who intended to sell that title at
discount
The problems that had arisen related to trading terms and credit limits. Acclaim UK placed no restrictions on rental and made no extra charges in respect of cartridges used for this purpose. It supported rental activity which was an effective advertisement for the best games, though of course for the poor ones it might have the opposite effect.

9.9. Acclaim's products were manufactured in Japan by Nintendo or Sega, except for cartridges for Sega Mega Drive (and NES cartridges for North America) which were manufactured by Acclaim's subcontractors in Mexico. The latter arrangement offered little financial advantage, apart from credit facilities, but it did give a faster turn-round and therefore greater control of timing. Minimum order requirements represented no problem whatever for Acclaim UK. They might for companies with less effective distribution networks. Acclaim UK was unable to provide information about cartridge costs, since such information remained confidential to its parent company in the USA, which had entered into the relevant supply agreements with third parties. It made the point that Nintendo's and Sega's total costs might be lower because they had created their own characters in Mario and Sonic, whereas Acclaim, for example, had to pay licence fees for the characters around which its games were built.

Accolade Europe Ltd

9.10. Accolade Europe Ltd (Accolade Europe) said that it was a sales and distribution organization for products created in the USA. The UK video games market had now entered a mature phase after a number of years of very high growth. Consumers were offered a wide range of products from high street stores throughout the country. Competition amongst retailers was intense, with heavy discounting on new titles now commonplace. In order to make their new releases `stand out from the crowd', games publishers found it necessary to spend ever-increasing amounts on advertising and promotion in what was principally a hits-driven business. The main benefit of having a title released simultaneously across several formats was that significant economies of scale could be achieved in a number of areas of marketing. However, the success of a title depended very much on whether or not it was a quality product in terms of the appeal of the subject, the playability of the game and the technical execution of the product overall.

9.11. Accolade Europe said that price was clearly an important part of the marketing mix for each product. The £10 increments for each pricing level were very important, and it believed £50 was the maximum achievable price for any title for any significant mass volume. Price points did not differ significantly according to genre although the higher cost of games which could be `saved' at the end of each playing session would have an effect on the price point. Accolade Europe said that over the last three years price points for new games had remained reasonably constant, and this in spite of the fact that games had improved greatly in terms of depth and size, sound quality and graphic presentation, all of which affected the cost of development and production. Another major influence in pricing had been the influx of low-price back-catalogue products which were now available. Given the newness of the market, such offers had not been available a few years ago. Retailers were free to rent Accolade Europe products if they wished to do so; no licence fees or other charges were payable.

9.12. Accolade Europe said that a major change over the last few years had been the level of product quality awareness shown by the consumer. This was largely due to the number of product-related magazines now available. The consumer was able to study the magazines and read reviews of the games prior to purchase. As to future developments, Accolade Europe believed the key changes for video games software over the next few years would relate very closely to the technological development of the new media carriers, and the speed of that development.

9.13. When Accolade produced its own games for Sega systems, it was alleged by Sega to have infringed Sega's initialization routine. Accolade had stated in court that it had done no more `reverse engineering' than was necessary to enable its games to be played. Sega had appealed but in 1993 the differences were settled out of court. At the same time Accolade Europe withdrew a complaint it had made to the European Commission. Accolade had become a Sega licensee. Accolade Europe cartridges for the Sega Mega Drive were assembled in the UK from components bought by Accolade Europe in the Far East, the USA, and other European countries. Accolade was also a Nintendo licensee. Nintendo cartridges were bought from Nintendo of Japan as finished goods.

CentreGold plc

9.14. CentreGold plc (CentreGold) said that it comprised US Gold Ltd whose main activities were the publishing, licensing, marketing and distribution of computer entertainment software and cartridges for games consoles in the UK, continental Europe and the USA; and CentreSoft Ltd whose principal activity was the wholesale distribution of computer and video games to UK retailers. It was probably the only UK company that had come from distribution into publishing. A further subsidiary, PDQ Distribution Ltd, provided tailor-made distribution services principally to entertainment software publishers. Its services included warehousing, stock control, distribution, sales ledger maintenance and sales and stock reporting.

9.15. CentreGold said that publishing was hit-driven and therefore inherently risky. The video games market was changing rapidly to take account of advances in technology and the introduction of new formats. Future developments were likely to move away from the present mainly cartridge-based format towards CDs which had greater versatility and capacity and could be produced at a lower cost. CentreGold thought that these developments were likely to undermine the market dominance of the two main cartridge suppliers, Sega and Nintendo, though both companies were also expected to develop their own CD-based media products. The costs of developing CD format games to utilize the graphic capabilities of CDs were likely to rise. Many of the smaller development houses might find it difficult to compete in this market. CentreGold now had two in-house teams of developers; previously it had contracted out all its development work. None of its proposals had been turned down by the manufacturers. Nintendo had a more rigid approval routine than Sega. Discussions with Sega on release dates had always been concluded to the satisfaction of both parties.

9.16. As a wholesaler CentreGold was not directly involved in the retail marketing and promotion of video games. Through CentreSoft it supplied both hardware and software to retailers and offered them varying discounts. The margins offered by suppliers to wholesalers were the same as, or worse in some cases than, those offered to multiple retailers for central drop. Because Bandai prices, in particular, left no margin, CentreSoft ceased to wholesale Nintendo products in August 1991, and many independent specialist customers could no longer obtain them. Since then the opening up of third party sources for Nintendo software had lessened the importance of securing access to Nintendo's own software.

9.17. Publishers competed amongst themselves on the quality, popularity and availability of their games, for licences to develop games relating to various current events (eg Winter Olympics) and on discounts. Publishers' prices could not be considered in isolation. They had to bear the risks of overstocking and the costs of providing a sale-or-return service to retailers. The rapidly changing nature of the market meant that poor stock control or marketing awareness could lead to significant losses. The steep cost of cartridge manufacture formed a very high proportion of total selling price and constituted a potential barrier to entry.

9.18. CentreGold had no control over final retail prices. Retailers competed amongst themselves on price, availability and on promotions. In recent months price competition between multiple and independent retailers had intensified. This had been further fuelled by over-optimistic sales projections which had led to excess stocks of software titles throughout Europe. CentreGold thought rental was beneficial for quality games though it did involve a good deal of administrative hassle because of licensor's rights.

Codemasters Software Company Ltd

9.19. Codemasters Software Company Ltd (Codemasters) said that the UK market had become very competitive since the arrival of Nintendo and Sega. Oversupply and the problem of predicting the video games buying habits of the public had caused some retailers to become disillusioned with the profitability of video games; this had created difficulties for publishers, irrespective of the quality of their products. Price levels had increased substantially, and the cost of software was perceived by the consumer to be high compared with hardware. The actual cost of producing a games cartridge was much higher than that for a cassette, floppy disc or CD. The selling price had to reflect the marketing as well as the production costs and this was an area where the very large overseas companies felt the need to spend large amounts, thus pushing up the end price to the consumer. The market would continue to evolve, with more powerful machines utilizing other media for delivery, such as CD-ROM as well as video on demand via cable or satellite.

9.20. Nintendo and Sega had been largely successful in controlling all software sold for use with their hardware, resulting in the Japanese parent companies receiving very substantial royalty revenue from third party publishers around the world. Such control did not necessarily encourage the creation of innovative software because the developers had to satisfy the requirements of the hardware companies first and the consumer second. Nintendo's and Sega's control of cartridge manufacture, as normally stipulated in their third party licences, meant a lack of real competition in cartridge production, which could lead to higher prices.

9.21. The US licensee of Codemasters' Game Genie video game enhancer had successfully defended Nintendo's allegation of copyright infringement, but the case had taken over four years and had been very costly.

9.22. The healthiest environment for original and innovative software was a completely open system whereby hardware manufacturers did not control in any way software developed for use on their machines. In a properly free and competitive environment creativity flourished and the consumer reaped the reward.

Domark Software Ltd

9.23. Domark Software Ltd (Domark), a publisher with an annual turnover of £8.6 million, said that Nintendo and Sega were able to provide machines affordable to everyone because they sold the hardware at next to zero margin and sought compensation on the software. The only way to make sure the profits from software accrued to them was to control its manufacture, something they did very well. A cartridge purchased from Sega for £16 would cost in the region of £6 on the open market. However, Sega's R&D costs in designing new machines had to be borne in mind. Domark had an agreement with Sega under which Sega could include Domark software in its rental scheme, Domark receiving £2.50 per unit.

9.24. The UK market for video games was very competitive, there was no lack of new titles coming on to the market, and recent moves in pricing by retailers were an indication that competition existed. More retailers were now stocking an expanding range of titles which brought choice closer to most consumers; the mail order market also existed for those who wished to shop in that way. An increasing number of companies had become licensees of Nintendo and Sega, and open architecture formats, such as the Amiga and the PC, had enjoyed good growth since 1990. If anything the UK video games retail market could be described as `over-retailed' or `over-competed'.

9.25. Domark said that software purchases by the consumer were very much dependent on price points. Through the development of the market in the last five years, the consumer was now sufficiently sophisticated to expect certain standards of game from each price point. For example, for the extra £10 that the consumer paid for a top-of-the-range PC game (compared with one at the lower end), he would expect extra game play along with cutting-edge graphics and sound. As regards future developments, Domark thought the key changes would come from more powerful technology being made affordable for everyone. Software would be shared on CDs and ultimately available to every home via cable television.

Electronic Arts Limited

9.26. Electronic Arts Limited (Electronic Arts UK) is a wholly-owned subsidiary of Electronic Arts Inc of Delaware, said to be the largest independent software publisher in the USA. Electronic Arts UK, which has operated in the UK since 1987, said that initially it sold directly to retailers; in 1989 it had re-evaluated its position and now dealt directly with some major retailers and through distributors with others. Electronic Arts UK would generally sell to anyone on a basis of wholesale volume unit prices (per case, per pallet, or for larger quantities). Sega had been its exclusive distributor for Sega-compatible products until March 1994. Its Nintendo cartridge products were solely manufactured by Nintendo of Japan and its Sega cartridge products were assembled by a subsidiary of Electronic Arts. Electronic Arts UK contracted with independent third parties for the manufacture and assembly of products for other systems. It had largely withdrawn from the Nintendo software market because, amongst other things, movements in exchange rates had made the business unprofitable.

9.27. Electronic Arts UK said that publishing video games was a high-risk business. It was impossible to predict whether a certain game would be a hit or not and this made costing very difficult. Magazines were more important in the UK than anywhere else in influencing customers. The average expected lifespan of a typical product was 90 days, though sometimes this could be considerably longer. Although Electronic Arts UK did not control retail prices, it nevertheless had to be sensitive to whether the expected retail price offered the consumer value for money. Publishers also had to take into account the manufacturing costs of cartridges which were considerably above those for other formats. Because cartridge prices were so high, independent publishers sometimes found it difficult to match the prices at which Nintendo and Sega sold their own games. Exclusive manufacture enabled Nintendo and Sega to charge independent publishers a royalty fee and possibly set a higher manufacturing cost than for their own products if they so wished. Electronic Arts UK declined to supply information about cartridge costs on the ground that such information was protected by confidentiality clauses in its parent companies' agreements with other parties.

9.28. Electronic Arts UK had suffered from recent price cutting by retailers of software. Sega had sold off extensive amounts of old stock into the market and this had clearly affected consumers' appreciation of the value of software and the amount that a retailer was willing to stock. Electronic Arts UK was finding it increasingly difficult to get full distribution for many of its titles on their release day because retailers were reluctant to stock a title until they were sure that it was going to be a success.

9.29. Electronic Arts UK had licences from both Sega and Nintendo to publish under their formats. It had never had a game refused nor had it any reason to believe that an Electronic Arts UK game had been treated less favourably than Nintendo or Sega products. The number of games allowed by Nintendo to be published in Europe had initially seemed somewhat restrictive but soon had been relaxed. There was no problem on this score with either company. All Electronic Art UK's games were available for rental at an additional charge of £5 per copy payable by the retailer. Electronic Arts UK thought it was perfectly reasonable that consumers should have a chance to try out a game out before buying it, but urged that strong measures should be taken against the pirate copying of games.

9.30. Interactive entertainment came in waves, each wave slightly bigger than the last. CDs would eventually supersede all other formats. Again piracy could be a problem. Further ahead home entertainment would most likely be dependent upon cable, satellite and telephone, with a greater variety and quality of software in the home.

Elite Systems Ltd

9.31. Elite Systems Ltd (Elite) answered on its own behalf, as the publishing arm, and also for its associated development company Motivetime Ltd. It had two-year Nintendo licences for each of the three formats (NES, SNES and Game Boy) but had been refused any form of licence by Sega. Its UK sales in 1993 amounted to just over £2 million. The key change in the last decade had been from an open market to one that was 70 per cent closed because only licensees could publish. The retail market was intensely competitive and the supply position for cartridges had changed from undersupply to oversupply. At present there was overcapacity in a competitive market and only the very good games resulted in a fair return.

9.32. Elite showed us a draft of a complaint against Sega that it had in mind to submit to the European Commission. This complaint, which if made would be in accordance with Article 3 of Council Regulation No 17, said that the real significance of Sega's patented or patentable security system did not relate to the technical requirements of the console system itself but to the power to use it to control the consumer's access to software which had not been approved by Sega. The cost of cartridges to licensees was understood to be greatly in excess of manufacturing costs, a difference which amounted to an additional royalty. Sega's approval process was understood to include consideration of `market saturation' in respect of particular types of game: thus even after obtaining a licence the licensee was not free to decide what software to produce or supply to the user. There were also understood to be limits on the numbers of games produced, which were considered to be discriminatory and arbitrary.

9.33. Elite's own proposals to Sega had been rejected, in some instances on the grounds that the games had already been published on competitors' systems and in others on alleged quality grounds which Elite did not accept. In Elite's view, Sega was creating artificial barriers to entry into the market for its own benefit and to the detriment of consumers and existing and potential third party suppliers.

9.34. Sega had a dominant position within the meaning of Article 86 of the Treaty of Rome and exploited it to prevent or strictly limit the use of competitors' software for a period following the introduction of a new console system to the market. Competition was permitted only when the profitability of software for any particular console had declined as a result of market saturation. Sega's practices were moreover liable to affect trade between EU member states.

Gametek (UK) Ltd

9.35. Gametek (UK) Ltd (Gametek), a subsidiary of a US company trading in the UK since August 1993, said that over the last five years the quality of software products had improved in terms of graphics display, primarily because of the change in technology from 8-bit to 16-bit machines. In addition to that, Nintendo and Sega were constantly developing new techniques for improving the graphics, display and speed of their machines. Software companies had responded to improving technology by raising their programming skills. Price levels for hardware had tended to fall over time while software prices had remained within a relatively constant range. The pricing of a game very much depended on its quality and on manufacturing and cartridge costs. Advertising and promotional expenditure within the industry had risen sharply over the last five years, largely as a result of competition for market share between Nintendo and Sega.

9.36. Gametek's reputation as a publisher was a key factor in determining its market position, and gave it access to distribution channels such as high street stores and major distributors. The form in which a game was published was important in so far as the unit revenues obtained from publishing software which was console-based were approximately twice those of a floppy disc-based game. Publishing for cartridge, however, was extremely risky. There was a minimum level of marketing support which the distribution network expected for game software. If the level of support fell below the minimum this would have a detrimental effect on the sales of games.

9.37. The pricing of software was becoming more important in determining sales of games, with the exception of instances where the quality was so high that consumers were prepared to pay whatever the asking price might be in order to obtain the game. The UK market for video games software was extremely competitive, particularly since the introduction of more third party publishers vying for the retailer's limited shelf space.

Intelligent Games Ltd

9.38. Intelligent Games Ltd, a UK company, said that Nintendo and Sega had regulated access to this booming market by controlling the manufacture of software for their machines. This limited consumer choice by restricting the availability of game genres which were not approved by the two companies, such as strategy and adventure games. In the free-access PC market there were as many of these kinds of games available as arcade-style action games similar to those designed for the consoles. In the Nintendo and Sega market, those games were outnumbered by more than 10:1.

Interplay Productions Ltd

9.39. Interplay Productions Ltd, based in the USA, had an annual turnover for video game software in the UK of under £2 million. Some licences from hardware manufacturers allowed it to control its own software manufacturing, others did not. All provided for a unit royalty, paid either separately or as part of the manufacturing cost.

Konami (UK) Ltd

9.40. Konami (UK) Ltd (Konami UK), a subsidiary of a Japanese company which is a leading designer and manufacturer of coin-op amusement machines, had a turnover in 1993/94 of about £15 million, of which £8 million comprised home video games software. It purchased finished Nintendo cartridges and Sega CDs from its parent company and Sega cartridges from SOJ. All these products were developed by or on behalf of the parent company. Konami UK said that the market position of any major publisher was mostly dependent on producing a product of the highest quality (in games, graphics, sound etc) and its acceptance by the consumer. Market support, price, reputation and genre were also important factors, but less so than quality. During the last three years a number of companies had benefited, by way of market share, through being Nintendo and Sega licensees. However, this had proved not to have been as profitable as was expected and there continued to be available to all publishers a number of major formats such as Commodore Amiga and IBM-PC. Konami UK believed Nintendo and Sega formats would become less important over the next few years because of the many new machines that were coming on to the market.

9.41. Some games achieved better sales at peak times, eg Christmas, while others were best released at quieter, less competitive times. Within certain sectors of the market, a licence attached to a game (eg cartoon or sports character, movie, television show) was very important. The level of quality of games was rising and the marketing support required continued to grow. It was becoming increasingly difficult to obtain the rights to `star' licences, as the licence owners themselves (eg movie companies) were becoming publishers in their own right and were therefore unwilling to license out their properties.

9.42. The UK games software market was very competitive, and competition at retail level was extremely high, particularly since the beginning of 1994. Prices had fallen during the year due to price cutting by retailers of major new games, and publishers also had reduced the price of older games. Konami UK would prefer to see lower retail prices for video games in order to achieve greater volume, but it was constrained by its buying prices and the level of gross profit it had to achieve to cover overheads, particularly marketing costs. This was particularly so with Nintendo games for which cost prices were higher and margins therefore relatively low. During the past year Konami UK had been forced to give up selling games for the NES because they were unprofitable. Price was important to the consumer in determining a purchase. For instance, when a particular game was discounted sales would increase, possibly several-fold. This was partly due to the consumer wishing to pay less and partly because discounting by the retailer was often linked to greater promotion of in-store visibility for a game. Konami UK did not generally supply games for rental although it was considering certain propositions from its customers.

9.43. Until the latter part of 1993 Konami UK's Nintendo games had been released under the Konami or Palcom brands because of Nintendo's restriction on the number of games released per year per label. For that purpose Palcom Ltd, a wholly-owned subsidiary of Konami UK's parent company, had existed in the UK for some years. However, since this restriction was eased by Nintendo last year the Palcom label was no longer operational.

9.44. When they entered the European market, Nintendo and Sega had brought with them many of the policies and practices that had made them successful in Japan and the USA. Amongst these were the strict control of manufacturing and of quality and genre of games from third party publishers. Initially the number of authorized publishers, and the numbers and types of games, had been very limited, but later more publishers had been authorized and limitations on numbers and types of games had been eased. Both companies had also initially controlled distribution, but had since allowed third parties to control their own sales, marketing and distribution.

9.45. As to future developments, Konami UK said that general market intelligence had led it to envisage major changes for video game software to follow the launch of new and improved hardware formats, and the introduction of CDs as the leading medium. During the next two to three years there would be greater competition from hardware manufacturers to establish their new formats. In the longer term it also foresaw the introduction of distribution of games by cable and satellite.

Ocean Software Ltd

9.46. Ocean Software Ltd (Ocean), a major UK developer and publisher of video games, said that it marketed and distributed its own products in the UK and had distributor arrangements for sales in the rest of Europe and an associated company in the USA. It was licensed by Nintendo to develop and publish games under Nintendo formats and had never had a game refused by Nintendo, which might, however, give advice. It had also recently obtained a Sega licence. Ocean had begun to supply games for rental and had made its last three titles available to Blockbuster for this purpose. No extra charge was made for these copies.

9.47. Ocean's reputation in the market-place was important. Because of its track record it had been invited to bid for the rights to market games such as Jurassic Park; its bid had been accepted, and the game had proved very successful. It had been able to initiate a bundling arrangement with Nintendo whereby its FIFA soccer game was sold as a package with Nintendo hardware.

9.48. Publishing was a high-risk business as it required a lot of funding; stocks had to be paid for up front as there was no trade credit. It was very difficult to judge whether a particular title would be successful or not, and it was important therefore, because of production cycles, that sufficient stock was available in the event of a title selling well; in cases where titles had proved to be less popular than expected, profits would suffer.

9.49. Ocean thought that cartridges would remain an important format. It believed Nintendo and Sega would develop compression techniques and offer these to their licensees, and that both companies would remain in the cartridge business. Cartridges of the future might well contain more information, but would not necessarily cost any more than at present. In Ocean's opinion the cartridge and PC markets appealed to different age groups, the former to the 6 to 18 age group and the latter to adults.

9.50. The price points of Ocean's own games were comparable with those of Nintendo. Discounting in the retail sector was peculiar to the UK, and many retailers would continue to sell games at below the RRP in order to increase consumer awareness and to attract business. Most of the discounting applied to hit titles. The prices that retailers charged for its products was something which Ocean said it could not, and did not try to, control; it only recommended what the selling price should be. Strong, well-advertised double A titles could be seen as loss leaders for some retailers. Price levels in the UK were comparable at present with those in the rest of Europe.

9.51. The 3DO venture had not yet seen the success its makers had envisaged. Ocean had obtained a licence and agreed terms, as well as buying all the necessary equipment, but had not yet produced anything for the system. Ocean said that the cost of development had prohibited it from writing for CD-i at present; there was a risk involved because games could take up to two years to develop and were now costing substantially more. Development expenses had increased tenfold which meant that a CD game could cost anything from $750,000 to $1 million to produce. The CD user base was small at present and price points therefore had to remain high. However, it was thought that the situation would change over the next two years because of the expected rapid growth in CDs; this would give publishers the option to sell more product and so lead to lower retail prices.

Sony Electronic Publishing Ltd

9.52. Sony Electronic Publishing Ltd (SEPL) provided evidence on behalf of itself and Psygnosis, a UK software company the Sony Group had recently acquired. SEPL distributed and sold video game products through Sony Group companies in each European country. Psygnosis carried out its own marketing activities.

9.53. SEPL said that the business was still evolving, with many competing technologies and formats, and new entrants. Up to 1990, sales of video games software were relatively small, with a low hardware-installed base. From Christmas 1990 to Christmas 1992 the business had grown rapidly with a three- or fourfold increase in the hardware-installed base. Since Christmas 1992 sales for existing formats had stagnated if they were not declining. However, with the arrival of new formats and systems in the near future, SEPL and Psygnosis expected significant growth in sales. This expectation was widely shared within the industry.

9.54. Innovation had raised the sophistication, capacity and detail of games. There had been a clear increase in the quality of the visual and audio components of software. Relevant developments in this connection had been the introduction of 16- and 32-bit hardware systems in addition to the original 8-bit formats, the launch of CD hardware systems and the increase in the ROM (Mbit) rating of software. There were many competitors in the market place offering increased choice to consumers.

9.55. A review of current prices of games indicated a wide range of prices, reflecting the various levels of sophistication and quality of content and strong competition at retail level. The relative pricing of games systems and video games software had narrowed considerably in recent years. The level of advertising and promotions expenditure had risen significantly, in line with the increase in the hardware-installed base since Christmas 1990. This in turn reflected the vigorous competition that existed.

9.56. Reputation as a publisher, quality, the format in which the game was published, price and the level of marketing support were all important so far as a publisher's market position was concerned. A good reputation as a publisher could be quickly earned and lost. SEPL and Psygnosis regarded quality of games as vital, to achieve consumer satisfaction and to overcome vigorous competition. The fact that video games could now be rented had further raised the importance of quality. The level of marketing support was also important in a very crowded market-place. It was beneficial for a game to be published in as many formats as possible in order to amortize marketing costs across a wider base.

9.57. There was strong competition at retail level: there were around 5,000 outlets in the UK which sold video games to consumers. The business was fragmented. Video games were offered by a number of different types of retailer, ranging from specialist chains and megastores to supermarkets, petrol stations and mail order operations. Entry was feasible for those who wished to try, as evidenced by Tower Records, a major US retailer now selling video games in the UK. Retailers competed in a number of ways, such as marketing, price, range of titles stocked, service, location and ambience, and in doing so appealed to different sections of the video games-buying public. Consumers were sensitive to price differences. Price competition was especially intense for the most popular games. Leading retailers were particularly keen to discount from publishers' RRP, and when they had done so (which had happened especially frequently over the last six months), many other retailers had followed in order to avoid getting out of line with their competitors.

9.58. SEPL supplied video games for rental on the same terms and at the same prices as games for sale. Psygnosis' video games were also supplied for rental on the same basis.

21st Century Entertainment Ltd

9.59. 21st Century Entertainment Ltd, a publisher with a turnover of £1.5 million, said that it had made the commercial decision to avoid publishing for Nintendo and Sega because it was a small company which did not have the financial resources to undertake the risks involved. It published for other platforms, and licensed some of its products to companies which were third party publishers for Nintendo or Sega.

Virgin Interactive Entertainment (Europe) Ltd

9.60. Virgin Interactive Entertainment (Europe) Ltd (Virgin Interactive (Europe)) was at the time of the hearing it attended a subsidiary of Virgin plc and a world-wide publisher of video games, with a turnover in the UK of £45 million. Virgin Interactive (Europe) said that it produced some titles on disc or CD whilst its cartridge titles were manufactured by either Sega or Nintendo. It had a close relationship with Sega; Virgin Mastertronic had held the Sega distribution agency for Europe from 1987 to 1991 (when it passed to SOE)-but had begun working on Nintendo products only in 1993.

9.61. Virgin Interactive (Europe) considered that the timing of the MMC inquiry would have been more appropriate a few years earlier. Then publishers had virtually no choice but to produce video games in cartridge format for use in either Nintendo or Sega hardware systems which dominated the market-a dramatic change from the complete freedom of publishing that had previously prevailed. Under the new regime many publishers had found it very difficult to obtain licences or to meet the console manufacturers' strict quality and production criteria.

9.62. Sega, but not Nintendo, required that it give consent at an early stage to the publishing of any specific product. This `concept approval' stage helped Sega to control timing and thus to avoid having (say) six soccer games published in the same month-though that could still happen. Both companies had procedures for technical approval before publication. With both companies charging around £20 for cartridges, the manufacturing cost was 70 per cent of the wholesale price. There was no other consumable durable of which this was true. Nintendo's terms of trade were fixed, but Sega had a diversity of different contracts. A few companies with a strong negotiating or strategic position had obtained different manufacturing terms. Nintendo used to regulate strongly the number of titles any publisher could produce in a year, but nowadays the number was such (ten for the SNES) that it could not be regarded as restrictive. Virgin Interactive (Europe) had never had a good game refused, though two less good ones had been turned down by Sega.

9.63. Virgin Interactive (Europe) said that the video games market would decline in 1994 despite aggressive competition and cost-cutting amongst retailers. There were virtually no `back-catalogue' sales:

90 per cent of sales were achieved in the first month or two. CD-based hardware platforms which were being introduced over the next few years would, however, compensate for this decline. Though Nintendo and Sega were also likely to compete in this new format their shares of the total market would be smaller than for the present cartridge-dominated games market. There would still not be a single, open, standard: people were not going to make games that worked on other people's hardware. Though the new hardware systems would initially be expensive prices would soon fall and the machines would increasingly appeal to the mass market. CDs already had an advantage over cartridges in having greater capacity and lower manufacturing costs.

Zeppelin Games Ltd

9.64. Zeppelin Games Ltd (subsequently taken over by the US company Merit Software Inc) told us that it had in seven years published over 330 games in traditional (non-cartridge) formats, and had experienced no restrictions whatsoever in their development or marketing. Its games for Nintendo or Sega systems had to be sold to licensed publishers. There were numerous restrictions applying to the production and sale of cartridge software and the high prices charged by the suppliers for cartridge production limited the profit that could be made by the publisher. The accusation against the two companies was that they `loss led' in the low price of their master computer units. Consumers bought a relatively inexpensive console not realizing the phenomenally high retail prices of the cartridge games they bought to maintain their interest.

Another publisher

9.65. Another publisher said that the key factors in obtaining licences from Sega and Nintendo were product-related. Sega controlled concepts for new games and its approval could not be taken for granted. The market-place for video games had matured considerably, with new hardware platforms increasing the capacity for producing more complex products. Prices had therefore risen. Competitive marketing, advertising and promotions, particularly from hardware manufacturers, had increased considerably. Quality and price were critical.

Consultation on remedies

9.66. We sought the views of several UK-based publishers on hypothetical remedies, in particular how far copyright or patent licences as of right would enable them to produce games without access to additional confidential know-how, and what would be the implications of requiring them not to enter into agreements with NCL or SOJ containing features the MMC might find to be against the public interest. The reactions were diverse. One publisher thought that for the remedies to have a significant effect, it would be necessary to compel NCL and SOJ to provide access to technical documentation (development manuals); furthermore, an order directed at UK publishers would be likely to have seriously adverse effects for them. Another thought the suggestion that the UK development/publishing community could extract itself from the NCL and SOJ licensing arrangements and still maintain a viable position in the industry world-wide was naive. The imminent advent of new machines would make access to the appropriate know-how essential. Recommendations based on the existing formats might prove irrelevant.

9.67. Another view expressed was that if NCL and SOJ were required to license the rights they held under UK patent and copyright legislation it would be possible for software developers to produce games, by reverse engineering, without additional access to know-how. However, such developers would remain at a competitive disadvantage because NCL, SOJ and their licensees started to produce games for a new system one or two years before it was launched. Others could begin to reverse-engineer only after that point. To be really effective, a remedy would have to require that rights be freely licensed as soon as they began to be used. There should be a similar requirement with respect to the use of the `tools' made available by NCL and SOJ to assist in producing games.

9.68. The same respondent said that a requirement on UK publishers of the kind proposed might result in NCL and SOJ offering no licences at all in the UK. It would be more useful to UK, and European, developers and publishers, and reduce the adverse effects of the present arrangements, if the European Commission were to recommend that European software publishers should not be required to enter into any restrictive licence agreements. Such action would encourage NCL and SOJ to offer new licences not containing features found to be against the public interest.

Wholesalers, distributors and importers

9.69. A summary of the views of CentreSoft, part of CentreGold, is in paragraph 9.16.

Bandai UK Ltd

9.70. Bandai UK, a wholly-owned subsidiary of a Japanese toy manufacturer, had begun distributing Nintendo products, in other European countries as well as the UK, in September 1990. Its directors' report and audited financial statement for the year ended 31 December 1993 recorded the transfer on 27 February 1993 of the company's distributorship of Nintendo hardware and non-licensee software to Nintendo UK. All employees associated with the Nintendo business had moved to the new distributor, to which the company's fixed assets and most of its stock of Nintendo products were sold. From 1 March 1993 the company had continued as a major supplier of toys and of Nintendo third party software imported from Japan. It had sustained losses in the latter respect because competition in the video games market drove sales prices well below the company's cost prices for most of its old inventory.

9.71. Bandai UK currently distributed only software sourced from third parties who produced software to be run on Nintendo platforms. These products were purchased direct from the licensees, such as Taito or JVC, and were shipped directly from Japan to the UK, normally to Felixstowe or Southampton, or occasionally by air. Sales were to department stores, major retail chains, specialist toy shops and smaller independent stores, at prices negotiated with each customer. Sales of video games were budgeted to decrease because Bandai UK's policy was to return to its traditional toy business.

Interactive Enterprises Ltd

9.72. Interactive Enterprises Ltd (Interactive) is a recently-formed company which imports and distributes both hardware (at first 8-bit and currently 16-bit) and software manufactured in Taiwan. Interactive said that the 16-bit console known as Nemesis, and the associated software known as Magic Bubble, were compatible with Sega systems. The console had been granted an export licence by the Taiwanese authorities who, Interactive said, believed it did not infringe copyright, the chips having been re-engineered.

9.73. Interactive explained that when it first imported supplies from Taiwan they were seized by Nottinghamshire Trading Standards Officers, allegedly at the instigation of Sega. The equipment was eventually returned to Interactive, which had, however, been unable to carry on its business for about a month during the course of the investigation. Interactive said that Sega was attempting to put it out of business and had threatened it with legal action on the grounds that it was infringing Sega's initialization routine.

Total Home Entertainment

9.74. Total Home Entertainment (THE), formerly known as Terry Blood Distribution, an autonomous trading division of John Menzies (UK) Ltd, said that it distributed home entertainment products to some 18,000 outlets, including both independent retailers and a number of retail chains. It provided next-day delivery from a range of 30,000 music products, 14,000 video products and 2,000 video games lines. The minimum order value was low, at £50. It competed with several other national distributors. There were also some regional distributors. THE had over 10 per cent of the audio and video market, but less than

1 per cent of that for video games. The reason for that was in part Nintendo's policy of dealing only with retailers and refusing to supply to wholesalers. Such action prevented THE from offering its customers a full range of video game products and effectively restricted its activities in that market. Nintendo was also reducing consumer choice by restricting supplies to major retailers and excluding many independent or non-traditional retailers. These practices were damaging to THE's business because trade credibility demanded that a full range be stocked. They were also uncompetitive and operated against the public interest.

9.75. THE argued that restricting the number of outlets and the availability of products in the market also gave suppliers greater control of prices and ensured that software prices were kept artificially high. Choice of hardware was crucial to the market. Once a consumer had invested in a particular console he was unlikely to buy another system and he was tied to buying software compatible with that system. THE thought that Nintendo and Sega had intentionally pegged hardware prices in the UK at artificially low levels to achieve fast market penetration. This had enabled them to keep most other potential players out of the UK market and to charge high prices for their software titles.

9.76. The video games market was driven by new releases. Pressures for latest titles and deliberate reductions by suppliers in the allocation of stocks meant that prices for these products remained around their RRP. Prices for older titles were gradually reduced. Price cutting on new titles and on hardware had, however, become a recent feature of the market, particularly by major retailers in the lead-up to Christmas. Price cutting had had a significant effect on THE's business. Some independent retailers had been driven from the hardware market and most were unable to compete with major retailers on prices for the latest video games. Suppliers might be giving multiple retailers more advantageous terms than independent retailers, thereby enabling them to offer more generous discounts.

9.77. THE thought the high licensing fees charged by Nintendo and Sega to third party producers, and additional costs, made third party products more expensive than they ought to be. As a result it was more difficult for third parties to compete equally with software titles developed and produced by Nintendo or Sega. Hardware suppliers also influenced the choice and availability of third party products. There should be a common technical standard and licensing should be abolished.

9.78. THE questioned Nintendo's refusal to allow the rental of its video games and Sega's imposition of a surcharge for rental products, which frequently comprised overstocks or old titles. Sega also charged retailers an annual licence fee of £400, excluding VAT, to join its rental scheme. Rental would increase a consumer's propensity to buy a particular title.

9.79. In THE's view there was not only a scale monopoly situation, but also a complex monopoly situation, in that both Nintendo and Sega so conducted their affairs as to prevent, restrict or distort competition, for example by imposing onerous and restrictive conditions in licences to third party publishers of software for their hardware platforms, operating a restrictive distribution system, imposing restrictive conditions of supply on retailers (required stocking, preferred shelf space, RRPs) and selling hardware to favoured retailers at little more than the cost of production. This monopoly situation operated to the benefit of Nintendo and Sega, the licensed publishers, the exclusive distributors and the favoured retailers. Even though the licences might contain restrictions to which the publishers objected, they still benefited because not all the publishers were Nintendo and/or Sega licensees so that those who were faced limited competition and acquired increased market power. The exclusive distributors, by virtue of their exclusive position, were not subject to normal competitive pressures. The favoured retailers, even though they too might complain of restrictions imposed upon them, faced limited competition in the high street. The practices described were uncompetitive practices undertaken for the purpose of exploiting or maintaining the monopoly situation.

9.80. In THE's view, the prices that Sega and Nintendo set for their hardware product (at little more than cost), together with their enormous promotional and advertising expenditure, acted as an effective barrier to new entrants. Traditional Atari hardware had all but disappeared, and new products were struggling. Philips CD-i had come on to the market and despite considerable `hype' had yet to make much impression. 3DO had yet to come to market. Without new entrants, Sega and Nintendo would be able to continue to dominate both the hardware and software markets. They would be in a position to control the distribution of product to retailers, the number of distributors within the supply chain, the prices retailers charged consumers, and the development (or otherwise) of the rental market. The result would be (as now) a limited number of retail outlets being able to stock the product, which, especially for new releases, would be sold at a higher price than would otherwise be the case. Development of the rental market would be inhibited. All this acted against the public interest.

9.81. The CD would be the delivery medium for video games in the future. The public interest would be best served by a common standard, as had happened with video cassettes, audio cassettes and audio CDs. Whether this happened for video games depended to some extent on the current market power of Sega and Nintendo being broken. There was a risk that this market power would be used to perpetuate their proprietary systems and so prevent a common standard emerging.

Retailers

Argos plc

9.82. Argos plc, the catalogue retailer, said that retailers competed on the basis of listing `must-have' products. The end consumer was fickle and highly fashion-orientated: games, and systems, could come into vogue virtually overnight. The larger-volume sales were concentrated in a handful of key software lines and hardware bundles. The overall margins achieved on all video games products were significantly lower than those normally earned on computer products.

9.83. More recently, competition had been based not only on availability but also on price. Argos had been told that if it cut prices of Nintendo's products it would fall to the bottom of the list in terms of supply. Deals and special value-added offers were not available to retailers considered to be disrupting Sega's and Nintendo's marketing policy. A further financial penalty was available by not giving protection on stock in hand following price realignments.

Blockbuster UK Group Ltd

9.84. Blockbuster UK Group Ltd (Blockbuster UK), the UK subsidiary of a US retailer, said that its budgeted revenue for video games in 1994 was £12.7 million, almost equally divided between sales and rental. Nintendo refused to supply its Ritz chain, comprising 90 per cent of its outlets, and withheld retrospective discounts if the conditions of supply were not met. It also thought Nintendo's terms unreasonable in as much as they required the retailer to stock all formats even if one or other of them was in his judgment no longer commercially viable. Another restriction was that a minimum number of titles for each format must be stocked. The Mega Drive/Sonic 3 bundle appeared to have been available exclusively to Dixons for a short initial period. The Mega Drive version of FIFA had been subject to restricted availability. Blockbuster UK had paid Sega some £374,000 for rental licences for its shops and now thought this reflected an over-optimistic view both of the games that would be made available and of the degree of protection that would be afforded against unlicensed competitors. Blockbuster UK nevertheless took a more favourable view of competition in the market than it would formerly have been able to do, because of the growing number of third party publishers willing to supply games for rental.

9.85. Blockbuster UK cited research findings that in the USA it was estimated that 80 per cent of purchases of software followed a rental trial. Sega had reported that the average Genesis (Mega Drive) owner spent $555 during the first two years, one-third of which was on rentals. Total US game sales in 1993 were estimated at $3,894 million and rental at $885 million.

Debenhams plc

9.86. Debenhams plc (Debenhams) said that it had started selling Nintendo's merchandise in 1988 and Sega's in 1991. The category had shown strong growth rising to sales of £4.27 million in 1992/93, but subsequently demand had fallen, margins had tightened and purchasing patterns had become unpredictable, to such an extent that Debenhams' `own buy' toy department had decided to cease handling this volatile product category in January 1994. Concessions (retailers who rented space within stores) would still sell video games. Being in stock (and equally getting out of stock) of the right games at the right times were particularly important in building share in this competitive market. The retail contracts introduced by Nintendo in March 1993 were more onerous than those employed by Debenhams' other suppliers, and resulted in slightly more NES stock being taken than was required.

Dixons Stores Group Limited

9.87. Dixons Stores Group Limited (Dixons) said that it sold video games software and hardware through its Dixons and Currys outlets. It had also recently bought and was expanding PC World, a chain of specialist stores dedicated to PC hardware, software and accessories, including computer games. Dixons had been one of the first major retailers to establish itself in both the video games software and hardware markets and retained the largest retail market share. It did not rent software from any of its stores. Retail distribution of video games had widened considerably over the last few years. This was particularly true for video game software where Dixons now faced competition from other electrical multiples, toy shops, specialist games retailers, major record shops, general retailers and video rental outlets. Competition for hardware sales was mainly from other multiple electrical retailers.

9.88. Whilst a retailer needed a reasonable range of games to provide credibility with the consumer, a small number of lines accounted for the large majority of sales. These key lines were widely available and major new games titles were usually the subject of a co-ordinated launch programme. While nearly all hardware was sold bundled with software, about 70 per cent of software was sold on its own. The gross margin achieved on hardware, software and accessories was lower than that on other product categories.

9.89. Price competition had always existed in the video games market but this had intensified in recent months, particularly in the lead-up to Christmas 1993. Previously there had been less price-cutting on new titles. Retailers had willingly accepted suppliers' RRPs on new releases as a means of improving their margins for the period of high demand which usually followed release. Retailers now heavily discounted new releases and this practice was likely to continue.

9.90. Suppliers preferred prices not to be discounted but Dixons had not been subjected to any pressure from suppliers not to cut prices. Nintendo's current conditions of contract were no more onerous than those of other suppliers. Increased price competition was indicative of a decline in the sales of video games. Dixons' own experience of falling hardware sales indicated that home penetration was now beginning to reach its saturation point. Whilst sales of cartridge-based formats would probably continue to decline, those of CD- and PC-based games were likely to increase over the next few years, provided the accompanying hardware was suitably priced to appeal to the mass market. There was every likelihood that Sega and Nintendo would continue to be important in the CD-based market but there would also be other major players some of which were already marketing their own products.

Future Zone Stores Ltd

9.91. Future Zone Stores Ltd (Future Zone), a subsidiary of Rhino Group plc, opened its first video games store in October 1992. With 78 stores it was now the largest specialist video games retailer in the UK and had about 10 per cent of the software market. It also stocked games accessories, books, magazines and a limited range of games hardware. Nintendo and Sega products accounted for about 40 per cent of its product line-up.

9.92. Future Zone said that it had found it easy to enter the market and it had not been discriminated against in any way by suppliers, with whom its relationship had generally been happy. New entrants might, however, find it more difficult to gain a foothold in the market as there were now a number of established specialist games retailers.

9.93. Until the advent of specialist games shops there had appeared to be very little, if any, competition in the high street which was probably due to the rapid market growth enjoyed until 1993. A recent decline in sales had increased price competition amongst retailers. Future Zone had always discounted a selection of software products in its stores. Consumers were highly price-sensitive.

9.94. Prior to 1994, Future Zone had rarely discounted new releases until initial demand had passed. Sometimes this lasted no longer than two weeks. It had, however, been in the forefront in the move to discount Sega's Sonic 3 released earlier this year, which it thought had been overpriced from the outset, and it had recently introduced its `Chartbusters' initiative which offered discounts on a selection of recently released games. Most publishers were keen to have their products included within this selection to benefit from the increased sales which were generated. Larger discounts were also given on games over a year old.

9.95. In the past there had been `elbow twisting' to maintain prices. This had now largely disappeared, except that one major publisher (Acclaim) had refused to supply one of its recent new releases without an assurance that it would not be discounted (see also paragraph 9.8). Future Zone said that its reputation as a specialist retailer could suffer by not having the latest releases. It needed to maintain good relationships with major publishers and apart from this one isolated dispute succeeded in doing so.

9.96. Future Zone said that it did not rent out video games because it believed time constraints made video games unsuitable for rental. This was something on which its senior management were well able to form a view, their previous experience having been in rental (with the Ritz chain, since acquired by Blockbuster). In Austria, for example, where there were no copyright restrictions on rental, the renting of games had never exceeded 8 per cent of video rental turnover.

9.97. As to future development, Future Zone thought that systems using CDs-cheap to produce and with excellent sound quality and graphics capabilities-were likely to become dominant within three to four years. Sales of PC-based games were already growing rapidly. There was no reason why Nintendo and Sega would not continue to be represented in this market. Hardware manufacturers would, however, have to ensure that their products were not overpriced if they wished to reach a mass market. Differences in the pricing of video games between the UK and USA, Future Zone said, were caused by differences in the retail property market.

HMV UK Ltd

9.98. HMV UK Ltd (HMV), part of Thorn EMI, said that its primary business was the retailing of recorded music, but it also stocked ancillary products including video games. Forty-nine of its stores now had video game and computer software departments. Price competition had not generally been a feature of the games market during its high growth phase from 1989 to 1992. Retailers had competed by having products available at release date and by carrying sufficient stocks to satisfy unpredictable demand surges. There had subsequently been a great increase in the number of retailers selling games, and not enough demand to sustain all of them. Price competition was now expected to be a permanent feature of the market, which had shifted from being hardware-driven to being software-driven. There was a very high element of stock risk. Fluctuating demand and lead times for deliveries from the Far East often produced a `feast or famine' situation.

9.99. Nintendo's terms had resulted in HMV having to stock some lines which it would not otherwise have chosen to take. Market forces had led to the current bout of discounting on the high street but this had not been reflected in a consequent reduction of manufacturers' prices.

Intertan UK Ltd

9.100. Intertan UK Ltd (Tandy) sold video games hardware and software, which accounted for just under 10 per cent of turnover, through 324 retail outlets. Margins in the video games business were among the lowest for any of its product categories. Nintendo stipulated a minimum range of products, and purchases from it were subject to quarterly retrospective discounts. This could lead to Tandy stocking more software titles than it would normally do, with greater risk of inventory obsolescence. It would prefer trade prices to reflect the total margin on the product rather than operate under a system of retrospective discounts.

Kingfisher plc

9.101. Kingfisher plc (Kingfisher) said that three of its subsidiaries were concerned with the supply of video games. Most of its 800 Woolworths stores sold software, and some hardware, and its Comet stores sold hardware and some software. Entertainment UK distributed entertainment software (CDs, videos and video games) to retailers, with Woolworths as its major customer. In addition, Kingfisher also had over 100 video rental outlets, operating under the name Titles, either directly owned or operated through franchises, four of which were renting out video games on an experimental basis. Explaining the role of Entertainment UK, and of wholesalers generally, in the recorded music business, Kingfisher said that there were many thousands of stock-keeping units and a rapidly-changing pattern of demand, which gave the wholesaler a special role. Similar considerations applied to video games.

9.102. Kingfisher said that the video games market was a fast-moving and risky business for manufacturers and retailers alike. Five years ago it barely existed in the UK. Since then many new competitors had entered the retail market including high street multiples and toy and specialist games retailers. Competition amongst retailers was primarily based on price and the breadth and availability of the product range. It was innovative and exciting software that led to hardware sales and expanded the market. The public was well served with a wide choice and range of attractive games readily available throughout the country. Kingfisher was, however, concerned at the high price of some of the games which it thought could be partly justified by the high investment risk that the industry had to bear. Margins on video games were low given the range offered and the often slow rate of stock turnover.

9.103. Price cutting was now fairly commonplace amongst retailers, especially in the run-up to Christmas. Some price cuts had also been introduced by the games suppliers. Retailers usually charged the RRP at the launch of a new game to recoup their investment. Price cutting might then take place once a game was a few months old. In Kingfisher's view this was a perfectly normal retail cycle.

9.104. Competition amongst video games suppliers was also likely to intensify. Technology was moving towards CD-based products with several well-known companies proposing to enter the market in the near future, with a range of different products in various formats. The major existing suppliers, Sega and Nintendo, were also developing new products. There was no guarantee that CD-based games would necessarily take sales away from the current console-based systems. Much would depend on the appeal and excitement of the games on offer and whether they were attractively priced.

9.105. As to its supply agreements, Kingfisher said that its sole concern at present was that Nintendo sought to impose certain potentially restrictive practices in its agreement, eg a minimum stock range and approved display arrangements. This could impede normal decision-making ability, for example if a competitor were to launch a better product. While those restrictions were generally observed, Nintendo had not tried to enforce them.

John Lewis plc

9.106. John Lewis plc said that it considered the basis of competition to be product range. Multiples and independent stores were its main competitors; the former were increasing their strength. Nintendo dictated the range of its hardware and software assortments stocked. These restrictions were different from normal commercial practice and meant that a number of slow-moving lines had to be taken. However, there was no pressure to adhere strictly to the terms of the agreement. The John Lewis Partnership had very firm criteria on advertising, marketing and promotion and did not actively promote video games systems and software. There was no room for negotiation on prices with either Nintendo or Sega.

The Littlewoods Organisation plc

9.107. The Littlewoods Organisation plc (Littlewoods), comprising Littlewoods Chain Stores, Littlewoods Home Shopping Group Ltd and Index Ltd, said that for hardware, price and the ability to market and promote heavily a discounted offer were paramount in today's market. For software, breadth of range and the flexibility to offer new innovative titles as they were launched was more important than price. The high street electrical retailers dominated the retailing of video games. Sega's terms of trade tended to be more flexible, Nintendo's more rigid.

John Menzies (UK) Ltd

9.108. John Menzies (UK) Ltd (John Menzies) said that it was possible to offer substantial savings on promotions, which were a key tool in increasing market share. Product availability, even on best-selling new releases, could be patchy. Getting product into store for the `street date' was vital. Trading conditions imposed by Nintendo and Sega had been relaxed greatly over the previous six to nine months (up to March 1994). Previously certain pressures (eg non-supply) could be brought to bear on retailers discounting prime software and hardware. There had also been occasions when one or two key suppliers had attempted to impose what were in John Menzies' view unreasonable charges, for example £5 for empty packaging/inserts when these had been stolen by customers. However, this practice too had been relaxed.

9.109. We heard also from Software on Demand Ltd, a wholly-owned subsidiary of John Menzies, which was the UK licensee of the EDOS system for the electronic downloading of software. Games were produced on demand in retail locations in eight formats (not Nintendo or Sega). The views of THE, also part of the John Menzies group, are summarized in paragraphs 9.74 to 9.81.

Our Price Ltd

9.110. Our Price Ltd, a subsidiary of W H Smith with over 230 outlets, said that by mid-1992 the market had peaked. Software sales were generated by effective marketing and availability, with price being largely insignificant. However, since then 16-bit technology had reached its full potential and there was confusion over the next generation of technology. This had led to more discriminating purchasing by consumers. The top titles commanded a greater proportion of sales, while sales of average titles had declined considerably. As the market volume had fallen, RRPs for the top titles had increased. Price had become the most important factor for consumers.

9.111. Our Price had been heavily encouraged to sell video games at RRP. In some instances, this had resulted in threats to withdraw marketing support if Our Price wished to discount the product. Nintendo stipulated the range of its products to be stocked. There had, however, been a marked improvement in working relationships recently.

W H Smith Ltd

9.112. W H Smith said that it had been an important player in this market from the beginning. Price discounting was an increasingly important element of retail competition, and was generally at the retailer's own expense and not encouraged by suppliers (who might, however, help in the worst circumstances of old, overstocked, lines). Consumers were becoming more discerning and more demanding. Other sales promotion techniques, range, availability, ambience and knowledgeable staff were also important.

9.113. Nintendo required that hardware be stocked if software was, which did not fit comfortably with the company's range objectives. It would have liked to reduce its range of hardware and the number of stores stocking hardware and outdated software ranges, but was prevented from doing so by the contract with Nintendo. Its failure to comply with some of Nintendo's other terms led to the withdrawal of retrospective discount (eventually paid, but only after additional orders were placed). Some other publishers (Ocean, Electronic Arts) also stipulated minimum order levels which were likely to increase stockholdings; in some cases, W H Smith might decide that the minimum order was in excess of the worthwhile investment in the product, which might therefore not be stocked at all.

Toys `R' Us Ltd

9.114. Toys `R' Us sold video games from its 45 outlets. Turnover in the year ended January 1994 had exceeded £25 million, with gross margins of 19 per cent on hardware and 29 per cent on software. It had refused to sign Nintendo's trading terms and policies and as a result there had been a delay in supply of some two and a half months. Thereafter a trading arrangement had been arrived at which did not involve signing the trading terms and policies document.

Virgin Retail Ltd

9.115. Virgin Retail, since merged with Our Price, under the control of W H Smith, said that the basis of competition had changed as the market had undergone very fast growth and there had been many new retail entrants. Whereas availability had been the key factor, price had now become more important. The popularity of individual games was highly sensitive to magazine reviews. Sales were now mainly generated from the top ten software titles; the rest accounted for only about 20 per cent of the total.

9.116. Virgin Retail said that Nintendo's conditions must be met in order to secure retrospective discount. In the past suppliers had been able to dictate to retailers by ensuring that product availability was poor, but this now occurred only on major releases. Virgin found itself obliged to buy stock in larger central quantities than it did in other entertainment areas such as music and video. The result had been that it had been left with large overstocks in the past and had incurred the cost of heavy mark-downs to clear stock. Acclaim had attempted to stop Virgin from cutting the price of NBA Jam by preventing it from acquiring sufficient stocks (see also paragraph 9.8).

A multiple retailer

9.117. Another multiple retailer said that competition between retailers was vigorous on both price and non-price factors. Historically there had been a high element of stock risk because of the very short life-span of most products. Achieved gross margin had been significantly less than planned and under-performed the company average. In 1992, cartridge prices appeared to be excessively high. Nintendo had sought to impose detailed stocking constraints on retailers. Its stipulation about shelf space bore no relation to its actual market share and resulted in its titles taking up a large percentage of display space leaving little room for other (third party) titles which were often superior. That position had been eroded as a result of greater competition. More recently there had been material improvements.

Mail order companies

9.118. *Empire Stores Group plc*, a mail order retailer, said that until recently the basis of competition had been depth of product range for software and unique bundling for hardware. In the last quarter of 1993 a hardware price war had started in the high street and quickly extended to top-selling software titles. As mail order committed itself to printed prices, it was hit badly by the high street price reductions. Both Nintendo and Sega had in the past restricted the choice of the number of hardware/software bundles available for mail order.

9.119. *Freemans plc* said that competition was based on price and product range. When a new or updated product was released the superseded product instantly had to be reduced in price to clear stock.

Nintendo had a requirement that minimum numbers be stocked and would not supply Mario All Stars unless Star Wing was accepted as well.

9.120. *Another company* said that cost prices were non-negotiable and retail prices therefore higher than it would wish. One supplier insisted that a minimum number of games in each format be offered. The basis of competition for retailer share was range and price. At the moment sales were more price-driven than ever before.

Complaints about Sega's rental scheme

9.121. The OFT had received a number of complaints from small retailers arising from the operation of Sega's rental scheme, as also did the MMC.

9.122. *Game Gallery* (Darlington) said that it had received a letter threatening injunctive proceedings on behalf of Sega in respect of a part-exchange scheme which operated on a buy-and-sell, not rental, basis and was a major part of its business.

9.123. *Pro-Swap* (Eastcote), which engaged in swaps, not rental, said that it had received letters from FAST (see paragraph 9.140) claiming that it was breaking the law. It could not afford to fight Sega and Nintendo in court even though it had received legal advice that they were probably in the wrong.

9.124. *Mr D Smith* (Port Glasgow) had been told by Sega to cease and desist from operating an exchange scheme he had just started, despite legal advice he had received that he was not in breach of the Copyright Act.

9.125. *The Software Shop* (Renfrew) had received a `cease and desist' letter from Sega to which it took the strongest objection. It operated an exchange (not a hire) service, without which many customers would not have bought a Sega console, because of the high cost of software. Exchange systems in fact created more sales, both of hardware and software. To demand that they cease was an unreasonable restraint that did not apply in any other industry. The Software Shop was unable to obtain Nintendo products because it could not agree to the excessive restrictions imposed.

9.126. *Sound and Vision* (Borrowash) believed that Sega's rental policy constituted a restrictive practice and organized a petition on the subject, signed by many of its customers.

9.127. *Take 1 Video* (Bognor) complained of Sega's enforcement procedures in connection with rental. It asked why Sega did not concentrate its efforts on the dealers who rented games without a licence instead of persecuting the dealers who had paid for one. Retailers were forced to buy rental products at top price from specified wholesalers.

9.128. *Ten to Ten Video* (Wokingham), also trading as Titles and Plaza (17 outlets), said that its main concern was for the less well-off sector of its customer base whose children could not afford to buy games but who would be able to rent them if the manufacturers would allow it. Sega had a limited licence arrangement which allowed the renting of old games whereas the games business was very much a hit, Top 20, type business. Nintendo did not allow any of its games to be rented.

9.129. *The Wantage Video Library* said that the video rental trade was almost entirely dependent on new releases but for games the rental market had to wait from six months to a year. To put prices up by 25 per cent to accommodate the Sega scheme was more than its customers, who were in the main aged between 8 and 16 years of age, could afford. Moreover the rental charge for some games would rise above the dearest video rent.

Trade associations

Entertainment Software Retailers' Association

9.130. ESRA was formed in March 1993 to serve the interests of independent specialist retailers primarily engaged in the sale or rental of both video films and video games, the latter accounting, on average, for about 15 per cent of turnover. There are currently about 150 members of the association with a total of 750 retail outlets. It replaced the previous Video Trade Association.

9.131. ESRA said that until recently the only way in which independent retailers could obtain video games was through wholesalers. The situation had now changed in that publishers were more willing to deal directly with major retailers. In ESRA's experience, Nintendo (like Bandai previously) was very selective about whom it was prepared to supply. When Nintendo and Sega had limited supplies of a title they serviced their major accounts, the high street multiples, first. Independent retailers had complained that they were unable to obtain supplies of particular products as and when they wanted them. It appeared, however, that on a number of occasions supplies coming into the UK could not meet peak demand.

9.132. Retailers acquired video films on the basis that they could be rented, a premium being paid for the `window' that ensured that the films would not go on to the sales market until three, six or nine months after rental release. Retailers had assumed that video games would be rentable in the same way. However, the opposite had been the case. Sega put products on to the sales market initially and some months afterwards might, if it so chose, put the product on the rental list. Its licence scheme had created conflict and indications were that the scheme was out of favour with retailers. The 250 Mega Drive games available for rental included few that would still earn money from the mass of consumers. There was a conflict of interest with the high street multiples, who did not want games rented while they were still selling them. ESRA's members were quite clear, in the overwhelming majority of cases, that it was not in their interests now to take out a Sega licence or to renew an existing one. Whenever Sega reduced the price of a particular product (for whatever reason) retailers who bought it for rental purposes still had to pay the full price, plus a £5 surcharge. ESRA added that Sega's decision to offer licensed retailers the right to buy its hologram separately from the product was something that ESRA had advocated for some time and this enabled retailers to obtain the keenest price. The age profile of people who regularly (as distinct from occasionally) rented was older than might have been expected, at 18 to 25. Rental stimulated sales of good games and effectively killed bad games.

9.133. As recently as 1993 few independent publishers, possibly only Accolade, had permitted rental of their games, but in 1994 there had been a significant change. Nearly all publishers were prepared to consider proposals for rental, a major factor being that they were now responsible for their own distribution. In its dealings with retailers, Sega had implied that it could enforce copyright on all software compatible with its hardware, but in ESRA's view that was not the case.

9.134. In ESRA's opinion, some swap or part-exchange schemes, as distinct from second-hand dealing, infringed copyright, and it had advised retailers to that effect. In 1993 Sega had issued some 1,700 `cease and desist' letters to retailers, but only 15 cases had reached the stage of a writ being issued. ESRA estimated that there were perhaps 5,000 specialist retailers, a majority of whom were renting video games, and that the overall retail stockholding of games available for rental might be in the region of 300,000, having declined from perhaps 500,000 at the end of 1993. As regards piracy, ESRA said that information it received from its members indicated that there was now an increasing number of counterfeit cartridges available in the UK.

9.135. The price cutting which had taken place prior to Christmas 1993 was an indication of slow sales and high stocks. It was probably the first occasion when ESRA members found themselves being undercut by the high street multiples. Prior to that, retailers were selling at the RRPs. The 16-bit market might have reached a peak as the 32-bit and CD markets were beginning to be addressed. More price cutting of 16-bit machines was likely in the event of any market recovery, because the industry would see it as a means of moving stock quickly prior to CDs gaining market penetration. When Sonic 3 was launched limited supplies were available to independent retailers, and many retailers had bought stock from high street multiples more cheaply than through their usual wholesale supplier. Independent retailers had received letters and telephone calls from customers who had previously placed orders with them for Sonic 3 stating that they intended to buy it from a major multiple instead.

9.136. The price of video games was a constant criticism levelled at retailers by consumers. However, price cutting would probably be a loss-making exercise for the high street multiples. Most independent retailers were unlikely to cut prices as their margins would not allow them to do so. From mid-1993 it was recognized that when particular titles had lost their attraction to the high street multiples, both Nintendo and in particular Sega would lower the trade price in an effort to try to stimulate more sales. Sega products had also come in from Europe. As a result, the same game from a variety of sources could have trade prices ranging from £19 to £40.

9.137. Looking to the future, ESRA said that the market had become more open and it expected the trend to continue. Even though cartridges were on a downward trend at present, the fact that new CD technology was now available led it to believe that overall the market would remain stable.

European Leisure Software Publishers Association Ltd

9.138. ELSPA said that as the association representing the computer and video games industry, among whose members were Sega, Nintendo and most if not all licensed publishers of games software, it was not in a position to comment with regard to the monopoly inquiry. It was not and never had been party to the content or detail of any agreements, pricing structures or distribution and licensing arrangements between the companies concerned. ELSPA provided a list of its members, to each of whom we wrote.

9.139. In 1994 ELSPA had also introduced a voluntary age rating system for labelling games by four age categories-3 to 10, 11 to 14, 15 to 17 and 18 plus-which its members were required to apply to all new releases by September 1994. This was intended to provide parents with more information on age suitability when buying video games which were not covered by the classification certificates introduced by the Video Recordings Act 1984 (see paragraph 9.151). Members had also agreed to be bound by the Code of Practice of the Video Standards Council. The Video Standards Council monitored the age rating system and any complaints from members of the public.

9.140. ELSPA added that it was active in seeking to prevent counterfeiting and copyright infringements, concentrating on entertainment as distinct from business software. It had taken over from FAST in 1994 an enforcement officer with special responsibilities to develop ELSPA's role in this area.

Federation against Software Theft Ltd

9.141. FAST was formed in 1984 by the software industry to lobby for a change in UK copyright legislation in view of uncertainties as to whether the Copyright Act 1956 protected computer programs. After this had been achieved (see Chapter 3) FAST was relaunched as an anti-piracy body with enforcement functions. It told us that it had nearly 500 members including all the major software and hardware companies and trade associations. In 1993 it handled 1,013 complaints and secured 55 successful criminal prosecutions. It had been involved in a number of cases relating to counterfeit cartridges for Nintendo and Sega systems and there were several more such cases pending. The problem was even more acute in the disc-based leisure sector where the ratio of pirate to genuine product was estimated to be in the region of 5:1. PC copy systems enabling software to be copied from cartridge to standard computer disc represented a real threat to the cartridge-based games industry.

National Association of Specialist Computer Retailers

9.142. The National Association of Specialist Computer Retailers (NASCR) was established in 1986 to represent the interests of independent retailers. According to NASCR about 12 per cent of retailers in the independent sector are members of the association, and their activities range from those who sell software only to those selling a general mix of products. Between them, members operate about 140 retail outlets throughout the UK. NASCR said that over 80 per cent of turnover in most outlets was video games orientated. The association was looking at ways to improve the competitiveness of its members by way of central buying and distribution.

9.143. NASCR said that the consoles market had peaked and was now in decline, and it expected the trend to continue. The industry was moving towards CD technology but its members still relied on consoles, some of which in future would take CDs. There were a number of problems associated with disc-based machines, which did not apply to machines that were console-based. However, PCs, because of their versatility, were likely to become more important in years to come.

9.144. The vast majority of NASCR members were against the idea of rental, although a few did engage in this activity. Reasons for opposing rental included the length of time needed to complete a game (the hire period could be up to five days), and there was the risk of piracy while games were out on rental. A rental-only business would require sufficiently large numbers of cartridges to be hired out in order to make such an operation viable. NASCR added that what was happening in effect was that most of the shops running legal rental operations were illegally renting later releases, but neither Nintendo nor Sega had taken action to stop this practice.

9.145. NASCR said that Sega had been serving `cease and desist' notices on retailers supposedly running illegal rental operations, though the majority were in fact dealing in second-hand goods via exchange. Members had gone under when faced with the threat of substantial legal costs. If only Sega would listen to public opinion and reduce the RRP, far more product would be sold and rental would be irrelevant. Part-exchange transactions might account for between 40 and 50 per cent of the turnover for a number of outlets.

9.146. NASCR said that options were diminishing because of the attitudes of the dominant players currently in the market-place; they did not see the relevance of the independent sector as it was easier for them to do all their business through multiple retailers. The effect on independent retailers was such that they were finding it difficult to survive. In many cases multiple retailers had an unfair advantage because they were being supplied on a full sale-or-return basis, which was not available to independent operators. Because of advance deliveries to multiple retailers' centralized warehouses, they were now getting supplies of new releases in some cases up to two weeks or more ahead of those in the independent sector. As a result, numerous sales were made by these retailers in advance of the official release date. The multiples also got higher margins, which enabled them to engage in price cutting which the independents could not match.

9.147. NASCR expected to see a rapid decline in the number of independent retailers. The large multiples would then be in a position to push prices up and control the price points because of the lack of competition from the independent sector.

British Medical Association

9.148. The British Medical Association supplied us with the views of its Paediatric Sub-committee. The Sub-committee was aware of children coming to harm from playing video games as a result of photosensitive epilepsy being provoked by the screen monitor which flickered while the game was being played. This light flicker could induce a fit in those children with epilepsy who were subject to this trigger factor-a minority of perhaps 10 per cent. A similar risk could arise from watching television, driving in a car along a row of poplars in sunlight, or psychedelic lighting at a disco. The video game did not cause the underlying epilepsy: it could only spark off an individual attack. If it did, the child might need to avoid video games. But they were not a general health hazard, and the problem described was no more a reason for banning them than the similar risk from television was a reason for stopping the sale of television sets.

Survey of photosensitivity

9.149. We also received the interim findings, dated 17 November 1993, of a national survey of photosensitivity conducted jointly by the Institute of Neurology, the National Society for Epilepsy and the National Hospital for Neurology and Neurosurgery. The survey had been prompted by recent concern about epileptic seizures that might have been triggered by electronic screen games. It was thought particularly important to know if people who had never previously reported seizures were liable to have a first seizure triggered by such games.

9.150. The most important, although not exclusive, potential mechanism was photosensitivity, a genetically determined trait that might be present through life without presenting any symptoms, but which in some cases (especially in children of school age) could result in epileptic seizures. The findings of the survey were that the overall annual incidence of cases with a newly presenting seizure and unequivocal photosensitivity in Great Britain was 1.1 per 100,000, but 5.7 per 100,000 in the age range 7 to 19. Within that age range, the annual incidence of first or presenting seizures considered to have been triggered by game playing was conservatively estimated to be 1.1 to 1.4 per 100,000, compared with an annual incidence of new cases due to all causes of 55 per 100,000. Proper advice should be given to each individual, but blanket restrictions should not be put on all patients with epilepsy, the majority of whom were not photosensitive.

Video Standards Council

9.151. The Video Standards Council was established in 1989 as a non-profit-making body to develop and oversee a code of practice and rules designed to promote high standards within the video industry. Members undertook to comply with the law, having particular regard to the Video Recordings Act 1984 and the Copyright Act, and to refrain from dealing in illegal or counterfeit products. The Council's activities extend to video games as well as films. It encouraged members to comply, *inter alia*, with the age classifications (15 or 18) introduced under the Video Recordings Act 1984, which, however, exempted video games (as well as videos designed to inform, educate or instruct, or concerned with sport, religion or music) unless they depicted to any significant extent human sexual activity or acts of force or restraint associated with such activity, or mutilation or torture or other acts of gross violence towards humans or animals.

Public concern about video violence

9.152. At an early stage of our inquiry violence in video films became the subject of considerable public and media attention, as had been the case from time to time in the past. We took note of the Home Secretary's statement in the House of Commons on 12 April 1994. He said that the Criminal Justice and Public Order Bill already provided for certain amendments to the Video Recordings Act 1984. The Bill would now provide for a penalty for supplying videos in breach of an age classification, and for supplying unclassified works. In addition the Bill would be amended to require the British Board of Film Classification (the `designated authority' under the Video Recordings Act 1984) to take into account certain factors when classifying a video, including, for example, whether it might cause psychological harm to a child and whether it portrayed techniques that it would be undesirable for a child to imitate. The amendments were subsequently made to the Bill, which was enacted on 3 November 1994. We also noted that the British Board of Film Classification would stiffen the standards it applied when classifying works according to their suitability for particular ages.

Members of the public

9.153. *Dr Hugh Saddington* described, from first-hand experience, the disparity in prices of both hardware and software between the USA and the UK. He said that he was informed by retailers on both sides of the Atlantic that personal imports were prevented by ensuring that US software would not work on UK hardware and vice versa.

9.154. *Dr J F Humphries* said that retail prices of cartridge games, except Sonic 3, appeared to be fixed, in contravention of the Resale Prices Act 1976, because retailers feared sanctions by the manufacturers. This contrasted with the free market in PC games.

9.155. Some 40 children, and a few parents, wrote to us following a reference to the inquiry in a BBC television programme. All complained of excessive prices for cartridges. One parent said that consoles were underpriced by companies which then used unscrupulous advertising methods resulting in `unmerciful pestering by kids whose pocket money could never cover the cost of software'. The fact that prices of games were all similarly high indicated a restrictive practice.

H H LIESNER *(Chairman)*

J S BRIDGEMAN

J F PICKERING

M R PROSSER

L M ROUSE

A J NIEDUSZYNSKI *(Secretary)*

14 November 1994