

April 26, 2012

The Honorable Lamar Smith, Chairman,  
The Honorable John Conyers, Jr., Ranking Member  
United States House of Representatives, Committee on the Judiciary  
2138 Rayburn House Office Building  
Washington, DC 20515

Dear Representatives Smith and Conyers,

The recent filing of the Department of Justice (DOJ) case against price fixing by five major publishers in the e-book market underscores the ongoing effort of antitrust authorities to define the proper role for antitrust at a key moment in the development of the digital economy. The economic efficiency and consumer benefit of digital distribution of goods and services are transforming the way the market meets consumer demand. Incumbent physical space firms that are confronted with a more efficient business model will stop at nothing to preserve their dominance. The actions of the antitrust authorities and others to ensure that nascent competition is not squelched by anticompetitive tactics should include the full range of antitrust powers – denial or conditioning of mergers and acquisitions, prevention of unilateral monopoly abuse, and blocking collusion.

The Department of Justice's recent e-book antitrust complaint immediately casts a spotlight on another action under review by the antitrust authorities that raises similar and parallel issues – the EMI-Universal merger. In seeking to block and unravel the price fixing scheme hatched by five publishers, the DOJ alleged that a cabal of five companies with a total market share of less than 50% could undermine or distort the growth of nascent competition from new digital distribution models by refusing to make their products available to alternative distribution models or by manipulating the terms, conditions or price of access to their products.

- **If five companies with a market share of less than 50% pose a threat to nascent competition from digital distribution models, does one company with a market share above 40%<sup>1</sup> pose a similar threat?**
- **Viewed through the lens of traditional antitrust practice and the lens of nascent development of digital distribution models, the UMG-EMI merger poses a significant threat to competition and demands close scrutiny and vigorous remedy by the Federal Trade Commission (FTC), the sister antitrust agency to the DOJ, that is reviewing the transaction.**

The post-merger market share of EMI-Universal is sufficient to give it the power to distort or even determine the fate of digital distribution models. Even if the FTC does not believe that a 40+% market share alone gives a single company the power to determine life or death for these emerging models, it certainly makes it very easy for that company to lead the effort to do so. With a post-merger three-firm market share of 90%, and with one or two companies following the lead of the dominant firm, the market would be vulnerable to anticompetitive harm resulting from conscious parallelism.

The most compelling reason to give the merger extremely close scrutiny is the potential for development of alternative business models in the transition to digital music distribution coupled with incumbent record labels' strong interest in diminishing the impact of digital disintermediation

---

<sup>1</sup> The Nielsen Company & Billboard's 2011 Music Industry Report, January 5, 2012, p. 3.

on their control of the marketplace. Incumbent major record labels have incentive to stifle new digital distribution platforms because those platforms begin to level the playing field among major labels, independent labels, and unsigned artists. Digital platforms are more likely to license unknown or niche music because, unlike their physical space predecessors, they are not constrained by time limits (like radio) or space limits (like physical stores). As a result, the major record labels lose one of their main selling points to musicians—namely, that they have the connections and influence that a musician absolutely needs to get his or her music out in the marketplace. Thus the dominant incumbent labels are particularly incentivized to stifle digital platforms that will decrease their influence as compared to smaller labels or unsigned acts.

Digital disintermediation is a powerful, consumer-friendly, competition-friendly force in the music industry, just as it is in the book publishing market, but it is not immune to the abuse of market power by entrenched physical space incumbents. Merger review is intended to be prophylactic, to prevent the acquisition of market power that raises the likelihood that anticompetitive, anti-consumer behaviors will occur and be effective. Giving a firm with a strong interest in retarding digital distribution substantially more ability to do so is a mistake that can be avoided by denying the merger outright, or crafting conditions that prevent the abuse of this newly acquired market power.

That is exactly the situation in the proposed merger between Universal and EMI in the music space. The merger will dramatically increase the concentration of control over sound recordings of popular music – current albums, catalogue albums and deep catalogue albums – to which competing distribution models must have access to succeed. The recently revised joint DOJ/FTC merger guidelines show that this merger raises serious concern about concentration, even when viewed as a traditional horizontal merger. Concern about nascent competition in the digital space significantly magnifies the threat posed by the merger. The post-merger firm would have a powerful position in the digital product space, controlling six of the all-time top ten selling digital artists and albums.<sup>2</sup>

## **THE IMPORTANT ROLE OF ANTITRUST**

### **The Merger Guidelines**

Under the joint Department of Justice/Federal Trade Commission Merger Guidelines, which were updated just two years ago, the consideration of proposed mergers begins with a straightforward analysis of market concentration. If a merger increases the concentration in the market by an amount that could result in a significant increase in the market power of the post-merger firm, then the merger demands scrutiny. Concentration is measured by the Hirschman-Herfindahl Index (HHI) because that index has a direct relationship to existence of market power. The thresholds at which concern is felt about mergers were raised substantially in the recent revision.

A market that is considered moderately concentrated used to be defined as one that exhibited an HHI between 1,000 and 1,800. An HHI above 1,800 was considered a highly concentrated market. Translated into everyday terms, a market with ten equal-sized competitors would have an HHI of 1,000. A market with 6 equal-sized competitors would have an HHI of 1,667. In effect, a market with more than 10 equal-sized competitors was considered unconcentrated, fewer than 5.5 was considered highly concentrated. In between the market is moderately concentrated. Under the revised guidelines, the unconcentrated threshold was raised to 1,800,

---

<sup>2</sup> *The Nielsen Company & Billboard's 2011 Music Industry Report*, January 5, 2012, p. 7

while the highly concentrated threshold was raised to 2,500, or the equivalent of 4-equal sized firms.

A merger is evaluated by examining the level of concentration of the post-merger market and the impact of the merger on the level of concentration.

*Moderately Concentrated Markets:* Mergers resulting in moderately concentrated markets that involve an increase in the HHI of more than 100 points potentially raise significant competitive concerns and often warrant scrutiny.

*Highly Concentrated Markets:* Mergers resulting in highly concentrated markets that involve an increase in the HHI of between 100 points and 200 points potentially raise significant competitive concerns and often warrant scrutiny. Mergers resulting in highly concentrated markets that involve an increase in the HHI of more than 200 points will be presumed to be likely to enhance market power. The presumption may be rebutted by persuasive evidence showing that the merger is unlikely to enhance market power.

In the Comments filed in response to the revision of the *Guidelines*, the Consumer Federation of America observed that, while the revisions accepted more concentrated markets, they would improve antitrust enforcement only if they were deemed to be more binding and led to more consistent action against to block harmful mergers. This is exactly the circumstance we had in mind.<sup>3</sup>

## **The Importance of Digital Disintermediation**

One of the most important focal points of public interest advocacy in understanding the impact of the digital revolution on consumers is to understand on how “digital disintermediation” has increased efficiency in distribution and benefited consumers in many markets including digital content industries, like music, e-books, newspapers, and video, as well as physical space industries. We believe that the UMG-EMI merger comes at a crucial moment for both antitrust and the development of the digital economy.

The Internet and the digital technology on which it rides are coming to maturity, after about 20 years of development in commercial applications. Unlike many other disputes over digital distribution of content, this one does not involve claims of piracy or concerns about privacy. It is entirely about efficiency and tactics that are intended to squelch competition from a more efficient, consumer-friendly approach to the production and distribution of products. Stopping this practice will send a strong signal that physical space incumbents will not be allowed to use anticompetitive practices to distort or undermine emerging digital alternatives.

In the mature, advanced industrial society of the late 20<sup>th</sup> century, distribution and transaction costs came to represent a large share of the total costs of goods and services. In the content industries, like book publishing, music and newspapers, transaction costs are as much as 80 cents on the dollar. Digital technologies can lower production and distribution costs and give consumers much greater flexibility and choice, thereby dramatically improving the fit between what is produced and what is consumed. Digital technologies also help the great mass of content creators and artists by expanding the market and making it easier to directly reach the consumer.

---

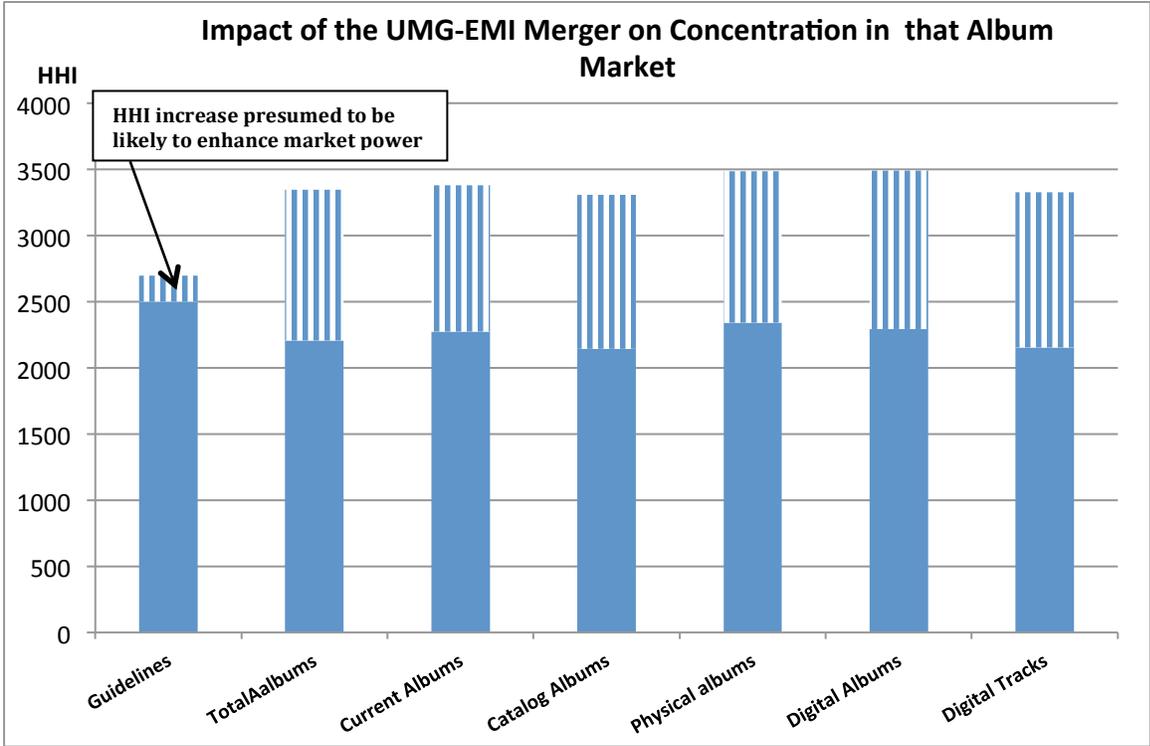
<sup>3</sup> Comments of Consumer Federation of America, *Department of Justice/Federal Trade Commission Horizontal Guideline*, June 4, 2010, pp. 3-4, “If the revision enables the antitrust authorities to make the thresholds more binding – to challenge mergers more consistently when they violate the thresholds – this will be an important step forward. Antitrust authorities had failed to challenge and the courts have failed to block too many mergers.”

Digital “disintermediation” is a powerful force for change and cost reduction that challenges the business models of the dominant incumbent firms because it dramatically reduces the need for middlemen. As technologies lower the cost of production and distribution, a surplus develops over the social surplus that is released. The sellers of information goods seem to think that because consumers were willing to pay a high price for their physical products in the past, they can keep the price high for digital products and pocket the cost savings as increased profit. However, in vigorously competitive industries (i.e. with large numbers of buyers and sellers and high elasticities of supply and demand), the vast bulk of the cost savings will be passed through to consumers. That is the why the antitrust laws are the front line of consumer protection.

**THE UMG-EMI MERGER RAISES SIGNIFICANT COMPETITIVE CONCERNS**

**Horizontal Concentration**

By a wide margin, the UMG-EMI merger is a merger that exceeds the levels where a merger is deemed to “potentially raise significant competitive concerns” and “warrant scrutiny.” Measured by revenues, the merger would move the market for recorded music sales from the unconcentrated range to the moderately concentrated range by increasing the HHI by over 500 points, five-times the level that triggers concerns. Looking at the market for albums, which is a distinct product<sup>4</sup> and the largest single source of record label revenue, the impact of the merger is much greater.



Source: The Nielsen Company & Billboard’s 2011 Music Industry Report

For each of the major categories of albums the merger moves the market from the moderately concentrated level to the highly concentrated level adding over 1,000 points to the HHI. This is five times the level at which a merger is “presumed to be likely to enhance market power.”

<sup>4</sup> Enders, *EMI: The Game of Musical Chairs Continues*, December 7, 2011, p. 14, notes that “On the demand side, CDs involve albums and digital download predominantly singles which makes them imperfect substitutes.”

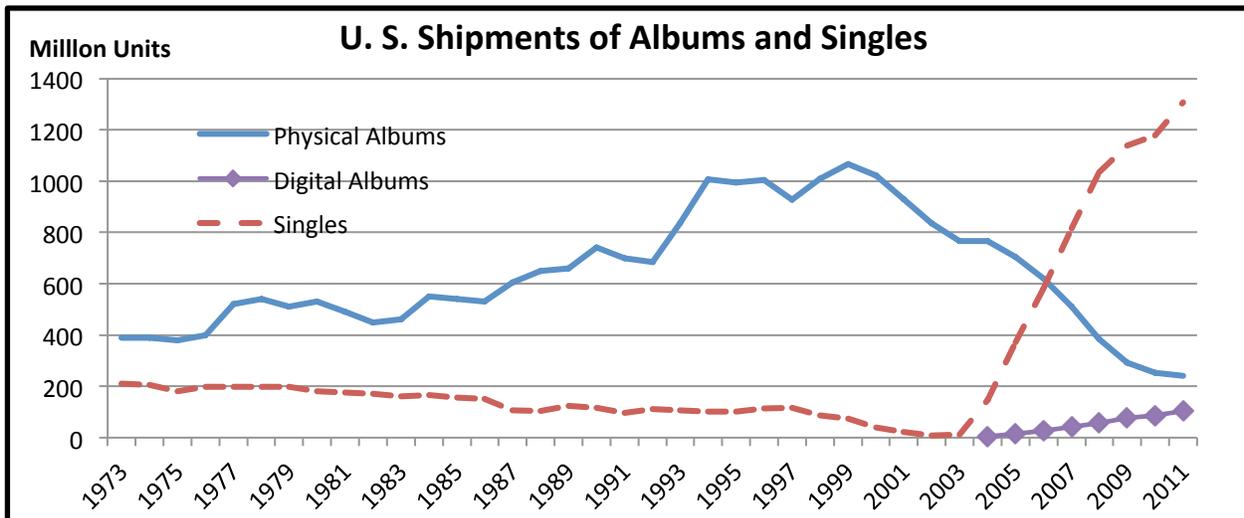
The issue of market definition will be hotly debated, as always happens in merger review, but we are convinced that album sales, which remain the dominant source of revenue for the labels, is a well-defined market. Moreover, the other factors that the *Guidelines* indicate can be taken into account indicate more scrutiny, not less.

- The top firms have been the same and their relative positions have been quite stable (except for mergers) for a decade.
- The industry has a history of anticompetitive conduct that resulted in consent decrees signed a decade ago.
- The three-firm concentration ratio is about 90 percent, which not only makes coordination a serious concern, but enhances the possibility of conscious parallelism developing in which behaviors reinforce the lead of the dominant firm without coordination.

### Digital Music

The consumer experience in the music space, the first sector that went through the process of digital disintermediation, provides evidence of the economic benefits. The dramatic explosion in sales of singles is testimony to the ability of digital technologies to deliver exactly the type of product that the consumer desires.

In the mid-1990s, record labels engaged in two practices that imposed severe harm on consumers. They adopted a price fixing scheme to keep album prices high, even though the new compact disc (CD) format dramatically lowered their costs and discounters had lowered prices. They eliminated the sale of singles, even though the CD was well-suited for the sale of singles. In short, they restricted output and raised prices, forcing consumers to purchase hundreds of millions more overpriced CDs to get the music that they wanted. The book price fixing case recalls this tactic – publishers raise the price of e-books to prop up sales of physical books.



Source: Recording Industry Association of America, various years.

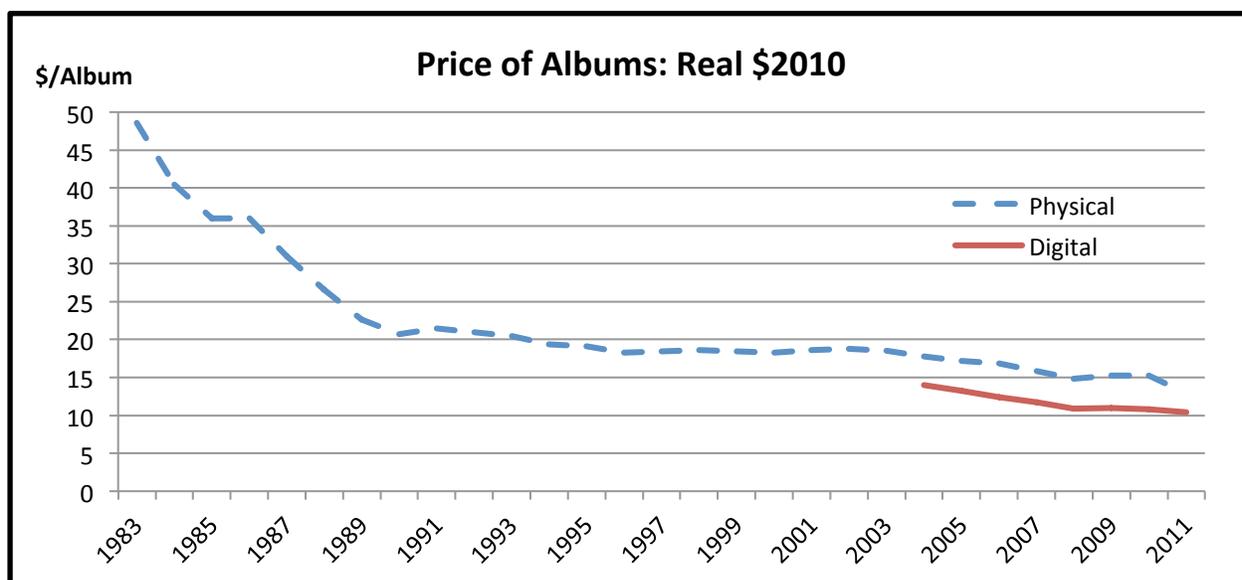
An antitrust consent decree ended price fixing and digital distribution made the sale of singles a compelling alternative. In 2011, consumers bought about 1.3 billion digital singles at an average of just over \$1 per single, for a total cost of \$1.5 billion. Since consumers typically want two or three songs per album, if the anti-consumer, anti-competitive practices of the recording

industry had not been thwarted by law and technology, consumers would have been forced to buy about 500 million albums at an average cost of about \$13 per CD to get the music they wanted. The total cost would have been about \$6.5 billion. Digital singles allowed consumer needs to be met more efficiently at a consumer savings of more than \$5 billion.

### **The Importance of Albums as Marquee Content in the Growth of Digital Alternatives Magnifies the Anticompetitive Potential of the UMG-EMI Merger**

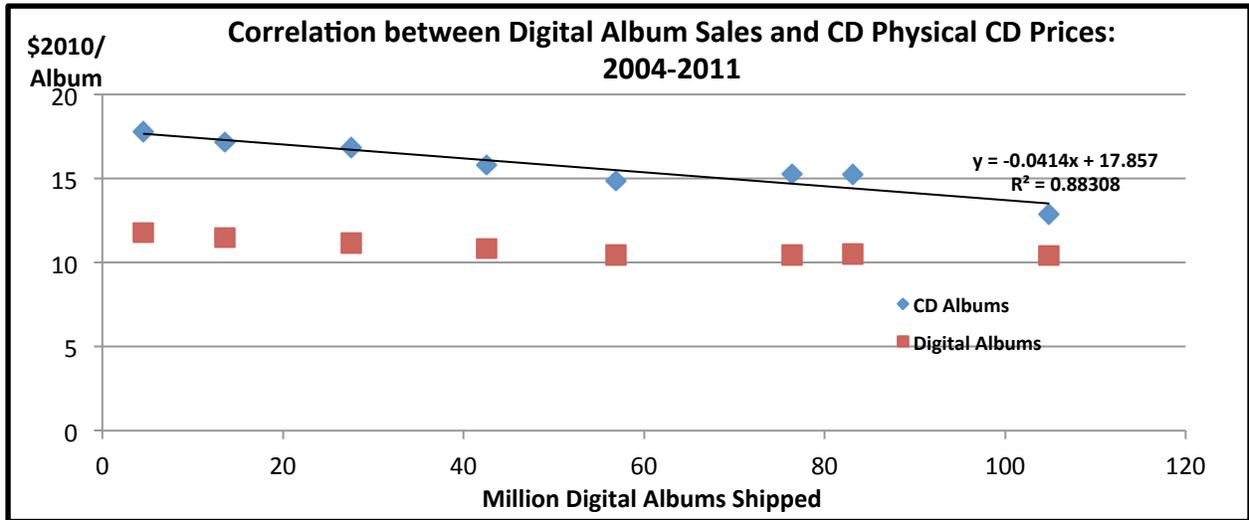
While singles have attracted the greatest attention and delivered the greatest benefit to consumers, digital album sales have been the fastest growing revenue stream of the labels in the past couple of years, topping \$1 billion in 2011. Album sales represent over 60% of the revenue of the major labels. In 2011, for the first time, the increase in the number of digital albums sold was larger than the decrease in the number of physical albums sold.

The claim that piracy will prevent the dominant post-merger firm from exercising market power does not fit the facts. Consumers spent over \$1 billion on digital albums in 2011, at an average cost of \$10 per album. If piracy is so easy, why spend that much money on legal products. If consumers are willing to pay \$10 per digital album and not resort to piracy, why would \$11 drive them to piracy? Why would a ten percent increase in the price of a digital album drive them to piracy, if \$10 has not? These are the price increases that merger review is targeted at.



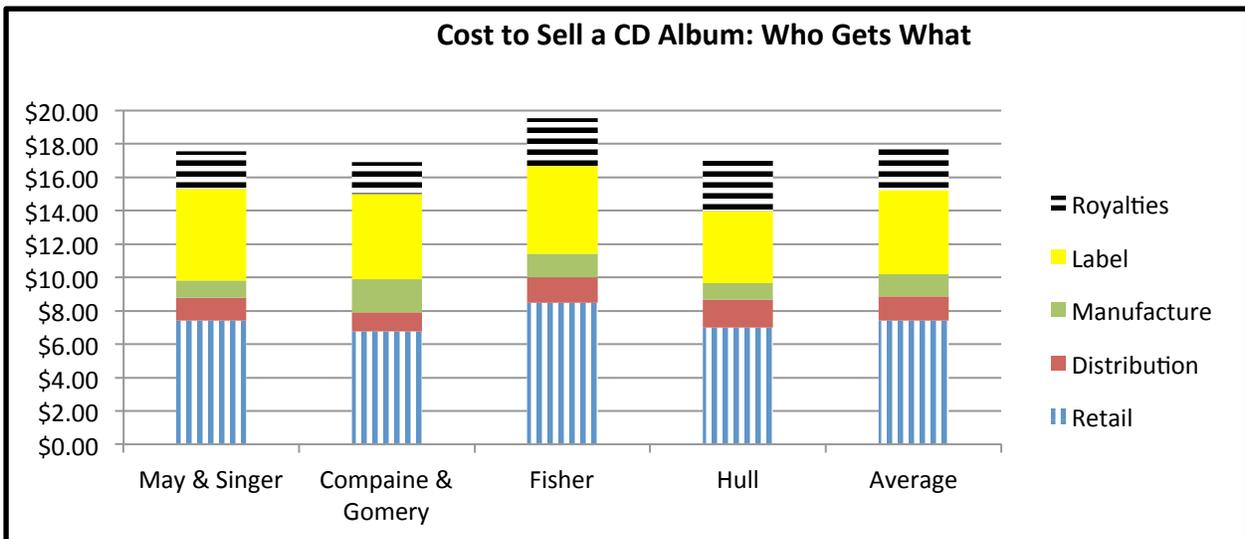
Source: Recording Industry Association of America, various years.

The pricing of CD albums had begun to show the effects of competition from digital albums. It was exactly this competition that the collusive e-book pricing fixing scheme was intended to squelch. It is this price competition that the record label price fixing of the 1990s squelched. It is this price competition that the UMG-EMI merger would put at risk. It is in this space that the major labels are strongest and it is in this space that the next battle over pricing may well be fought. Digital competition arrived at the same time that the major labels signed their second consent decree in less than a decade, so it is impossible to disentangle the effects of antitrust enforcement and digital competition. At present, however, the two go hand-in-hand. Antitrust enforcement is vitally important to prevent the labels from undermining or dampening competition from digital distribution.



Source: Recording Industry Association of America, various years.

The price tag of \$10.00 for a digital album and declining prices for physical albums may look like remarkably good deals for consumers, given the history of pricing in the industry, but digital technologies are transformative – dramatically lowering production, distribution and transaction costs. Physical space, brick and mortar costs have been about 60% of the cost of an album. They are largely eliminated. As the need to administer a large physical production and distribution network and spend a lot of resources trying to match supply and demand decline, the label costs should fall significantly as well. The fees that digital distributors, like Apple, have taken may be too high as well. With more competition and new business models, the price of a digital album could be lower and closer to the cost.



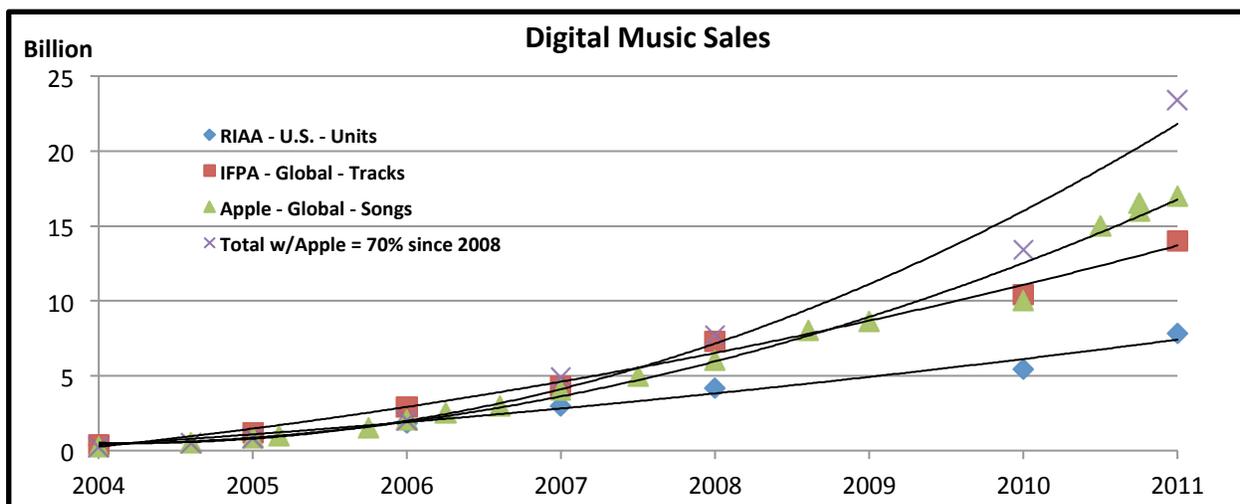
Sources: William Fisher, *Promises to Keep* (Stanford, Stanford University Press, 2004), Appendix for May and Singer, Compaine and Gomery and Fisher; Geoffrey P. Hull, *The Recording Industry* (New York: Routledge, 2004), 2<sup>nd</sup> ed., pp. 182 and 259 for CDs and Digital, respectively.

The striking thing about the breakdown of who gets what from a physical album sale is the small share that artists get. Needless to say, as the costs of physical distribution are eliminated, they strive to increase their take. As noted above, digital disintermediation could give them greater leverage in the scrum over the rents both because they can go directly to the audience and because

they have more alternatives. We think artists have benefited in this way, but there is a second way they have benefited, as well.

Millions of artists sell music on iTunes and other digital distribution services, the vast majority of whom had no way to reach the consumer in the brick and mortar world because they could not get a recording contract. Digital distribution has diversified and deconcentrated the recorded music space, but as shown earlier, the major labels still dominate the revenue stream of the music industry through their control of albums and the alternative digital models are early in their evolution.

Estimating how large a role digital distribution plays in allowing unsigned artists to reach the public is difficult, in part because there are no centralized entities to count them. However, comparing the estimates of digital sales from distributors to the estimates of sales claimed by the representatives of labels, we do find a gap that today is close to 3 billion units for Apple songs alone and 9 billion for all digital sales. This is certainly good news for unsigned artists, but the question that the antitrust authorities face is whether the dramatic increase in concentration in control of albums would pose a threat to competition in the space.



Sources: RIAA - Annual Units Shipped, IFPA, Digital Music Reports, various years, Apple, Milestones as reported in Wikipedia.

Access to the content of the majors remains indispensable to building new distribution models. It is not feasible to succeed on the basis of unsigned artists alone. The concentration of control of albums in the hands of a dominant player in a highly concentrated market poses a severe threat to competition and dynamic innovation in this space. As the majors gain greater leverage, alternatives and artists lose out.

### THE CRITICAL ROLE OF ANTITRUST AT A KEY MOMENT IN THE THIRD INDUSTRIAL REVOLUTION

The UMG-EMI merger is part of a long list of issues that antitrust authorities have faced in recent years as digital disintermediation unsettles important product markets. Access to content for distribution in new digital models has been a prominent part of several antitrust actions, including the e-book complaint and the complaint that laid the basis for the settlement in the Comcast NBC merger,<sup>5</sup> as well as the resistance of antitrust authorities to suspending the antitrust

<sup>5</sup> Acting Assistant Attorney General, Sharis A. Pozen, *Remarks*, Brookings Institution, April 23, 2012. The Comcast-NBC merger also demonstrated how merger conditions must be monitored and enforced to be effective in protecting competition.

laws to allow newspapers to control digital distribution of news content. These content focused actions to preserve competition are part of an even longer list of cases in which the Department of Justice and the Federal Trade Commission have recognized the importance of stopping old-fashioned anti-competitive behavior from undermining nascent competition and the development of alternative business models in cyberspace. Their efforts run the gamut from traditional concerns about horizontal concentration (AT&T-T-Mobile) and anticompetitive, most favored national clauses (Visa-Master Care; Blue Cross Blue Shield), to unilateral anticompetitive monopolization (Microsoft; Intel), to vertical leverage in physical space products (Ticketmaster), to vertical leverage in digital products (Google-ATA).

This sharp increase in antitrust activity stems from two factors. On the one hand, the antitrust authorities have come back to life after a long slumber. On the other hand, the dramatic transformation of the economy driven by digital technologies is part of the “quarterlife crisis” of the third industrial revolution. The incumbent economic order is being overturned. The most powerful actors who are entrenched in the old order will use their resources to promote their interests at the expense of the public interest unless antitrust enforcement steps in.

Antitrust in the 21<sup>st</sup> century will have to be sensitive to the new economic reality, where small numbers of platforms play an important role. Large firms dominate platforms at the center of the digital economy because of the superior economics made possible by dramatic reductions in transaction costs and the ease and importance of vertical linkage in digital production. Because basic economics drive platform dominance, it becomes vitally important to ensure open competition for the complements that flow on those platforms.

The need for openness is a two edged sword. The owners of the platforms must not be allowed to leverage their market power to distort competition on the platform. The suppliers of the complements (in this case music) must not be allowed to manipulate the supply of “marque” content to distort platform competition or extract monopoly rents, especially in the name of defending inefficient, outdated physical space business models. Blatantly anticompetitive practices that are intended to frustrate efficient processes like digital disintermediation must not be tolerated. Thus, we view vigorous action to address the anticompetitive threat of the UMG-EMI merger as an important part of the effort to reinvigorate antitrust in America and the battle to ensure that consumers get the full benefit of the digital revolution.

Sincerely,

Mark Cooper,  
Director of Research, Consumer Federation of America

Jodie Griffin  
Staff Attorney, Public Knowledge