

## 2 Conclusions

### Contents

	<i>Page</i>
Introduction .....	6
Background .....	7
The record companies .....	7
Retailing of records .....	8
The importance of copyright .....	9
The monopoly situations .....	10
Record companies .....	10
Retailers .....	14
The relevant issues .....	15
International price differentials .....	16
Comparisons with the USA .....	16
Comparisons with other countries .....	21
Parallel imports .....	21
Competition in the record industry .....	23
Profitability of the record companies .....	25
Price structures .....	26
Competition in retailing .....	27
Profitability of the retailers .....	28
Contracts with artists .....	28
Position of record producers .....	32
Promotion and marketing .....	32
Discounts to retailers .....	33
Availability of vinyl LPs and singles .....	33
Collecting societies .....	34
Phonographic Performance Limited .....	34
Video Performance Limited .....	34
Record charts .....	35
National charts .....	35
Retailers' charts .....	36
The public interest-conclusions .....	36

### Introduction

2.1. The Director General of Fair Trading referred the supply of recorded music to the MMC on 14 May 1993 for investigation under the monopoly provisions of the Fair Trading Act 1973.

2.2. In announcing the reference the Director General drew attention to the relatively high prices of CDs when compared with the cost of other formats and with prices in the USA. He expressed concern that the record companies' use of copyright law to restrict parallel imports of lower-priced CDs may be frustrating competition. Similar concerns had been expressed by the National Heritage Committee of the House of

Commons and by Consumers' Association. The conclusions of the National Heritage Committee's report<sup>1</sup> are reproduced in Appendix 2.1.

2.3. Although the price of CDs was the main focus of the inquiry, our terms of reference are not confined to this issue. They embrace the whole field of recorded music and require us to investigate and report on 'the supply in the United Kingdom of pre-recorded compact and vinyl discs and pre-recorded analogue and digital tapes on which music is reproduced without visual image'. A number of other issues were raised with us in the course of our inquiry and we record our conclusions on all of them in this chapter.

## **Background**

2.4. The UK has a large and internationally important recorded music industry. The retail value of sales in the UK amounts to over £1 billion per annum and UK employment associated with the industry exceeds 48,000. In addition, the industry earns considerable income from licensing its recordings overseas. The structure of the industry is complex and diverse, involving many activities from the creative work of songwriters and artists to the manufacturing, distribution and promotion of the finished records.

### **The record companies**

2.5. The core activity of a record company is creating and exploiting copyright in sound recordings. Most record companies achieve this by signing contracts with artists under which the artist usually agrees to record exclusively with that record company for a period. In exchange for this commitment the artist will usually receive an advance of royalties at the start of work on each record album and, by virtue of copyright legislation, the record company will own the copyright in the recordings. A pop artist will usually write his own songs which he will record in a studio with the help of a record producer.

2.6. When a satisfactory master recording has been made the record company will send it to the manufacturing plants where it will be reproduced on CDs, cassettes or vinyl. The most important activities of the record company will then be the marketing and promotion of the new release and its distribution to retailers. Promotion may take the form of videos and interviews on television, advertisements in the musical press and other media and personal appearances by the artist. Some promotion may be carried out jointly with particular retailers. In the case of a pop record the aim will be to get the record played on the radio and to secure a place in the record charts, which will then lead to further exposure and increased sales.

2.7. The cost of making a record, including the artists' advance and costs of a video, can be very significant (up to £1 million or more for a pop album by a superstar). Thus a large number of copies then need to be sold before the record company will recover its initial costs. How many will be sold is difficult to predict in advance, particularly as only a small proportion of the pop artists signed by a record company actually achieves success. To try to secure those successes the company will put a great deal of effort into seeking to establish (or 'break') new artists during their early careers. If an artist becomes established the record company will seek to promote the artist's career and maintain a long-term relationship. If success is not achieved, the contract will be allowed to lapse. The initial outlays comprise a major source of risk for the company.

2.8. There are five large multinational record companies operating in the UK which are known as 'the majors'; their market shares (by volume of albums sold in 1993 by the companies and their subsidiaries) are:

---

<sup>1</sup>The price of compact discs, Fifth report of the National Heritage Committee, 1992-93, HC 609.

	%
EMI Records Limited and Virgin Records Ltd (EMI)	23.8
PolyGram UK Holdings Plc (PolyGram)	21.3
Warner Music UK Limited (Warner)	10.3
Sony Music Entertainment (UK) Limited (Sony)	9.6
BMG Records (UK) Limited (BMG)	7.0

Together these five companies have a UK market share of 72 per cent.

2.9. The remaining 28 per cent of the market is supplied by some 600 independent record companies. Many of these are very small companies, some making only one or two releases a year. However, the independent companies are a very important part of the record industry since they are often at the leading edge of developments in pop music, with the ability to discover new talent and establish new fashions. They also have to face the risks inherent in developing new repertoire.

2.10. As well as supplying records in the UK, the record companies exploit their recordings overseas. Normally this is done by licensing an overseas company to supply records in a particular country. In the case of the majors this will usually be the record company's local affiliate. The independent record companies will often rely on unconnected companies to perform this function, including the majors' overseas affiliates. Licence income generated in this way is an important source of income for UK record companies and makes a significant contribution to the country's invisible earnings (see paragraph 5.222). The UK is second to the USA as a supplier of recorded music to the rest of the world: the industry's trade association (the British Phonographic Industry Ltd (BPI)) estimates that 18 per cent of world sales have a connection with the work of UK artists, while the UK's home market represents only 7 per cent of world sales.

## **Retailing of records**

2.11. Records are sold both through shops which specialize in music and shops which sell a much wider range of products. The specialists include chains, such as HMV and Our Price, and many small independent retailers. The non-specialists include multiples such as W H Smith and Woolworths as well as an increasing number of 'non-traditional' outlets such as supermarkets and petrol stations. In addition, mail order and record clubs account for some 12 per cent of the market.

2.12. The largest retailers and their 1992 market shares are:

	%
W H Smith Group plc (W H Smith)	8.1
Our Price Limited (Our Price) (a subsidiary of W H Smith)	18.5
Woolworths plc (Woolworths)	15.0
HMV UK Limited (HMV)	13.5
Virgin Retail Limited (Virgin Retail) <sup>1</sup>	4.2

Together these companies make up almost 60 per cent of total retail sales.

2.13. Records reach the retailers from the record companies by a variety of routes. Some 60 per cent go direct from the record company's nominated distributor to the retailer, 28 per cent go through a wholesaler and the remaining 12 per cent reach consumers through mail order suppliers. Almost all deliveries to retailers go direct to individual shops rather than to retailers' central warehouses. For example, each of W H Smith's some 300 outlets receives deliveries direct from the major record companies and other distributors. All Woolworths' stores are supplied by the wholesaler Entertainment UK Ltd, a sister company in the Kingfisher Group.

---

<sup>1</sup>Virgin Retail is a joint venture owned 50 per cent by W H Smith Limited and 50 per cent by Virgin Retail Group Limited. Proposals have been announced for Virgin and Our Price to merge and form a company in which W H Smith will have a 75 per cent shareholding.

2.14. All the major record companies operate their own distribution businesses and so a retailer who orders direct from distributors will have to order stock from several sources (the five majors plus up to 20 others for independent record companies' releases). Wholesalers generally handle the releases of all record companies and so a retailer will only have to order from one wholesaler if he uses this route. The main wholesalers also offer another service known as 'rack-jobbing'. Rack-jobbing is a method of supply used by non-traditional retail outlets (such as petrol stations). A rack-jobber supplies a complete package of records and display material and is responsible for maintaining the stock, typically on a sale or exchange basis.

## **The importance of copyright**

2.15. Copyright lies at the heart of the recorded music industry. It allows record companies to invest money and enterprise in creating commercial recordings which can be exploited in both the UK and overseas markets knowing that they have legal protection against unauthorized reproduction. Copyright is also important in ensuring that the talents of successful artists and songwriters are rewarded. The protection of copyright is therefore crucial both to the creative side of the music industry and to the businesses of the record companies. UK legislation on copyright is primarily contained in the Copyright, Designs and Patents Act 1988 (the 1988 Copyright Act).

2.16. Two principal types of copyright are involved. First, copyright exists in the music which is performed by an artist, that is in the words and music of a song and in the composition of a classical composer. Secondly, a separate copyright exists in the sound recording when a particular artist performs a musical work and it is recorded. In the UK, music copyright lasts until 50 years after the death of the composer and copyright in a sound recording lasts until 50 years after the record is released.

2.17. A songwriter or composer will normally assign the copyright in his or her music to a 'music publisher', a business set up to exploit and protect composers' works. The activities of music publishers fall outside our terms of reference since they do not supply the reference products. Although some music publishers are affiliates of record companies, many artists sign up with publishers not associated with their record companies. The music publisher will collect a royalty for the songwriter/composer for every record containing his or her composition which is sold by a record company. This is known as a 'mechanical royalty'. It is collected by the Mechanical Copyright Protection Society (MCPS) on behalf of the music publisher and composer.

2.18. Under the copyright legislation the copyright in a sound recording will normally be owned by the record company, though the copyrights can be licensed or assigned to others. As we have noted in paragraph 2.10, a UK record company will normally license overseas exploitation to a local company and in this case the UK record company will receive a licence fee for every record sold abroad. Conversely, when a UK record company is licensed by an overseas company to issue its sound recordings in the UK (typically records of an artist signed to that company) the UK record company will pay a licence fee for every record sold.

2.19. The copyright legislation grants a bundle of rights to a copyright owner which includes the exclusive right to make copies and the exclusive right to perform the work in public (including broadcasting). Thus record companies also receive licence fees every time a record is played in public (eg in clubs or pubs) or is played on the radio or television. These fees are collected by Phonographic Performance Limited (PPL) on behalf of the record companies.

2.20. Finally, the copyright legislation gives a copyright holder the right to control imports. This derives from the territorial nature of copyright, under which UK legislation gives certain rights in the UK and other countries give rights in their territories. These may differ from country to country but generally conform to international conventions under which most countries have agreed on reciprocal arrangements for a minimum level of copyright protection. Generally, records can only be imported into the UK with the permission both of the owner of the UK copyright in the music and the owner of the UK copyright in the sound recordings.

2.21. The provisions of the EEC Treaty provide an exception. Where a record has been lawfully put on the market in one member state, by the copyright owner or with his consent, the record is able to enjoy free movement within the EC without the payment of licence fees or customs duties. Moreover, under an EC Directive<sup>1</sup> which has to be implemented by 1 July 1994, all member states will be required to provide copyright owners with the right to control imports from outside the EC (which the UK copyright legislation already does). The provisions of this Directive and other copyright legislation are discussed more fully in Chapter 4.

## **The monopoly situations**

### **Record companies**

2.22. A scale monopoly situation under section 6(1)(a) or (b) of the Fair Trading Act (the Act) is taken to exist when at least one-quarter of all the goods of a particular description which are supplied in the UK are supplied by or to the same person, or by or to members of the same group of interconnected bodies corporate. We find that no record company, nor any such group of interconnected companies, has a market share of 25 per cent or more.

2.23. A complex monopoly situation under section 6(1)(c) and (2) of the Act is taken to exist when at least one-quarter of all the goods of a particular description which are supplied in the UK are supplied by or to members of the same group consisting of two or more persons (not being a group of interconnected bodies corporate) who, whether voluntarily or not and whether by agreement or not, so conduct their respective affairs as in any way to prevent, restrict or distort competition in connection with the production or supply of goods of that description. We provisionally found that the five major record companies, with a combined share of over two-thirds of the market (see Table 5.21), all engaged in a number of practices which appeared to prevent, restrict or distort competition in connection with the supply of recorded music. The practices were:

- (i) adopting similar pricing policies to each other for the various formats (CD, music cassette and vinyl) of 'full-price' albums and singles;
- (ii) declining to license imports of some sound recordings in which the company holds the copyright and licensing others only on payment of a fee under the MCPS/BPI import scheme; and
- (iii) entering into recording contracts with artists which include terms that restrict the artists' ability to exploit their talent fully and restrict competition in the supply of recorded music (eg in clauses relating to the extent of copyright acquired, length of contract, exclusivity, options, obligations to exploit recordings, royalty rates, packaging and other deductions from royalties, and/or arrangements for accounting for and auditing royalties).

2.24. We wrote to BMG, EMI, PolyGram, Sony and Warner notifying them of our provisional finding that they, and their record company subsidiaries, were members of such a group since they each engaged in one or more of the practices listed in the preceding paragraph. We invited the companies' views on our provisional finding and on a number of issues which had been raised with us concerning their behaviour and its effects. The list of issues is reproduced in Appendix 2.2.

2.25. In their responses, each of the companies argued that a complex monopoly situation did not exist. We consider their main arguments in the following paragraphs.

---

<sup>1</sup>Directive 92/100/EEC (the 'Rental Directive'), OJ No L346/61, 27 November 1992.

## ***Submission that other companies engage in the practices***

2.26. The companies pointed out that they were not the only record companies which engaged in the three practices on which we had based our provisional finding. Since the practices were common throughout the industry, it was claimed, we should not single out the five majors as members of a group constituting a complex monopoly situation. It followed that either there was no monopoly situation at all or the members of the group should be extended to include all the companies, however small, which engaged in the practices. Precedents were cited of earlier reports of the MMC<sup>1</sup> where the complex monopoly had included large numbers of companies, including many with only small market shares.

2.27. We accept that in certain previous reports the MMC have included in complex monopoly situations all or virtually all the companies which engaged in the relevant practices which prevented, restricted or distorted competition. We now, however, have the guidance of the courts in *R v MMC and another ex parte Ecando Systems Ltd* (ECS).<sup>2</sup> In the High Court, Mr Justice Simon Brown held that the MMC had a wide discretion in applying the complex monopoly provisions of the Act. In the Court of Appeal, Lord Justice Ralph Gibson said 'there is force in the submission for the appellants that the questions at the first stage of the inquiry by the Commission, including whether a complex monopoly exists, and if it does in favour of what person it exists, are on their face primarily issues of fact'. He went on to accept that the MMC had acted properly when they carried out a considerable degree of selectivity.

2.28. We note that in ECS the Court of Appeal were inclined to classify the questions as 'primarily' issues of fact. They did not hold that they were exclusively ones of fact. We have carefully considered the judgments in ECS and have come to the view that the complex monopoly question is one both of fact and degree. We have also found of assistance the judgment of the Court of Appeal in *R v MMC and others ex parte Visa International Service Association*.<sup>3</sup> The Court of Appeal agreed with Mr Justice Hodgson that when the MMC apply the complex monopoly provisions 'it is permissible and necessary to give consideration to commercial realities'.

2.29. We have noted that the market share of the five major record companies in 1993 was 72 per cent of the number of albums (see Table 5.22) and that these companies have maintained a significant market share for at least the last ten years. During that period no other company, apart from Virgin which has now been taken over by EMI, has had a market share of more than 5 per cent. Not only have these companies maintained a significant market share in the UK for a sustained period but their affiliates in other countries have a significant market share internationally which gives them unrivalled access to the work of major artists throughout the world. This adds to their strength in the UK.

2.30. In addition, we observe that in evidence to us, and throughout the record industry and those who do business with it, these five companies are known as 'the majors'. The evidence of market share and the way they are regarded by others in the industry as well as outside it lead us to conclude that the commercial reality is that if these five companies were to act in a similar fashion, they could influence the practices of the whole industry. Having regard to the judgments and the commercial circumstances we have discussed above, we consider that 'the majors' should all be included in any group which may give rise to a complex monopoly situation in relation to the supply of recorded music. We consider, however, that in the circumstances it is unnecessary for us to include companies with a smaller market share than 'the majors'.

2.31. In defining the group we have given particular consideration to the position of MCA Records Ltd (MCA), the sixth largest company in 1992 when it supplied 4.1 per cent of albums in the UK. Although MCA is a multinational company, in contrast to the other five it has only recently acquired a market share of this size, having generally had a share of between 1 and 2 per cent between 1983 and 1990. Moreover, MCA still has few artists signed in the UK and it does not have its own distribution arrangements. We have concluded that MCA does not at present enjoy a similar position to the five largest companies and that it should not therefore be included in the complex monopoly group.

---

<sup>1</sup>*The Supply of Beer: a report on the supply of beer for retail sale in the United Kingdom*, Cm 651, March 1989; *The Supply of Petrol: a report on the supply in the United Kingdom of petrol by wholesale*, Cm 972, February 1990; *Motor car parts: a report on the wholesale supply of motor car parts within the United Kingdom*, Cm 1818, February 1992.

<sup>2</sup>Unreported judgments of Simon Brown J on 30 September 1991 and of the Court of Appeal on 12 November 1992.

<sup>3</sup>[1991] CCLR 13 at 21.

### ***Practice (i)-similar pricing policies***

2.32. The companies argue that they have not, consciously or unconsciously, followed the same pricing policies as each other. To the extent that their prices are similar, they say that this is a result of market forces rather than of any practice designed to prevent, restrict or distort competition. Furthermore, any similarity in pricing policies does not have anti-competitive consequences since competition is in fact vigorous.

2.33. We observe that there is consistency in the pricing of full-price CDs relative to full-price cassettes. For each of the companies the published prices to dealers of full-price albums on CDs, whether classical or non-classical, are around 50 per cent higher than the published dealer prices of equivalent cassettes. Table 2.1 (which is based on Tables 7.1 and 7.2) shows that the range is from 42 per cent to 54 per cent. The prices of LPs are generally the same as for cassettes.

TABLE 2.1 **Published prices to dealers for full-price albums, September 1993**

Type of record	PolyGram	EMI	Sony	Warner	BMG	Unweighted average
Non-classical, full-price						
Cassette price (£)	5.25	4.99	5.17	5.30	5.35	5.21
CD price (£)	7.59	7.56	7.59	7.96	7.59	7.66
Difference (%)	46	52	47	50	42	47
Non-classical, deluxe full-price						
Cassette price (£)	5.53	5.13	5.35	5.66	5.60	5.45
CD price (£)	8.15	7.86	8.03	8.21	8.14	8.08
Difference (%)	47	53	50	45	45	48
Classical, full-price						
Cassette price (£)	5.53	5.29	5.17	5.51	5.34	5.37
CD price (£)	8.15	8.14	7.59	7.96	7.89	7.95
Difference (%)	47	54	47	44	48	48

Source: See Tables 7.1 and 7.2.

2.34. The cost of manufacturing records is only a comparatively small part of the record companies' total costs, being on average £1.32 for CDs, £0.66 for cassettes and £0.93 for LPs (see Table 8.10). The remainder of the costs are royalties or licence fees, which are contracted to be a percentage of the selling price for each unit sold, and costs which relate to the title as a whole and are independent of the formats on which it is sold, such as recording costs, advances, marketing and promotion. The fact that the record companies' prices for CDs are about 50 per cent higher than for cassettes or LPs is not therefore the result of differences in the direct costs of producing the different formats. It is very largely a marketing decision for the record companies how they set their prices for the different formats in order to cover their costs and make a profit on their repertoire as a whole. Accordingly we consider that as the companies all make similar decisions their price setting constitutes a way in which they 'conduct their respective affairs' within the meaning of section 6(2) of the Act.

2.35. Having established that the companies' pricing policies constitute a practice, the remaining requirement of a complex monopoly situation is that the practice should prevent, restrict or distort competition in some way. We are not at this stage of our analysis required by the Act to make any judgment as to whether the effects of the conduct are good or bad, nor about the overall effects of the conduct on competition in the context of the market. Since price is an important component of competition, both at wholesale level and at retail level, we conclude that competition is restricted by the similarity of pricing policies between the companies. The process and operation of competition in the supply of recorded music would be different if the companies had adopted different pricing policies from each other and there would consequently be different opportunities for other record companies and retailers.

### ***Practice (ii)-restrictions on imports***

2.36. The companies do not deny that they sometimes decline to license imports or that they participate in the MCPS/BPI import licensing scheme through which they levy a fee when imports are licensed. However, they argue that the law gives them the right to prohibit imports, that they do so only occasionally and then for good reasons and that the MCPS/BPI scheme is designed to facilitate imports rather than impede them.

2.37. We accept that the 1988 Copyright Act<sup>1</sup> gives the owner of the copyright in a sound recording the right to control imports of that sound recording from outside the EC. However, the 1988 Copyright Act does not impose any obligation and it does not compel record companies to refuse import licences or to charge a fee if it grants them. A record company could decide that it would allow imports without charging a fee; it could decide to charge a different licence fee from other companies; it could decide to prohibit all imports; or it could follow a policy which varied according to whether or not an affiliated record company had produced the record which was to be imported.

2.38. That the companies all prohibit imports in certain circumstances and charge the same scale of fees when an import is not prohibited is therefore a practice capable of forming the basis of a complex monopoly situation. The fact that copyright law gives them certain rights does not prevent the way they exercise those rights being such a practice for the purpose of the Fair Trading Act.

2.39. This view is reinforced by the fact that section 144 of the 1988 Copyright Act specifically provides for the Secretary of State to vary the terms of a copyright licence or to order compulsory licences following an MMC report containing an adverse finding on the public interest.

2.40. The practice has an effect on competition compared with a situation in which imports were licensed either with no fee or with a lower fee (or indeed with a situation in which they were never licensed). This does not imply that the effects of the scheme are good or bad. The argument that the import licensing scheme is pro-competitive because it facilitates imports falls to be considered as part of our examination of the public interest.

### ***Practice (iii)-artists' contracts***

2.41. The companies have argued that the provisions in artists' contracts do not restrict competition and are in fact the way in which artists are able to exploit their talents fully. It is claimed that exclusivity and other provisions on copyright and length of contract are essential to enable the industry to function at all.

2.42. We believe these are all matters which bear on our consideration of the public interest if we conclude that a monopoly situation exists. Each of the major companies does normally include provisions in its contracts which provide that artists will give their services on an exclusive basis for a period which will, if the artist is successful, extend for several years. Clauses in the contract will also normally provide for the company to hold the copyright for its full term, describe the geographical extent to which the company is entitled to exploit the copyright and specify any obligation for the company to exploit the artists' recordings. It is clear on the face of such provisions that they restrict the artist's freedom to offer his recording services to other companies and so prevent, restrict or distort competition. This does not imply, however, that their effects are either good or bad or that the provisions operate against the public interest. We consider the consequences of the practices in paragraphs 2.128 to 2.147.

2.43. We accept that there will also be detailed provisions in the contracts, notably those relating to financial matters, which will vary widely from case to case. Nevertheless their common approach to the application of clauses restrictive on the artist and the marked degree of uniformity in the general contractual framework governing the relationship are such as to constitute a practice pursued by each of the five companies.

---

<sup>1</sup>Section 22.

### ***Conclusion on the record companies' complex monopoly situation***

2.44. We conclude in the light of the preceding discussion that a monopoly situation exists by virtue of section 6(1)(c) and (2) of the Act (a complex monopoly situation) in that the following companies (being members of one and the same group for the purpose of these provisions) supply at least one-quarter of the recorded music supplied in the UK:

BMG Records (UK) Limited  
EMI Records Limited and Virgin Records Ltd  
PolyGram UK Holdings Plc  
Sony Music Entertainment (UK) Limited  
Warner Music UK Limited  
and their respective record company subsidiaries

and these companies so conduct their respective affairs as to prevent, restrict or distort competition in connection with the supply of recorded music in that they each engage in one or more of the following practices:

- (i) adopting similar pricing policies to each other for the various formats (CD, music cassette and vinyl) of 'full-price' albums and singles;
- (ii) declining to license imports of some sound recordings in which the company holds the copyright and licensing others only on payment of a fee under the MCPS/BPI import scheme; and
- (iii) entering into recording contracts with artists which include terms that restrict the artists' ability to exploit their talent fully and restrict competition in the supply of recorded music (eg in clauses relating to the extent of copyright acquired, length of contract, exclusivity, options and obligations to exploit recordings).

2.45. We conclude that this monopoly situation exists in favour of the companies mentioned in the preceding paragraph.

### **Retailers**

2.46. In relation to retailers, we provisionally found that there were two monopoly situations.

### ***Scale monopoly situation***

2.47. A scale monopoly was provisionally found to exist in that W H Smith and Our Price, being members of the same group of interconnected companies, supply at least one-quarter of the recorded music supplied in the UK. As shown in Table 6.3, these companies supplied 26.6 per cent of the recorded music sold at retail level in 1992. We provisionally found that the monopoly situation existed in favour of the two companies and we invited their comments on our provisional finding and on the issues listed in Appendix 2.3.

2.48. W H Smith and Our Price accepted the existence of the scale monopoly and we therefore confirm our provisional finding that a monopoly situation exists by virtue of section 6(1)(b) of the Act and that it exists in their favour.

2.49. Although the companies accepted the existence of the monopoly situation, they argued that there were no facts that operated, or may be expected to operate, against the public interest. We consider this later in the chapter.

## ***Complex monopoly situation***

2.50. In addition to the scale monopoly, we also made a provisional finding of a complex monopoly situation in respect of retailers in that W H Smith, Our Price, HMV and Woolworths (in association with Entertainment UK Ltd) were members of a group whose members supplied at least one-quarter of the recorded music supplied in UK and appeared to so conduct their affairs as to prevent, restrict or distort competition in that they engaged in the following practice:

securing discounts and promotional support from suppliers of recorded music that are larger than those made available to other retailers.

2.51. This finding was based on preliminary figures for discounts in respect of albums on the lines of those shown in Table 1 of Appendix 8.4 and on evidence we had received about the amounts the major record companies spent on co-operative promotions with the large retailers (see, for example, paragraphs 11.50 to 11.52). We believed competition might be distorted if the major retailers were able to use their market power to obtain large, non-cost-related discounts which were not available to smaller retailers.

2.52. In response to our finding the members of the group argued that they did not receive larger discounts than some of those retailers which were excluded, for example Virgin Retail, Boots, Menzies, Tower Records or Andys; that the smaller retailers received discounts in other forms, including free singles, which counterbalanced the file discounts of the larger retailers; and that much of the promotional support received by the larger retailers was directed towards advertising which promoted sales of particular records and was of benefit to all retailers.

2.53. We have examined the evidence in support of these arguments and have estimated the effective discounts for albums and singles for different retailers after taking into account file and other discounts, free goods, returns, marketing and support and differences in the distribution services provided by the record company. The results are discussed in paragraphs 8.47 to 8.58 from which it can be seen that singles are of particular importance to the independent specialist retailers and it is on singles that they achieve significantly better terms.

2.54. Precise figures cannot be calculated because of the different nature of the benefits. However, taking account of all these discounts and allowances, and including singles as well as albums, we consider that the largest retailers which we included in our provisional finding of a complex monopoly situation do not consistently receive higher benefits in the form of discounts and promotional spending than other retailers. We therefore conclude that there is no complex monopoly situation among retailers of recorded music.

## **The relevant issues**

2.55. Having established the existence of a complex monopoly situation in favour of the five major record company groups and a scale monopoly situation in relation to retailing in favour of W H Smith and Our Price, we are required by our terms of reference to consider whether those companies are taking any steps to maintain or exploit the monopoly situations, whether any actions or omissions on their part are attributable to the monopoly situations and whether there are any facts which operate, or may be expected to operate, against the public interest. We believe the supply of recorded music as defined in our terms of reference is the relevant economic market in which to consider these questions and we have received no argument to the contrary.

2.56. When the reference was made the main area of concern was the price of CDs, particularly in comparison with other countries. The Consumers' Association had pointed to the higher prices charged for CDs in the UK compared with the USA and had attributed this to the fact that under the copyright legislation the record companies were able to control parallel imports. The National Heritage Committee of the House of Commons in its report of May 1993<sup>1</sup> saw the question in the following terms:

---

<sup>1</sup>See footnote to paragraph 2.2.

When the Committee decided to conduct this inquiry, it was looking for an answer to what seemed a very simple question. Why do compact discs cost quite a lot more in the United Kingdom than they do in the United States?

In its conclusions, which are reproduced in Appendix 2.1, the Committee also attached importance to the question of parallel imports and called for price reductions by the record companies and the retailers.

2.57. We consider these issues first. We then look at the other issues that have been raised with us in the course of our inquiry, including the relationship between artists and record companies, the extent of the companies' spending on marketing and promotion, the reduced availability of vinyl LPs and singles, the activities of relevant collecting societies and some issues relating to the record charts.

## **International price differentials**

### **Comparisons with the USA**

#### ***Popular perceptions***

2.58. A popular perception of many international travellers is that a record costs the same number of dollars in the USA as it costs pounds in the UK. Thus a full-price CD which is on display at £14.99 in London might be seen in a shop in New York at a price of \$14.99 which, at an exchange rate of £1.50 to the pound, implies that records are 50 per cent more expensive in the UK.

2.59. We need to look more closely at these perceptions to see if they are soundly based and are representative of the generality of record albums.

2.60. The first step is to examine the effect of different tax arrangements. There are two aspects to this. First, tax rates vary between the countries. In the UK VAT is levied at 17.5 per cent on records while in the USA sales tax is lower, varying between cities and States but generally from around 3 to 8.5 per cent. Secondly, one needs to make comparisons on a like-for-like basis so that tax is either excluded in both cases or included in both cases. In the UK the prices displayed in the shops include VAT; in the USA the displayed price excludes tax, which is added to the total bill at the till. The effect of this is that the purchaser of a CD which is priced at \$14.99 in New York will actually pay \$16.23 when 8.25 per cent sales tax has been added.

2.61. In order to make useful comparisons we need to eliminate the effect of these tax differences. We therefore use prices exclusive of tax in the remainder of this chapter. On a without-tax basis the purchaser will pay £12.76 in London and \$14.99 in New York (equivalent to £9.99 at an exchange rate of \$1.50 = £1, which was the average rate between July 1993 and December 1993).

2.62. Thus a retail price which at first sight appeared to be 50 per cent higher in the UK is actually only 28 per cent higher if tax is taken off in both cases. These figures only hold good at an exchange rate of \$1.50 to the pound. If the dollar strengthens against sterling then the price differential will narrow: if the dollar weakens the differential will widen. These perceptions are all crucially influenced by the prevailing exchange rate.

## ***Differences in retail prices***

2.63. In order to establish a more soundly based understanding of the extent of differences in the prices of records between the UK and the USA we carried out a number of studies. These studies were more comprehensive than previous studies we have seen. We also had the benefit of a number of detailed price comparisons prepared by the record companies as part of their evidence to us. Throughout the discussion of the studies we use prices without tax and convert US dollars to sterling at an exchange rate of \$1.50 to £1.

### ***Full-price pop albums***

2.64. We engaged a market research company (BMRB International) to carry out a survey of the prices of full-price pop albums in the UK, USA, Denmark, France and Germany. A full description of the survey is provided in paragraphs 7.51 to 7.56 and Appendix 7.2. Briefly, the survey looked at the retail prices in each country of eight popular titles by artists with international appeal selected from the repertoire of the five major record companies. However, national tastes differ and to allow for the fact that these titles did not reach the same chart positions in each of the countries and also for the possibility that they were at different stages in their life cycles, the survey also covered the records which were at particular positions in the national charts of each country. The prices were recorded of the albums which were numbers 1, 5 and 10 in the charts of each country at the time the survey was carried out.

2.65. The survey concentrated on full-priced popular albums because these are by far the largest selling group of records. Full-price albums represented 80 per cent by value of all UK album sales in 1992 and popular titles represented over three-quarters of all albums sold in that year. Chart records are particularly important because they make up a high proportion of these sales.

2.66. We found a fair degree of variability between the prices of the different pre-selected titles but more consistency in the prices of the three records in chart positions 1, 5 and 10. We found that the prices of the pre-selected albums on CD were on average between £10.06 and £11.78 in the UK while in the USA the prices of the same CDs were between £9.45 and £10.53. For each title the price in the UK was higher than in the USA, on average by 8.7 per cent. For the CDs that were at numbers 1, 5 and 10 in the album charts in their respective countries, the average prices were slightly lower and prices in the UK were only 7.3 per cent higher than in the USA.

2.67. From this evidence it appears that the prices of full-price pop CDs are on average about 7 to 9 per cent higher in the UK at an exchange rate of \$1.50 to the pound.

2.68. The survey also showed that on cassette these albums were on average 14.8 per cent more expensive in the UK for the same titles and 8.8 per cent more expensive for the same chart positions.

### ***Full-price classical albums***

2.69. We carried out a separate study of the prices of full-price classical albums. It was not possible to do this in the same way as for the survey of pop records because of the lower availability of classical titles in the shops, classical representing 9 per cent of UK album sales but only 4 per cent of US sales, and because of the more variable pricing of classical records-where a higher proportion are available in the mid-price and budget price categories. Instead we asked five major retailers to provide the retail prices for selected titles, again selected from the repertoires of the five major record companies, in their UK stores and in the stores operated by their affiliates in the USA. Although this is narrower than the survey of full-price pop records we believe it is adequate to give a broad indication of price differentials. The study is described in more detail in paragraphs 7.67 to 7.70 and Appendix 7.4.

2.70. The study indicated that in the UK the average retail price of full-price classical CDs is higher than pop CDs, but in the USA this is not the case. The result is that the differential between the countries is wider for full-price classical CDs with prices on average about 26 per cent higher in the UK than in the USA. Our survey found that in many cases the popular perception of pound:dollar equivalence was correct as a CD which cost £14.99 in the UK (including VAT) was often priced on the shelf at \$14.99 (excluding

sales tax) in the USA. The effect of mid-price and budget items on the average price of classical albums is discussed in paragraph 2.73.

### *Average prices*

2.71. The discussion so far has dealt only with full-price CDs. In order to gain a complete picture we need to take account of all price ranges and to look at the buying habits in the two countries.

2.72. As discussed in paragraph 7.105, UK purchasers appear to buy a higher proportion of mid-price and budget CDs than US purchasers. Although our own surveys did not look at mid-price or budget CDs, other evidence (see paragraphs 7.95 to 7.105) indicates that the prices received by the record companies (ie the net dealer prices) of these categories are lower on average in the UK than the USA. This suggests that, when all price categories are taken into account, the average price differential will be lower than we found in our surveys of full-price records.

2.73. In the classical record field, although full-price records showed a price differential of about 26 per cent, some 55 per cent of classical albums sold in the UK are in the mid-price or budget categories (see Table 5.14). Sony's retail price comparisons for its classical albums (full-price and mid-price) showed that the average price in the UK is only 7.6 per cent higher than in the USA (see paragraphs 7.71 to 7.74 and Appendix 7.5). The broader range of classical prices in the UK may be a reflection of the different demand here for classical records. As already noted, classical makes up 9 per cent of UK album sales but only 4 per cent of US sales.

2.74. The Sony retail study covered popular as well as classical albums. On the pop record side the price differential was 6.1 per cent. It should be noted that Sony does not produce any pop CDs at budget price in either country.

2.75. We conclude from this that while full-price pop CDs are on average about 7 to 9 per cent more expensive in the UK and full-price classical CDs are 26 per cent more expensive, the differentials covering all price categories are somewhat lower.

### ***International price comparisons and the exchange rate***

2.76. When comparing prices of recorded music in different countries, an exchange rate is chosen to convert those prices into a common currency. The comparisons described above used an exchange rate of £1=\$1.50, the average market exchange rate in the second half of 1993.

2.77. Local prices of recorded music are set at intervals and are not changed in line with every change in exchange rates. However, in a period of floating exchange rates, those rates can fluctuate frequently and so it is difficult to know which rate to use for making price comparisons. If market rates are used, a price comparison on one date may give apparently quite different results from a comparison on another date. Thus if we had used £1=\$1.75 (around the average exchange rate for 1992) in making the price comparisons we would have concluded that the prices of full-price pop CDs were some 25 to 27 per cent higher on average in the UK rather than the 7 to 9 per cent described above. Alternatively, if the exchange rate used had been £1=\$1.25, UK prices would have been *lower* than US prices, by 9 to 11 per cent. (In the first quarter of 1985 the exchange rate reached a low point of £1=\$1.12.)

2.78. Under a system of floating exchange rates differences in the rates of inflation between countries may be expected over a number of years to be reflected in the movements of exchange rates: the latter in effect to compensate for the former. Similarly over a number of years exchange rates can be expected to adjust to other factors, such as differing economic policies. But at any point in time it is impossible to know whether the current exchange rate is approaching a sustainable long-term rate between two currencies. We have attempted to overcome this problem by using the average £/\$ rate for the second half of 1993. A six-month average will eliminate short-term fluctuations in the exchange rate. The figure we have used (£1 = \$1.50) is in fact very near the average for the whole of 1993.

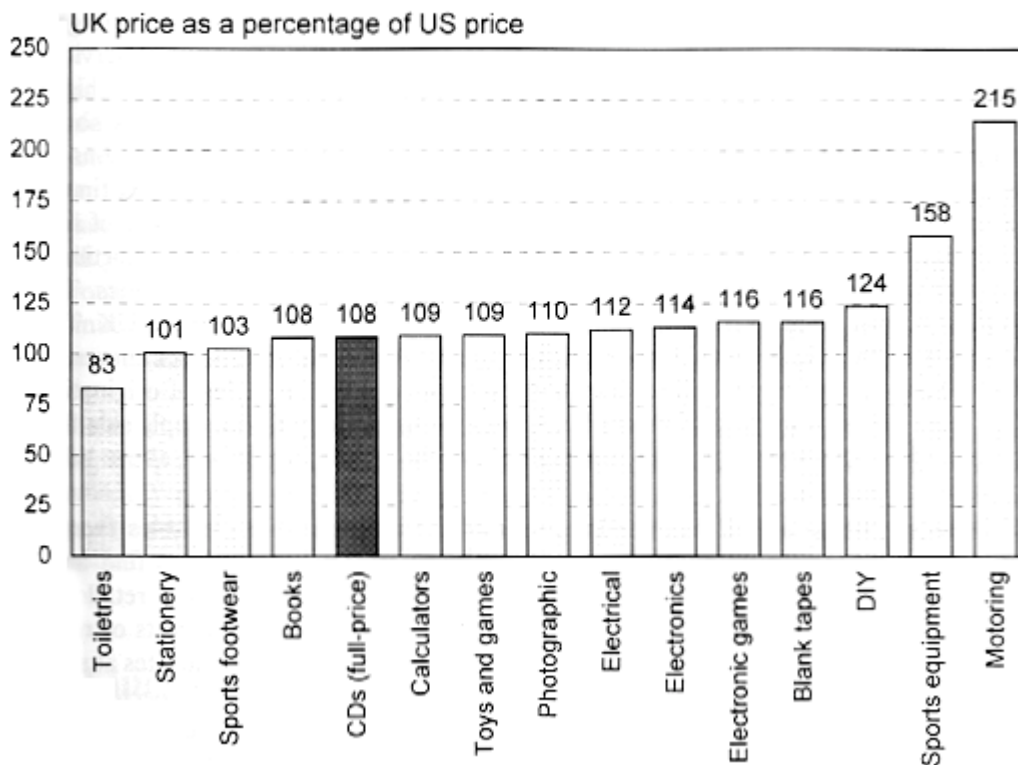
2.79. Some record companies argued that sterling is overvalued at £1 = \$1.50 relative to the US dollar. They suggested to us that international price comparisons should be based on purchasing power parities (PPPs). We have considered the relevance of PPPs. In effect, use of PPPs stands the exchange rate problem on its head. Instead of trying to estimate the 'sustainable long term rate' from observations of market exchange rates, it compares directly what consumers can buy with their money in different countries. This suggests what the exchange rate should be. Thus the PPP between two countries is the 'exchange rate' at which the price of a basket of goods would be the same in the two countries. Estimates of PPPs between the UK and the USA have for the last few years been below the market exchange rate, indicating that price comparisons using market exchange rates will show that goods are more expensive in the UK. Even if PPPs were used, there would still be a difficulty in choosing the appropriate rate to use since no generally accepted PPP exchange rates are available. Different estimates of the PPP can lead to widely differing estimates of the relative prices of goods in the USA and the UK.

2.80. While remaining sceptical about the value of evidence which relies on PPPs, we recognize the problems involved in making price comparisons using market exchange rates. We therefore decided to concentrate on the question whether recorded music was exceptional in the consumers' experience in each country. Accordingly we have carried out a survey of the prices of a wide range of consumer goods at £1 = \$1.50 (described below) to see how the relative price of recorded music between the USA and the UK compared with the relative prices of other goods in those countries.

2.81. In order to match circumstances as closely as possible we chose mainly products which were manufactured goods relating to leisure activities and which had a UK retail price of less than £30. The survey is described in detail in paragraphs 7.85 and 7.86 and Appendix 7.6. We found that in almost all product groups average prices were higher in the UK than the USA, the majority of differentials lying in the range 8 to 16 per cent and the weighted average being 9 per cent. Figure 2.1 summarizes the results, together with our estimate of the differential for full-price pop CDs.

FIGURE 2.1

**Price differentials (UK/US) for various product groups**



Source: Management Horizons survey (see Appendix 7.6).

2.82. This evidence confirms that for a wide range of broadly comparable goods there is a systematic difference in the purchasing power of consumers in each country which is favourable to the USA. The survey also shows that retail price differences for recorded music between the UK and the USA are not out of line with a range of other goods. We examine the factors which might explain the particular position of recorded music in the next section.

### ***Factors affecting the prices of recorded music in the USA and UK***

2.83. In addition to the exchange rate applying at any particular time, there are a variety of other factors which will affect the supply and demand conditions for goods and hence their prices. To the extent that these factors differ between countries so will the prices ruling in each market. Here we look at factors which may affect the supply and demand for recorded music. The record companies told us that demand and willingness to pay for recorded music differ between the USA and UK because of differences in income levels, tastes and the range available and relative prices of alternative leisure products. This must be true, particularly for classical records where the scale and range of demand is reflected in a broader range of price categories, but it is difficult to link these factors directly to differences in prices between the two countries. It is possible to be a little more definite on the supply side.

2.84. The price which the consumer pays is composed of three main elements:

- (a) the prices, net of all discounts, charged by the record companies to the retailers;
- (b) the mark-up retailers add to this price to allow for their costs and profits; and
- (c) sales taxes.

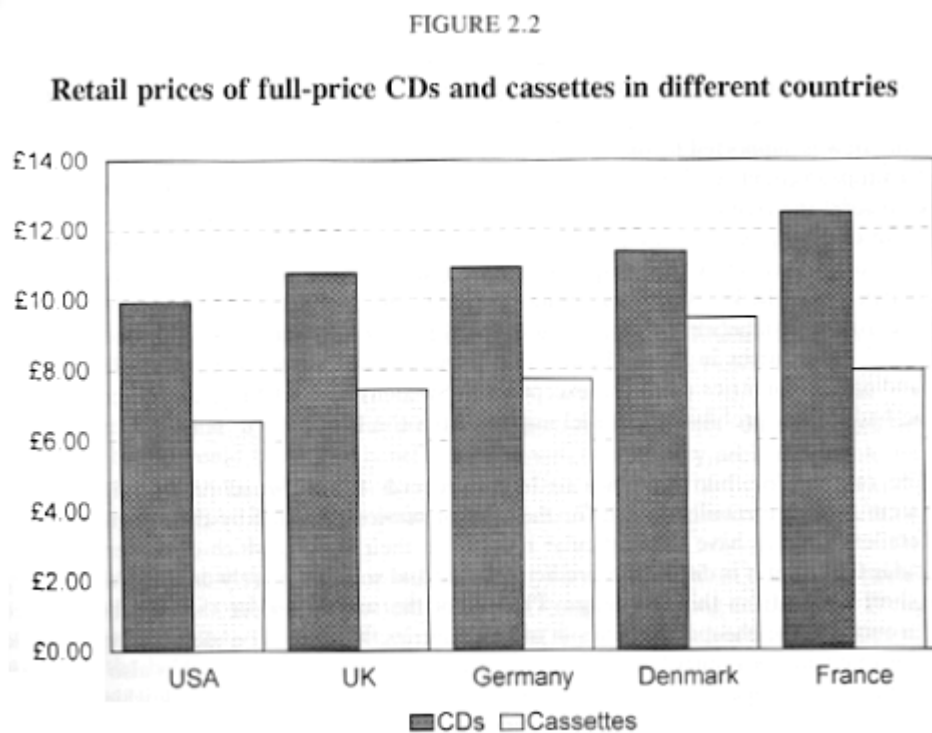
The effect of differences in sales taxes between the USA and the UK has been discussed in paragraphs 2.60 to 2.62. We look now at the prices charged by the record companies and then at the retailers' gross margins.

2.85. The record companies provided us with a number of reasons why the prices charged to retailers may be lower in the USA than those in the UK. The first concerned the higher level of service they provided to retailers in the UK. Most importantly, in the UK the record companies were in general responsible for delivery to individual retail outlets whereas in the USA large retailers tended to handle their own distribution. This and other elements of higher level of service, such as a faster turnaround of orders, meant that the record companies' distribution costs were higher in the UK. Second, the royalty rates paid to artists and composers were higher in the UK so increasing record companies' costs in the UK relative to those in the USA. The third set of reasons related to the relative size of the two markets. The US market for recorded music was over four times as large as the UK market and this enabled US companies to reap the benefits of economies of scale which lowered the cost and risks of supply. Manufacturing costs were reduced by longer production runs and fixed costs, such as Artist & Repertoire (A&R), could be spread over wider volumes. Top-selling records in their respective markets sold many more copies in the USA than in the UK. This meant that the rewards of the big hit would go further in the USA to offset the losses incurred in both countries as a result of the many failures inevitably associated with the policy of originating a wide range of different kinds of music. It has not been possible to quantify these supply side advantages enjoyed by record companies in the USA, but we believe the arguments set out above have force.

2.86. UK record companies claim that the power of the major retailers enables them to claim larger discounts than their counterparts in the USA. We have not been able to find any reliable evidence on differences between the USA and the UK in the mark-ups that record retailers apply to the prices they pay to record companies. The conventional wisdom is that the costs of retailing are lower in the USA. This arises primarily from the greater availability of good retail sites at significantly lower rentals and to greater labour productivity. Many of these factors would be expected to influence not just the price of records but also the prices of a wider range of retail products and this would be consistent with our findings that price differentials for CDs are not generally out of line with other products.

## Comparisons with other countries

2.87. To get a broader picture of UK prices in an international context we also included France, Germany and Denmark in our study of the retail prices of full-priced CDs and cassettes (which is described in paragraph 2.64). The average retail prices without tax which we found are shown in the graph at Figure 2.2. It will be seen that, while UK prices are generally higher than those in the USA, they are lower than in each of the other countries. Prices of CDs were found to be 2 per cent higher in Germany, 16 per cent higher in France and 6 per cent higher in Denmark.



Source: BMRB Survey (see Appendix 7.2).

2.88. Because our study did not include the mid-price and budget categories it does not provide us with information on the differences in the average prices paid in these countries. We have, however, looked at other evidence, which is discussed in more detail in paragraphs 7.93 to 7.105. The material covers a wide range of countries including Japan and Canada as well as European and Scandinavian countries. Much of it is based on record company data but we see no reason to doubt the reliability of the data and since the companies are large suppliers with consistent recording systems around the world we believe it gives a fair reflection of those companies' relative prices. Although much of the evidence is based on wholesale prices, the relativities of these prices between countries can be expected to give some indication of relative retail prices.

2.89. The conclusion that emerges from these international comparisons is that, although prices of CDs are higher in the UK than in the USA, in general the UK has lower prices for CDs than most other countries. We recognize that changes in circumstances, for example currency fluctuations, will alter the position of particular countries from time to time but such individual cases do not alter the general conclusion that prices in the UK are not systematically higher than those in other countries.

## Parallel imports

2.90. The Consumers' Association has argued that the price differentials between the UK and the USA are only sustainable because of the right to control parallel imports which is conferred on a copyright

owner by the 1988 Copyright Act. Its reasoning is that if retailers were free to import records from the USA they would do so and this would force the UK record companies to lower their prices so that they were closer to US levels. We now examine the evidence for this in the context of the legal basis for copyright described in Chapter 4.

2.91. We have already established that the price differentials between the UK and USA for recorded music are not significantly different from those for a wide range of other products. Most of these products are not subject to copyright constraints. Parallel imports can take place. Nevertheless price differentials remain. This suggests that the similar differential for recorded music is not due to copyright. Other factors, apart from copyright, inhibit such trade. No doubt these include the costs of transport and import duties which would also affect trade in recorded music (where import duty of 5 per cent is payable). It therefore seems unlikely that allowing parallel imports would be effective in reducing the price of recorded music at the present exchange rate.

2.92. This view is supported by the level of price differentials for recorded music between the UK and other European countries. Under the provisions of the Treaty of Rome copyright cannot generally be used to restrict the free movement of records within the EC once they have been lawfully put on the market in one member state by the owner of the copyright or with his consent. Parallel imports can therefore take place. However, despite the comparatively low transport costs and the absence of customs duties within the EC, this freedom has not led to the elimination of price differentials, some of which are higher than between the UK and USA. We also note from Tables 7.12 to 7.14 and those in Appendix 7.7 that prices in Japan, France and Denmark are higher than in the UK as are those of the Scandinavian countries (with the exception of Sweden) and yet these are all countries which at the time had no law prohibiting parallel imports from the USA.

2.93. The reasons for this reluctance to import records from abroad on any significant scale probably stem from the retailers' need for the type of service provided by their regular sources of supply. Retailers need to have the particular records on their shelves which customers want to buy at a particular time. Yet it is difficult to predict demand and so retailers rely on being able to acquire stocks at short notice from their suppliers. This is not the sort of service that can be obtained by shopping around for the cheapest supplies in other countries: it depends on maintaining a good long-term relationship with local distributors or a local wholesaler. Such a relationship also brings with it the opportunity to participate in joint promotions and some rights to return stock which a retailer is not able to sell. Sources of parallel imports would not allow returns and so the retailer's stockholding risk would be increased. We believe that these reasons, combined with the added costs of transport and duty, explain the lack of parallel imports where they are not prohibited. However, the incentives could well be different if differentials widened significantly, perhaps as a result of substantial movements in exchange rates. Even in this case it seems likely that only chart releases by superstars would be imported since these are the items where a high level of sales can reasonably be predicted. Entrepreneurs are unlikely to be interested in importing catalogue items such as classical CDs, where the low level and unpredictability of demand for a particular title would not make the risks worthwhile.

2.94. Although the provisions which enable copyright owners to restrict imports are contained in the UK's national legislation, our freedom to change this situation would be constrained by any requirements of EC law and of international conventions to which the UK is a party. The UK is a party to the Berne Convention. This convention does not explicitly require member countries to give copyright owners the right to control imports although experts in the World Intellectual Property Organisation (WIPO) argue that such a requirement is implicit in its provisions. A proposed protocol to the Berne Convention is under discussion in WIPO which would have the effect of making such a requirement explicit (see paragraph 4.48) but it is not clear whether it will be adopted.

2.95. Of more central relevance is the adoption of the EC Rental Directive.<sup>1</sup> It is generally accepted that this will require all member states to provide the individual owner of copyright in a sound recording with the right to prevent or control imports from outside the EC from July 1994. From this date not only will the UK be unable to relax the existing provisions to this effect in the 1988 Copyright Act but other member states, such as Denmark, which do not currently have such provisions will have to introduce them. We

---

<sup>1</sup>See paragraph 2.21.

conclude, therefore, that not only would it be unlawful with effect from 1 July to alter the present statutory position under the 1988 Copyright Act by removing the present right of a copyright owner to block parallel imports but to do so would go against the whole trend of international developments in the protection of intellectual property.

2.96. Moreover even if it were lawful for the UK to withdraw the right to control imports, we have been told that there would be serious consequences for the record industry. The basis of copyright is that it is territorial. There can be different licensees in different countries who will plan their exploitation in the light of local circumstances and will also have negotiated their licence payments on this basis. Any departure from this principle of territoriality would cause loss to the industry. This can happen in a number of ways. Where a parallel import displaced a sale in the UK of a record by a UK-signed artist, the UK record company would receive less revenue in licence fees and so would the music publisher. Moreover there would be a significant delay in payment. Where the artist was signed to a different record company overseas (known as 'dual-signing') the UK record company would receive no revenue at all from the sale, despite having invested in advances and promotional costs. The record companies also explained how the impact of their marketing plans, which are sometimes timed to coincide with an event such as an artist's tour, could be diminished by parallel imports. It is not only the record companies and music publishers that would lose revenue as a result of such imports; the royalties paid to artists and songwriters would also be reduced. Finally, lack of control over parallel imports would mean that it would become more difficult to control piracy which we have been told already causes serious losses of income to copyright owners.

2.97. We believe that a change in the UK's position would not only be contrary to EC requirements, but it would bring few benefits to consumers since any arbitrage would be likely to affect only a few titles and would almost certainly not affect the prices of the highest priced catalogue items which have been the focus of consumer complaints, including classical records.

2.98. We conclude that there is no case for altering either the right to control imports currently provided by the 1988 Copyright Act nor the MCPS/BPI import licensing scheme. We recognize that the scheme facilitates the ready import of records that are not available on the UK market while ensuring that the holders of UK rights are not deprived of a reasonable income. We have received no evidence that the price of the stamp under the import scheme (at £1.25 per CD) is set at too high a level, nor do we believe this to be the case.

## **Competition in the record industry**

2.99. For at least the last ten years the five major record companies have held a combined market share of at least 60 per cent by volume of albums sold. Currently their market share is at a high point of 72 per cent. Within this total the share held by each of the major companies has fluctuated as they have competed to meet the demands of the record-buying public. Competition is vigorous to find and retain successful artists, market and promote their products to the public and to persuade retailers to stock and display them. The increased concentration in retailing has meant that the strong position of the major record companies is now mirrored by large and powerful retailers. This countervailing power gives rise to intense competition between record companies, first to get their products stocked and, second, to ensure prominence in the outlet. Special discounts, payments for co-operative advertising, returns allowances and other financial incentives are negotiated between the retailers and record companies to obtain these benefits.

2.100. In addition to competition amongst themselves, the position of the major record companies is also challenged by the many independent record companies which make up the remaining 30 to 40 per cent of the market and by new entrants. Over the last ten years new companies have entered the market and some have left. This constantly changing picture is shown in Table 5.22. The majority of those that have entered have remained relatively small or have disappeared. But the diverse and volatile nature of demand creates continuing opportunities for the smaller companies to achieve considerable success. While the market share of each of the independents is less than 5 per cent, Virgin before its acquisition by EMI had a market share throughout the period of around 6 to 8 per cent. MCA now has the Matsushita Corporation of Japan behind it and this could influence its long-term future growth. In the 12 months to September 1993 the independents were responsible for 15 per cent of the albums entering the Top 40 charts. Taking a longer view, of the new artists who have become established in the UK since 1981, defined as those who

have achieved sales of over 100,000 with at least one album, over one-third (more than 100 artists) were signed to companies other than the majors.

2.101. The independent record companies are noted for their variety and dynamism. The strength of this independent sector is widely seen as one of the characteristics of the UK music industry which keeps it second only to the USA as a supplier of recorded music to the world. As Table 5.23 shows, concentration is higher in almost all other countries in the world, including the USA. It is comparatively simple to set up business as a record company. The essential requirement is to have a source of repertoire, either in the form of a contract for an artist to produce recordings in the future or in the form of a catalogue of copyrights in existing recordings. It is not necessary to own a recording studio, manufacturing facilities or a distribution network since all of these can be hired on the open market when required. Thus barriers to entry are low.

2.102. The risks for a small company are considerable at the initial stages if it is investing in new artists; that is, it must sink costs which may not be recouped. But it may be successful; there is evidence that many independents are willing to make the attempt. The majors tell us that only one in ten of the pop artists with whom they sign contracts turns out to be successful. Of course the majors can cope with this situation by spreading the risk over a number of artists. Similarly, they can spread their risks for particular records they release because, although they do not know in advance whether a particular title will sell a few hundred or several million copies, they have enough titles covering every genre of music to ensure that they receive a reasonably predictable flow of income. The small company, sometimes with only one artist, is not able to spread its risks in this way. Nevertheless, there are several hundred small record companies and a constant supply of hopeful artists seeking to sign with them or one of the majors. Some of the successful independents work in particular niches, where the majors do not compete so strongly, and many concentrate on innovative or 'alternative' music which sometimes leads to the establishment of a new fashion in musical taste which the majors are then anxious to emulate.

2.103. All this leads us to the conclusion that the UK record industry continues to be highly competitive with the potential for new companies to enter the market.

2.104. The economics of competition in the record industry are different from most areas of manufacturing because each recording is unique and, through the copyright system, can be marketed only by the owner of the rights or his licensee. However, as we discuss in paragraph 2.102, because the record company does not know which releases will sell in large numbers, it is forced to price its products under broad price categories. The company's profit depends on its skill in spotting successful artists in an industry where demand is governed by rapidly changing fashions. If it does this successfully its sales in the UK and its net licence fees from abroad will exceed the advances and other costs which it invested in order to secure the artist's services and make the initial recording.

2.105. How does this competition translate into price competition? Initially there was only one format, the 78 rpm record. Subsequently this was replaced by more durable vinyl singles and albums (LPs). Later the cassette was established which competed primarily on its portability and recordability rather than any improvement in sound quality and, more recently, we have seen the establishment of the CD which is now the highest selling format. The advent of the CD brought a step change in quality with its better sound from digital recording and its greater durability than earlier formats.

2.106. Figure 7.1 and Table 7.6 show movements in the prices of the different formats over the years. We can see from this how each new format enters at a high price and then falls as it becomes the leading format. The graph shows clearly that CD prices are conforming to this pattern.

2.107. Prices are also forced down by competition from independent record companies which choose to compete in particular niches. For example, Naxos has specialized in classical music by lesser known orchestras. Its lower CD prices, possible because of its lower costs in making recordings, have forced the majors to respond by introducing their own ranges of classical CDs at mid-price. Similarly in more popular genres of music Tring International Plc (Tring) has introduced CDs selling at a retail price as low as £2.99 mainly in non-traditional outlets such as petrol stations. It has done this mainly by acquiring copyrights which do not involve a major investment in A&R and selling its CDs in large quantities. More recently Tring has signed an agreement with the Royal Philharmonic Orchestra for recordings of its performances which are expected to retail at £4.99. The majors have responded to competition from companies like Tring by introducing their own ranges of budget-priced CDs.

2.108. We conclude that despite the established position of the majors competition is vigorous among the record companies and that the majors are unlikely to be able to exercise market power to the disadvantage of consumers, either in respect of their acquisition of artists or in their pricing policies.

## Profitability of the record companies

2.109. Profitability is normally measured either as a return on turnover or a return on capital employed. In the case of the record companies, the capital employed in each of the last five years is either negative or very small, making return on capital employed an unsatisfactory measure of profitability. Return on turnover (or 'revenue') is therefore the only practicable measure of profitability that can be derived from the accounts of the major record companies. Table 2.2 shows that in the last five years the aggregate returns on revenue of the recorded music businesses of the five major record companies have varied from a high of 7.1 per cent in 1989 to a low of 2.8 per cent in 1992.

TABLE 2.2 **Aggregate results of the core recorded music businesses of the five major record companies, 1989 to 1993**

	1989	1990	1991	1992	1993 <i>estimated</i>
Revenue (£m)	564	645	691	817	843
Profit before interest and tax (£m)	40	31	28	23	49
Return on revenue (%)	7.1	4.8	4.0	2.8	5.9

Source: Table 8.3.

2.110. Results for different companies have varied over the years. In the last five years some have made negative returns and on only two occasions has a company made a return on revenue of more than 10 per cent. We conclude from this that the companies' accounts prepared in accordance with generally accepted accounting standards do not reveal any evidence of excessive profits, indeed the profits are not high for a high-risk industry.

2.111. Although the profits shown in the accounts of the record companies are prepared in accordance with generally accepted accounting standards, it has been put to us that profits may be understated in that the accounts do not reflect any build-up over time in the value of the catalogue of copyrights. We have sought advice in an attempt to quantify the effect on the accounts of the copyright value. A study carried out for us by KPMG Peat Marwick, which is described in paragraphs 8.36 to 8.43, suggested that after adjusting for notional copyright value the companies' profitability, averaged over the last three financial years, would have increased by 1.7 percentage points on turnover.

2.112. The method used by KPMG to make these calculations suffers from significant limitations, as was made clear by the consultants themselves (see Appendix 8.2). We do not believe therefore that much weight should be placed on these notional adjustments. The adjusted results even if accepted do not suggest that the record companies' profitability is excessive. Moreover, the value of the copyrights would only be realized on the sale of the catalogue. Additional cash flow is not available from unrealized gains. If the catalogue is not sold, its value, if any, will materialize in due course from future record sales or from licence income. In this event there will be royalty payments to artists and composers and the additional revenue will be reflected in the financial results for the company.

## Price structures

2.113. In describing their pricing policies to us, the major record companies argued that the level and structure of prices had developed as a result of competition between themselves, other record companies, new entrants and the buying power of the major record retailers. It was the result of a competitive market and did not reflect any dominance of the major record companies or collusion between them. We look first at the pricing of new releases and then at the pricing of different formats.

2.114. The record companies told us that when reviewing the overall level of prices they took account of overall economic conditions, the change in their costs, changes in competitors' prices, the rate of inflation and the prices their products sold for in other countries. When pricing a new release, they faced the problem that the level of demand for each recording was highly uncertain at the time it was released. The record company incurred substantial costs prior to the release of each new record-in supporting the artist, making the recording and in marketing and promoting it. However, the unpredictability of demand meant that in practice it was not possible to price records on a cost plus basis. Even if it were, it would not make sense to charge a higher price for a less successful record to cover its higher unit costs and a low price for a successful record because its fixed costs could be spread over a larger number of sales. Successful records helped to recover the costs of unsuccessful records. Moreover, given that some 200 new recordings were issued each week, it would not be feasible to price each record individually in order to attempt to maximize profits on an individual record on the basis of likely demand.

2.115. The record companies told us that at current price levels consumers did not appear to be particularly sensitive to price changes so that price changes for recorded music as a whole would only have a minor impact on sales volume. But the price charged for a particular title could affect the demand for that title. The record companies pointed out, however, that the ultimate price to the consumer was determined by the retailers. They argued that the retailers' practice of using a limited number of price points and charging higher prices for non-chart material restricted their opportunity to reduce prices to stimulate demand for particular recordings. The use of low prices to promote recordings of, for example, new artists was also constrained by the need to ensure that such recordings were not perceived as low quality products since such a public perception would be damaging to the successful development of the artist.

2.116. In practice therefore, we were told, the record companies priced each new release at one of a limited number of dealer pricing points. They concentrated on competing with other record companies' recordings through promotional campaigns and dealer-specific discounts designed to achieve sales success. Later in the life cycle of a recording, when sales tailed off, a record company may try to increase sales through lower pricing strategies, special promotional campaigns with specific retailers and re-releases of older records at mid-price.

2.117. As to the pricing of different formats (CD, cassette or vinyl), the record companies told us that they aimed to maximize the value of their copyright subject to the constraints of the competitive market. They did this by charging a higher price for CDs reflecting the consumer's greater willingness to pay for the higher sound quality, durability and user-friendliness of the CD.

2.118. Although the cost of manufacture for CDs and cassettes differed by a comparatively small sum, manufacturing costs made up only a small proportion of total costs and most costs were not related to format. The problem they faced, the record companies argued, was to set prices across formats to recover their fixed costs and maximize their returns. Setting different prices for different formats increased the total demand for recorded music by providing a range in terms of price and quality to suit different consumers' needs. This, they argued, was common practice in industries based on the exploitation of copyright. The owner of the copyright sought methods of discriminating between customers on the basis of willingness to pay. In book publishing, hardback books were generally issued before paperbacks. Similarly films were released in well established echelons or 'windows': first-run cinema, second-run cinema, video to rent, video to buy, pay-television and finally free television. In these cases, as with recorded music, the price achieved by the copyright owner depended on the demand characteristics of the market and not on the cost of physical reproduction. In the case of recorded music, different formats were issued at the same time, the different prices charged reflecting consumers' differing perceptions of quality and value and hence willingness to pay.

2.119. The record companies argued that price differentiation by format, which was practised by record companies world-wide, had resulted in greater sales, lower costs, lower prices, and a greater variety of product in the market. When the CD was first introduced its higher quality had merited a higher price. Its sales and market share had grown rapidly so that it was now the dominant format. As with other technological innovations, the real price of a CD had fallen over time as had the differential between CD and cassette prices. This, the record companies argued, reflected the normal process of supply and demand interacting over time to produce a price level and price structure in a competitive market.

2.120. We accept the record companies' analysis of the basis of their pricing policy. They clearly face restraints in pricing new releases and we have found no evidence that the level of prices reflects a lack of competition. We accept that price discrimination can increase the range of goods available in the market and the volume of goods sold. Similarly we accept that owners of copyright are justified in offering that copyright in different formats and at different times to maximize their returns from it. Problems arise, however, if such practices are employed in such a way as to abuse market power.

2.121. We do not believe this is the case here. The competitive nature of the recorded music industry, and in particular competition in the production of new titles and in the market for artists, together with the freedom of entry to the industry, leads us to conclude that the major record companies cannot abuse their position in the market. The entry of Naxos with mid-price classics and Tring with budget price CDs are examples of the challenges that they face from the independent sector. The similarity in the pricing policies of the major companies does not appear to be the result of any lack of competition. Rather it is a reflection that competitive pressures have forced them to act in broadly similar ways.

## **Competition in retailing**

2.122. The significant reduction in the number of independent specialist retailers over the last few years and the strong position of the major retailers has led to some concern that competition in record retailing may be deficient. Here we consider the degree and vigour of this competition.

2.123. Records are sold to the public by a number of different types of retailer: specialist chains such as Our Price and HMV, non-specialist multiples such as W H Smith and Boots, independent specialists, various other types of retail outlets which have not traditionally sold records such as supermarkets, and various mail order operations of which by far the most important are the record clubs. Over recent years there has been a significant decline in the number of independent specialists but many new types of retail outlet have begun to stock recorded music. These range from major grocery chains, such as Asda, to small retail outlets in high traffic locations such as petrol stations. In part the decline of the independent specialist reflects the general trend in retailing in the UK and elsewhere away from smaller independent to larger multiple retailers. But these trends do not mean that small retailers are not viable. They can and do survive if they offer consumers something different in terms of service or specialization in particular music genres. Entry is feasible for those who wish to try and there are entrants on a more significant scale, as witness the arrival in the UK of Tower Records and Sam Goody, two major US record retailers. Of increasing importance and a further threat to the established retailers are the record clubs and mail order businesses which now account for 12 per cent of total retail sales.

2.124. Record retailers compete in a number of ways such as price, range of titles stocked, service, location and ambience and in doing so appeal to different sections of the record-buying public. Music enthusiasts are likely to be attracted to the specialists with their wide range and knowledgeable staff. More occasional buyers are more likely to buy in the non-specialist multiples or in other convenient but not traditional outlets for recorded music. We have been told that one aspect of competition between retailers, price, is particularly important. While the demand for recorded music in general may not be very sensitive to price, consumers are sensitive to price differences between retail outlets for the same product. Price competition is particularly intense for the most popular (ie chart) material. Most retailers discount these products and are keen to avoid getting out of line with their competitors.

2.125. In our view record retailing, in terms both of the structure of the industry and conduct in the market, is a competitive market. We do not believe that W H Smith and Our Price have market power which enables them to exploit their scale monopoly position.

## **Profitability of the retailers**

2.126. Our view that the major record retailers could not exploit their position is borne out by their results, which show that they are making profits on their recorded music business which are modest. Tables 1 and 2 in Appendix 8.6 show that taken together W H Smith and Our Price have achieved a profit before interest and tax on recorded music of only [ \* ] per cent of sales over the four years to 31 May 1993. [

*Details omitted. See note on page iv.* ] Although the profit levels over the last three years have no doubt been adversely affected by the recession, they lead us to conclude that the two companies are not able to exploit their combined market share of 26.6 per cent by charging high prices in order to make excessive profits.

2.127. W H Smith, Our Price, HMV and Virgin Retail have all had gross margins in the range [ \* ] to [ \* ] per cent in the last four years. Woolworths had lower gross margins, but Table 9 of Appendix 8.6 shows that, when the additional margin which its wholesaler affiliate, Entertainment UK Ltd, earns on its purchases is included, the combined gross margin for the year ended 31 March 1993 fell within the same range. The tables in Appendix 8.6 show that the profits before interest and tax of all the companies have generally been less than [\*] per cent of sales. We do not regard this as excessive.

## **Contracts with artists**

2.128. Some artists, through their managers, claim that the terms of their contracts with record companies restrict their ability to exploit their talent (see paragraphs 10.45 to 10.65). They argue that the contracts are inequitable in their effect on artists and, by reducing competition, lead to higher prices for recorded music. The managers highlight three particular aspects of contracts which they consider most significant in this respect: the record companies' insistence on owning copyright for its full term, the standardization of contract terms and the provisions giving the record company the exclusive right to release recordings made by an artist. They believe the record companies are able to insist on these restrictive features by taking advantage of the relative weakness of the artists' negotiating position.

2.129. It is argued on behalf of the artists that record companies should be required to change the nature of their contracts so as to allow more competition for artists' services and for the copyright in their past recordings. It is claimed that this would not only give artists more equitable rewards but would reduce the control that the major record companies have over the supply of recorded music and so benefit consumers through greater choice and lower prices.

2.130. We regard it as inevitable that the record companies, in their negotiations with artists, will seek to obtain maximum control over copyrights. Equally the individual artist will seek to maximize his advances, royalties and other benefits from the record companies. Provided there is competition between the record companies to secure the services of artists, as we believe there is, and provided the new artist is advised by professionals with appropriate experience, the negotiation of contracts should lead to an equitable outcome.

2.131. A new artist is likely to be interested in securing the maximum advances since he may have no other source of income and he does not know whether his recording contract is going to prove successful. Of course, he will also want to sign with the record company which he considers is most likely to launch him on a successful career. This will vary according to the genre of music and for some artists it will lead them to sign with an independent record company.

---

\*Figures omitted. See note on page iv.

2.132. At this stage a new artist may have relatively smaller interest in the details of other contract terms and, if his recording career does not prove successful, they are unlikely ever to assume significance. However, the artist will normally have the benefit of professional advice and all the major record companies told us that they would not sign a contract unless the artist was advised by a specialist lawyer. The reason for this is that the record company wants to protect its contracts from challenge in the courts on grounds of restraint of trade.

2.133. If an artist does achieve success there are in practice opportunities to renegotiate the contract and at this stage the artist will be in a stronger position. The main concern of an artist who has achieved some success is likely to be to improve his or her long-term revenues. Over the years the courts have struck down some of the more far-reaching restrictions contained in a number of artists' contracts. As a result a number of the more onerous clauses in general use in the industry have been removed or adjusted in the artists' favour. No record company will want to include clauses in a contract which in the light of such decisions may lead to the contract being declared unenforceable. Thus, in addition to competition, there are other safeguards both for the new artist and the established artist. As a result, the terms offered to and accepted by artists have improved significantly over the last 20 years with the greatly increased royalty rates and other features described in paragraph 5.139.

2.134. We consider in the following paragraphs the three particular features of contracts which were highlighted by managers.

## **Ownership of copyright**

2.135. The artists' managers suggest that either the artist should own the copyright and license it to the record company for a period or that the period of the record company's initial ownership of the copyright should be limited so that it will pass to the artist at the end of the contract or at some earlier time, for example when all the advances have been recouped. It is argued that a shorter copyright period would have a number of benefits. It would lead to a more lively market in copyrights which would not only give the successful artist potentially greater rewards but would lead to the establishment of a market price which would allow artists and others to raise finance from sources other than the record companies so providing a better funded, more open and competitive industry. Furthermore if the record companies were forced to take a shorter-term view they would be likely to spend less on marketing and promotion, so lowering the costs of securing a hit and making it easier for independent record companies to establish their artists. This effect would be speeded up if the major record companies were also required to divest themselves of their existing catalogues of copyrights. They would then no longer be able to cross-subsidize new artists and so competition with new independent companies would be enhanced. Finally it was argued that this heightened competition would lead to greater efficiency and so lower retail prices and this would be achieved without lowering artists' income.

2.136. The record companies say that they are not as inflexible over copyright as has been suggested. They have sometimes negotiated contracts where they hold copyright only for a period but in such contracts they would expect to adjust the other terms so as to ensure that the payback period was commensurate with the period for which they owned the copyright. Although contracts in this form had been negotiated in the past, in general new artists currently preferred to secure larger advances and royalties rather than ownership of copyright. The same normally applied at the point where a contract was being renegotiated. In such cases an artist would often willingly agree to extend the term of an agreement in return for larger advances and royalties.

2.137. Record companies go on to point out that, even where successful artists have acquired control of the copyright, there is no benefit to the public interest. An artist's only avenue for protecting and exploiting his copyright is to license it to a record company and this is achieved by auctioning it to the highest bidder. The consumer does not benefit because he is primarily interested in the artist and only to a limited extent in the particular label on which the recordings are published. Hence the only beneficiary is the artist, who is able to achieve a greater share of the income generated by his copyright. The effect of paying more to the artist would be either an increase in the dealer prices charged to the retailer (and hence to the consumer) or the spending of less on A&R to develop new artists. Neither of these outcomes, the companies argue, would be in the public interest. Moreover the companies do not consider that there is anything inequitable in the arrangement. Since the record company bears the initial investment risks it is entitled to the benefits

when there is a success. Otherwise, it will be unable to maintain the flow of new artists because of the high level of failures amongst those signed by the record companies. Evidence for this is provided by detailed figures made available to the MMC by one of the major record companies (see paragraph 8.61). In the case of classical music, where sales of individual recordings tend to be spread out over a long period of time and are relatively small, a restriction of the period of copyright to, say, ten years would be too short a period in which to recover the investment.

2.138. Finally it was argued on behalf of the record companies that the independents would be the companies most severely affected if the period of copyright ownership were curtailed. Independent companies needed their copyrights and a reasonable length of contract in order to be able to secure licensing agreements to exploit their artists' recordings overseas. Independent record companies would also suffer in that their investment in developing an artist who turned out to be successful would be difficult to recover if the artist were able to take the copyright and transfer it to one of the major record companies as soon as he achieved success.

2.139. We have carefully considered the arguments for changing the present arrangements and the views expressed by the record companies. We have found nothing which leads us to believe that the outcome is other than the result of free bargaining between the parties or that artists do not have adequate opportunity to secure competing offers. As well as offers from the major record companies, both established artists and promising new artists have the possibility of negotiating a different type of contract with an independent record company. Under the 1988 Copyright Act the copyright would normally be owned by the record company and, unless it agrees to assign or license that copyright, the company would be entitled to exploit it for 50 years. Of course, under the terms of the contract between the company and the artist, the latter will normally receive an agreed share of the proceeds in the form of royalty payments. We do not see anything inherently inequitable in these arrangements, nor do we consider that a case has been made for interfering with the period of a record company's ownership of copyright.

2.140. In reaching this view we have taken account of the record company's need to make a profit on its successful records which is sufficient to cover its investments in new artists, many of whom will prove unsuccessful. While we can understand that successful artists would prefer that such profits accrued to them, we recognize that record companies need to seek new artists who will meet the changing fashions in popular music and will ultimately replace the present generation of successful artists. In any event, since the record companies take the risk of investing in artists when they are unknown, they should not have the rewards taken away on those occasions when their investment turns out to be successful.

## **Standardization of contract terms**

2.141. The artists' managers criticized the similarity of terms offered by the major record companies which, in their view, reduced the ability of an artist to negotiate improved terms. They suggested that contracts always included unnecessary complexities, such as 'packaging deductions' from royalty payments, which only served to obscure the true rate of royalty. The managers suggested that such unsatisfactory features could be eliminated if a Minimum Terms Agreement were laid down as a starting point for negotiations. They also advocated the prohibition of certain provisions relating to the assignment of copyright or which had the effect of reducing royalties (see paragraphs 10.53 to 10.56).

2.142. In response to these criticisms the record companies said that it was not surprising there were superficial similarities between their contracts. A contract for recording services needed to cover certain issues and so most contracts contained clauses on the same subjects. The fact that artists used a comparatively small circle of lawyers who sought inclusion of particular clauses also added to an appearance of similarity. However, the companies said that the details of those clauses were all available for negotiation and each company had contracts containing a wide variety of different provisions which had resulted from individual negotiations with artists. Even the traditional packaging deduction was not insisted on by companies, though they found that artists usually preferred its inclusion because it enabled them to claim that they received a higher 'headline' royalty rate than would otherwise be offered. The companies also said that a degree of similarity could enhance competition because it made it easier for an artist to compare competing offers from record companies.

2.143. We accept that a well-drawn contract will always need to deal with all those issues which arise in the relationship between a record company and artist, just as one would expect to find similarities in the range of matters regulated by a lease or by a contract of employment. We examined a number of individual contracts of each of the major record companies and found that not only were there differences between the companies in the way they usually dealt with particular issues but there were wide differences in the contracts which any one company had with its individual artists. For example, the number of albums normally covered by a contract with a new artist varied from five in the case of one company to eight in the case of another. Some contracts based royalties on dealer prices, some on retail prices. And, contrary to the views of the artists' managers, we found significant variations in the details of other clauses. This leads us to conclude that there is scope for individual negotiation of all the terms of the contract and that there is competition between record companies in the terms they offer artists-in the detailed provisions as well as in the amount of advances and royalties.

## **Exclusivity**

2.144. A particular illustration of the effects of the exclusivity provisions often included in recording contracts was provided by the evidence of BBC Audio International Limited (BBC AI) (see paragraphs 10.115 to 10.123). BBC AI said that record companies were able to use their exclusivity to prevent or delay the entry of new competitors into the market. In their case the provisions were preventing a new company from exploiting the BBC's archives which contained a valuable collection of classical recordings of historical interest. BBC AI advocated that record companies should be required to give undertakings that they would not enforce their exclusivity in respect of a performance given more than ten years previously.

2.145. The record companies involved in the dispute with BBC AI said that their concern was not to keep out competition but to protect their contractual rights and intellectual property. The exclusivity provisions in their contracts with classical artists normally prevented the artist making any recording for issue on another label during the period of the contract and also prevented the artist re-recording a title during a period after the contract ended. The latter case was known as 'title exclusivity' and was intended to protect a company's investment in the recordings made towards the end of a contract. Without title exclusivity, which typically lasts for a period of five or ten years, an artist would be free to re-record a title for release on a competing label within days of a contract ending.

2.146. In the case of the BBC the companies had particular concerns. The recordings held by the BBC were generally made for broadcasting while the artists were under contract to the record company. They were often live performances of works which were also available from the record company in a recording made in a studio. The record companies were happy to allow the BBC to broadcast the live performance but not to release it as a record, particularly since it would probably not be of the same quality. Although some at least of the recordings concerned were now quite old, the record companies were not prepared to see them released as records without proper recognition of their rights.

2.147. The exclusivity provisions are the most restrictive aspect of contracts-on the face of them such clauses restrict competition because they prevent an artist performing for a competing record label. However, we have heard evidence of the way a record company invests in developing an artist's image and career and the company would have no way of securing a return on its investment if the artist were free to make records for another company. We accept therefore that in general a degree of exclusivity is necessary. Of course, in an individual case it is possible that such provisions may be so restrictive as to be unreasonable. In such cases the law provides a remedy by way of an action for 'restraint of trade'. With this safeguard available for individual cases we do not consider it necessary for the MMC to make any finding in respect of the exclusivity provisions common to recording contracts. In the particular case of BBC AI we believe the matter is most appropriately resolved by negotiation between the parties or, failing that, through the courts.

## **Position of record producers**

2.148. Record producers, who work with the artist in the studio while a record is being made, claim that they should be entitled to a share in the copyright of recordings they help to make (see paragraph 10.84). Under section 9(2)(a) of the 1988 Copyright Act the first owner of copyright in a sound recording is 'the person by whom the arrangements necessary to make the recording are undertaken'. Producers believe they are such a person in some, if not all, cases and that the record companies were refusing to recognize this and were depriving them of a share of PPL's income.

2.149. We have studied statements made in Parliament during the passage of the Bill which was to become the 1988 Copyright Act (see paragraph 4.15) and in our view these make it clear that section 9(2)(a) was intended to put sound recordings on the same footing as films, where the established practice was that copyright lies with the person who takes the financial risks of investing in its production.

2.150. If the producer of a sound recording, or the artist, makes the recording at their own expense rather than with advances from a record company, then the record companies recognize that person's ownership of copyright. This sometimes happens with major stars.

2.151. The 1988 Copyright Act does not appear to give the producer any claim to ownership of copyright in other circumstances. Moreover, we consider it reasonable that copyright should lie with the record company where it takes the financial risk. We do not therefore believe that the record companies are acting unreasonably, nor do we suggest any change in the law.

2.152. Interpretation of the law is a matter for the courts and, irrespective of any view expressed by the MMC, a producer who considers his rights are being denied can seek redress through the courts. It is not therefore appropriate for us to take any action on this issue.

2.153. Producers also argue that they are being denied a share of the income of PPL to which they are entitled. If a producer does own the copyright in sound recordings, which we recognize in paragraph 2.150 will sometimes be the case, then he can assign his copyrights to PPL and receive a share of its income in respect of the public performance of those sound recordings. In other circumstances the producer receives his remuneration from the record company or artist and it is a contractual matter whether the producer is remunerated by flat fee, royalties on the sale of records and/or a share of other income. We see no reason to conclude that the arrangements for remunerating record producers normally result from the unreasonable exercise of monopoly power by the record companies either in their contractual arrangements with the producers or through their influence on the way PPL distributes its income.

## **Promotion and marketing**

2.154. It was suggested to us that the large sums spent by the record companies on promotion and marketing (including supplying free records to retailers) could have the effect of restricting actual or potential competition from independent record companies with their more limited resources. Such spending might also reduce the royalties paid to artists because royalties are not normally paid on free stock and are normally paid at half-rate for television-advertised records.

2.155. Marketing and promotion are the main weapons of competition between the major record companies in seeking retail sales. This is especially true of full-price records where there is only limited scope for price competition because of the system of price points used by retailers (see paragraph 7.39). Although the smaller independent record companies may not be able to spend equivalent amounts, they have other means of competing and alternative and less costly ways of promoting their products. They can compete on their reputations for particular styles of music and they have opportunities to promote their records through the music press, where we are told that the 'indie' labels are particularly well covered, and in radio programmes dedicated to particular styles of music. Some measure of the success of these alternatives can be seen in the fact that 16 per cent of singles entering the main chart in the 12 months to September 1993 were released by independent record companies. It is clear that independent record companies are able to become established and achieve success and we do not, therefore, consider that the

major record companies' practices in relation to marketing and promotion are restricting their ability to compete effectively.

2.156. So far as artists' income is concerned, we have heard that, far from objecting to this spending, artists generally seek maximum promotion for their releases, including expensive television advertising, because they believe it is effective in selling more records. Moreover in at least some contracts the artist is given the right to approve or be consulted about television advertising. In any event, the terms on which royalties are paid in such cases is a matter which can be negotiated as part of the contract if artists consider it important. We do not therefore consider that artists are being exploited through any reduction in royalties that results from promotion and marketing.

## **Discounts to retailers**

2.157. Concern was expressed that the major retailers were distorting competition with independent retailers by securing from the record companies unduly large discounts and contributions to joint promotions. It had been suggested that this was the cause of the reduction in the number of independent specialist retailers which has taken place in recent years, from around 2,200 in 1984 to just over 1,000 in 1992. As discussed in paragraphs 2.50 to 2.54, although the larger retailers obtain file discounts which are not generally available to independent retailers, the independents gain other forms of discounts and benefits with the result that the larger retailers do not consistently receive higher benefits in total. Although we concluded on this basis that there was no complex monopoly situation involving the major retailers we need to consider the position of the scale monopolists, W H Smith and Our Price.

2.158. The tables in Appendix 8.4 show that these two companies taken together do not stand out as receiving the highest discounts or promotional support and we therefore conclude that they are not exercising market power to secure excessive discounts. This is consistent with our finding that there is strong competition among retailers so that the discounts received by different groups of retailers are the result of the different opportunities they offer record companies for promoting and selling their records.

2.159. In our view, it is this competition which has caused less efficient retailers to leave the market. Those that are more efficient continue to survive as do those that have been able to distinguish their services from those of the multiples by serving niche markets or offering specialist advice to their customers. This conforms to a general trend which is being experienced in all types of retailing.

2.160. As far as consumer choice is concerned, we are encouraged by the way in which the large specialists are expanding the number and size of their stores so as to offer a wider choice of music to consumers. In addition, as we note in paragraph 2.123, significant new entrants have joined the market. We therefore conclude that the file discounts and promotional spending obtained by W H Smith and Our Price are not distorting competition.

## **Availability of vinyl LPs and singles**

2.161. Record companies are issuing far fewer records on vinyl albums, particularly classical albums, and some retailers (including W H Smith) have ceased to stock any vinyl albums or singles. Some consumers claimed that this was being done not in response to consumer demand but in order to increase sales of the more profitable CDs.

2.162. Although W H Smith and Woolworths have now ceased to stock vinyl albums they say that they have done so only in response to declining demand. The sales figures for vinyl albums (see Table 5.8) show that there had been a very substantial reduction in sales before these two companies ceased to stock vinyl albums in December 1992 and in 1991 respectively. We conclude therefore that the retailers were responding to changing customer demand when they decided to make space available for CDs, videos and video games at the expense of vinyl albums. Despite the decline in sales of vinyl, there is still some demand which is met by specialist shops such as HMV and Virgin Retail. In the case of vinyl singles, consumers also have a wide availability in Woolworths' stores and in many independent shops.

2.163. The record companies say that they have reduced the number of new albums released on vinyl in response to the falling demand. They claim that if retailers ordered more vinyl they would supply it. The figures in Tables 5.8 and 5.9 bear this out, showing that while vinyl represented only 5 per cent of album sales in 1992 (down from 23 per cent in 1989) the annual number of titles released on vinyl has fallen by only half over the same period.

2.164. We understand that the decline of vinyl is a world-wide trend and that it is not available at all in some countries because the demand has dried up to the extent that it is no longer profitable to manufacture or retail it. In the light of the evidence in the preceding paragraphs we conclude that the policies of the record companies and W H Smith and Our Price towards the formats they supply are not the result of their respective monopoly positions.

## **Collecting societies**

### **Phonographic Performance Limited**

2.165. Representatives of both the smaller independent record companies and record producers felt that the major record companies effectively controlled PPL and used their position to deny them a fair share of PPL's revenues from broadcasting and other public performances of records.

2.166. PPL explained to us that while it had a total of around 1,350 members only 16 were full members, the remainder being associate members. Nine of the full members are from independent record companies. Only full members can attend and vote at PPL's annual general meetings. The day-to-day control of PPL lies with a Board of 12 members of which the majority are drawn from the major record companies. The Board has until now decided which companies will be admitted as full members. Although it would appear from this that PPL is effectively controlled by the major record companies, we were told that the Distribution Committee, which decides on the allocation of PPL's income, has a majority of members from the smaller independent companies.

2.167. Towards the end of our inquiry we were told that the Board of PPL was considering changes to its rules for admission to full membership. Under the proposed new rules, full membership would automatically be extended to a substantially greater number of companies. A rule change on these lines should help to reassure the independent companies that control of PPL will be more broadly based.

2.168. PPL is improving its distribution of income as better information becomes available so that record companies (including independent companies) and performers will receive a share of the income which is more closely related to actual playing time of their records. We are satisfied that there is no substance in the complaint that the major record companies are exploiting their monopoly position to deprive others of a fair share of PPL's income.

2.169. We have already dealt with the position of record producers in paragraph 2.153.

### **Video Performance Limited**

2.170. MTV Europe (MTV) complained that Video Performance Limited (VPL) was the vehicle for collusive and anti-competitive behaviour by the major record companies towards its broadcasting of music videos. Although the supply of music videos does not come within our terms of reference we examined this issue since it could be that the record companies' actions in this field were attributable to the monopoly situation which we have found to exist in recorded music.

2.171. The MMC's report on *Collective licensing*\* examined the merits of collective licensing bodies and noted that the convenience they offer to both the owner and the user of copyright is unlikely to be matched by any other means. The report concluded that such bodies were the best available mechanism for licensing sound recordings provided they can be constrained from using their monopoly unfairly.

---

\**Collective Licensing: a report on certain practices in the Collective Licensing of Public Performance and Broadcasting Rights in Sound Recordings*, Cm 530, December 1988.

2.172. VPL is a collective licensing body. It licenses the use of videos by other broadcasters besides MTV and by those who give public performances (for example, clubs and public houses). It also provides a cost-effective way for record companies to license their videos and hence offers the advantages of convenience which were identified in the report on collective licensing. Moreover, for MTV it offers the added advantage of licences for the retransmission of videos in various countries of Europe. If MTV considers that VPL is using its monopoly unfairly in relation to the terms negotiated for MTV's use of videos then it can pursue its complaints through the EC and the courts, as it already is. Since these avenues are open to MTV we do not consider it necessary for us to make any finding in respect of the operation of VPL or the particular matters on which MTV is in dispute with it.

## **Record charts**

### **National charts**

2.173. Umbrella Organisation Ltd (Umbrella), which represents some of the smaller independent record companies, suggested to us that the major record companies distorted competition by the way they sought the inclusion of their records in the 'independent chart'. However, evidence from the major record companies satisfied us that independent companies, which were represented on the relevant BPI committee, had been the ones to decide on the criteria for inclusion in this chart. Records *distributed* by the major record companies were not eligible, whether or not the label was owned by a major. The majors did not support this rule, which they believed had no basis in logic and which disadvantaged them in competing for contracts to distribute independent labels. We could find no evidence to support a finding that the majors were using their monopoly position to disadvantage independent record companies in relation to this chart.

2.174. Our main concern with the national charts was whether they were being distorted by the record companies' practice of giving away free records to retailers. We were told that this practice was widespread for newly-released singles and its purpose was to ensure that the records were stocked by retailers and were offered for sale to customers at an attractive price. The volume of free singles distributed was considerable, sometimes reaching 50 per cent of a retailer's stock, in the first few weeks after a record was released. It is clear that the intention is to stimulate sales at an early stage in a record's life so that it will get into the singles chart, which is the key to getting the record played on national radio, in particular on the BBC's Radio 1 FM.

2.175. The major record companies have argued that all companies engage in this practice, including independent record companies, and it is part of the means by which companies compete for sales. They regard it as a legitimate promotional tool which is equivalent to giving a discount on singles.

2.176. The main arguments against the practice are that it could create a distortion in the charts and so mislead consumers, that it might distort competition between record companies (to the disadvantage of independent record companies) and that it might distort competition between retailers (to the disadvantage of independent retailers).

2.177. On the other hand, we note that the practice does not prevent singles from independent record companies getting into the singles chart since they released 16 per cent of the chart entries in the 12 months to September 1993. Moreover we have received no complaints from independent record companies about the practice, which suggests that they are not disadvantaged by it. As far as competition between retailers is concerned, since independent retailers are the main recipients of free records, the practice can be regarded as strengthening competition since the independent retailers do not receive discounts and other promotional support to the same extent as large retailers. We also attach weight to the argument that the record companies should be free to promote singles since these are themselves such an important competitive element in stimulating sales of albums and in establishing new artists.

2.178. Although we retain some concern about a practice which is designed to influence chart positions, we consider that on balance the benefits of not interfering with the competitive process outweigh its disadvantages and that no change is required in connection with the practice. Moreover it does not appear to be connected with the existence of the major record companies' monopoly situation.

## **Retailers' charts**

2.179. A number of the major retailers, including W H Smith and Our Price, display their own charts which are not based on the national charts compiled by Gallup.\* Concern has been expressed, by the record companies and others, that these charts may mislead or confuse consumers, particularly where they are based on the retailers' predictions of future sales rather than actual sales in the previous week.

2.180. The retailers explain that the national charts do not meet their needs because they are not geared to the type of customer who buys in their particular shops. Thus W H Smith sells records which appeal to the wider public who use its shops and it has few sales of records in specialist genres, such as dance music. However, such records sometimes come high in the national charts. W H Smith does not want to promote records which its customers will not buy. We can understand this concern but believe it is unacceptable to display a chart which might well have the effect of misleading consumers into thinking that it represents the previous week's best-selling records. We were also concerned to learn that W H Smith had in the past charged record companies for inclusion in its chart.

2.181. The effect of this practice by W H Smith and Our Price is not sufficient to warrant a finding that they are exploiting a monopoly position. However, we consider that all retailers which display charts that differ from the recognized national charts, whether they are called 'charts' or some other title such as 'hit-lists', should make clear at the point of display the basis on which they have been compiled. W H Smith has now introduced such a practice and we suggest that the Director General of Fair Trading should seek to ensure that other retailers follow the same practice. We believe this is a matter which he will want to consider in the context of his consumer protection functions.

## **The public interest-conclusions**

2.182. The origins of our inquiry lay in the concern that the price of CDs was higher in the UK than in other countries. We have found that some retail prices, particularly of 'full-price' CDs, are higher in the UK than in the USA, after making due allowance for differences in VAT and sales tax. UK prices are lower than in most other countries. We have also found that the price differential between the UK and USA for full-price popular CDs is no higher than for a wide range of other products.

2.183. We do not ascribe the price differentials to the right of a copyright owner to control parallel imports. It seems unlikely that removing that right would lead to a reduction in the price of recorded music generally. In any event, it would be inconsistent with international developments in intellectual property, including the EC Rental Directive. Uncontrolled parallel imports could also be damaging because of the increased risk of piracy and the general weakening of copyright protection, which is territorially based.

2.184. We have found that there is strong competition both among the record companies and among the retailers. It is also clear that neither the record companies nor the retailers are making excessive profits. Since the markets are competitive it follows that, despite the monopoly situations which we have found to exist, the companies in whose favour they operate are not able to exercise market power in a way which enables them to exploit their monopoly positions. We therefore conclude that the prices for recorded music in the UK are set at levels determined by effective competition within the UK market. We have also found that the record companies compete with each other to sign both new and established artists, which gives artists adequate bargaining ability to negotiate the terms of their contracts.

---

\*By Millward Brown since February 1994.

2.185. We have already concluded that two monopoly situations exist in relation to recorded music. A complex monopoly situation exists in favour of the five major record companies (see paragraph 2.44) and a scale monopoly exists in favour of W H Smith and Our Price (see paragraph 2.48).

2.186. We now conclude that the companies in whose favour those monopoly situations exist are not taking any steps to maintain or exploit them. Nor are there any actions or omissions attributable to the existence of the monopoly situations. We have found no facts which operate or may be expected to operate against the public interest.

2.187. Background information on the industry, and the evidence on which our conclusions are based, can be found in Chapters 3 to 13 which form Part II of our report.

G D W ODGERS (*Chairman*)

D G GOYDER

M E BEESLEY

J EVANS

D P THOMSON

A J NIEDUSZYNSKI (*Secretary*)

14 April 1994