United States Senate

COMMITTEE ON THE JUDICIARY

WASHINGTON, DC 20510–6275

August 3, 2012

The Honorable Chairman Jonathan Leibowitz
Federal Trade Commission
600 Pennsylvania Ave., N.W.
Washington, D.C. 20580

Dear Chairman Leibowitz:

We are writing regarding the proposed acquisition by Universal Music Group ("Universal") of the recorded music business of EMI Group ("EMI"), which is now under review at the Federal Trade Commission. Our Subcommittee on Antitrust, Competition Policy and Consumer Rights held a hearing on this proposed acquisition on June 21, 2012. This letter summarizes the findings of our investigation into this transaction. In brief, without reaching any final judgment as to the legality of the deal under the antitrust laws, we believe this proposed acquisition presents significant competition issues that merit careful FTC review to ensure that the transaction is not likely to cause substantial harm to competition in the affected markets. In the course of this review, we also urge the Commission to be mindful of the changes in the music industry in the last decade, particularly the shift to online distribution as the preferred way consumers purchase music.

This acquisition, if consummated, would combine two of the nation's four major record companies and reduce the number of major competitors in the recorded music business from four to three. These four companies own the record labels that produce approximately 88 percent of the recorded music distributed in the United States. A combined Universal/EMI would have nearly 40 percent U.S. market share, measured by revenue,[1] and would control 51 of the titles listed in the Billboard Hot 100 list for 2011.[2]

Universal argues that this acquisition will benefit consumers and artists because EMI is a company in decline and will greatly benefit from the infusion of Universal's capital and expertise. It contends that these resources will improve the labels currently owned by EMI and thereby increase opportunities for artists and expand choice for consumers. In the words of Universal CEO

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[1] Nielsen Company & Billboard's 2011 Music Industry Report, *http://www.businesswire.com/news/home/20120105005547/en/Nielsen-Company-Billboard%E2%80%99s-2011-Music-Industry-Report* (hereinafter "2011 Nielsen Music Industry Report"). In 2011, Universal's "total album" market share (catalog and current title) was 29.85% and EMI's was 9.62%. These market share numbers are based on the record labels Universal and EMI own, combined with those they distribute for other labels. The combined Universal/EMI will possess a market share of approximately 29% with respect only to the labels that they own. See Ed Christman, *What Exactly Is An Independent Label? Different Definitions, Different Market Shares*, Billboard.biz (July 18, 2011), *http://www.billboard.biz/bbbiz/industry/indies/what-exactly-is-an-independent-label-differing-1005281802.story.*

[2] Written Testimony of Edgar Bronfman, Jr. ("Bronfman Written Testimony"), Senate Antitrust Subcommittee hearing on "The Universal Music Group/EMI Merger and the Future of Online Music," June 21, 2012 ("Senate Antitrust Subcommittee Universal/EMI Hearing"), at p. 5.

Lucian Grainge, this deal "is a historic acquisition for Universal which will ensure the preservation of EMI, its artists, and their music."[3]

The acquisition's critics, however, argue that this merger of direct competitors would give a combined Universal/EMI the power to block the launch of new digital music services, would risk higher prices for purchasers of physical recordings, and would significantly disadvantage independent record labels. The merging parties deny that this acquisition would harm competition. They argue that, even with the increased market share, the combined company would lack the ability to raise prices, given the bargaining power of both online distributors, like Apple iTunes, and large chain stores selling CDs. They further contend that a combined Universal/EMI would have no incentive to block the launch of new digital distribution services, but instead retain an incentive to distribute its music as widely as possible.

The effect of the proposed acquisition on digital distribution of music, and particularly on the ability of new entrants to launch new services, is particularly critical to determining whether the acquisition will have any substantial anticompetitive effects. Digital distribution now accounts for approximately half of all music purchases, and that number continues to grow.[4] Digital technology gives consumers greatly increased choice with respect to how they consume music, and is often more convenient than going to a physical store. Digital services also significantly lower the cost of manufacturing and distributing music, which can lead to lower prices if passed along to consumers. For these reasons, digital services continue to grow in popularity.[5]

Consumers have a strong interest in maintaining robust competition among digital music services, including by new entrants. As noted by the American Antitrust Institute, "[c]ompetition to become the platform of choice for audiophiles has clearly encouraged service providers to innovate, with the result that consumers enjoy a wealth of options, most of which have the central purpose of getting music to consumers for lower prices and with greater convenience."[6] In addition, innovative digital music services provide additional channels for new and independent artists to distribute their music, enhancing musical diversity and giving artists alternatives to the large record companies.

The acquisition's critics argue that the deal may threaten the development of new, innovative digital distribution services. They contend that the catalogue controlled by a combined Universal/EMI with 40 percent market share will become a "must have," such that any digital service could not launch or succeed without access to these recordings. For this reason, they argue, Universal/EMI will become a "bottleneck" with the ability to block the launch of any new digital service, or force onerous contract terms on such services.[7] Critics further suggest that the combined

[3] Responses of Lucian Grainge to Sen. Kohl's Follow-Up Questions for the Record, Senate Antitrust Subcommittee Universal/EMI Hearing, Response to Question 1.
[4] *2011 Year-End Shipment Statistics*, Recording Industry Association of America (June 8, 2012, 11:19 AM), *http://76.74.24.142/FA8A2072-6BF8-D44D-B9C8-CE5F55BBC050.pdf.*
[5] According to a recent Nielsen survey, 72% of consumers choose purchasing music online via their personal computers or mobile devices as their overall favorite manner of buying music. *Shopper Sentiment: How Consumers Feel About Shopping In-Store, Online and via Mobile,* Nielsen Wire (June 6, 2012), *http://blog.nielson.com/nielsonwire/consumer/shopper-sentiment-how-consumers-feel-about-shopping-in-store-online-and-via-mobile/.*
[6] Statement of the American Antitrust Institute, Senate Antitrust Subcommittee Universal/EMI Hearing, June 21, 2012 ("American Antitrust Institute Written Testimony"), at p. 8.
[7] In the words of Edgar Bronfman, Jr. of Warner Music, "As a result [of the proposed acquisition], new music services would have to view Universal/EMI as the barrier to entry. . . . Universal/EMI alone would determine which services would live or die. It would have the power to unilaterally withhold support from new digital services or to make deals with them only on supra-competitive terms. Controlling access to vital repertoire that no other competitor could

company will have an incentive to block new digital services out of the fear that new services could develop into powerful distribution platforms that would compete with Universal/EMI, reducing its leverage with new artists and other record labels.[8]

In addition, the acquisition's critics note that EMI has played a "maverick" role in its willingness to contract with new, innovative digital services. They fear the potential consequences for those new services if EMI is no longer in the marketplace,[9] particularly since they claim that "Universal has shown a propensity to hold out" rather than embrace new services.[10]

Universal denies that it will have the means or incentive to block emerging digital services. Lucian Grainge, Universal's CEO, testified that "we would be insane not to license, develop, make our music available through as many platforms, through as many retailers as possible." Mr. Grainge further testified that "we license, we embrace as many digital platforms and as many business partners as we can." He denied the argument "that we would constrict who we sell to," saying, "if we do not sell, we go out of business. My artists will leave . . ." The deal's proponents also argue that, even absent the acquisition, the size of Universal's current catalog and the importance of the artists it already has under contract (ranging from U2 and Lady Gaga to Kanye West and the Rolling Stones and many others) already makes Universal a "must have" for new digital distribution services. If this is true, they argue, the acquisition would not meaningfully change the competitive situation.

We urge the Commission to pay close attention to the impact of this deal on digital music distribution services in assessing competitive consequences. There are considerable factual disputes in our hearing record as to (1) whether this acquisition would make Universal a greater gatekeeper of digital distribution platform success, (2) whether EMI is presently more open to licensing new services than other major record companies, and (3) whether Universal has been hostile to licensing such services in the past. Our Subcommittee has not reached any conclusions as to the merits of these factual disputes. Resolution of these issues will be vital in determining whether or not this acquisition will substantially harm competition in the digital music distribution market.

We also urge the Commission to consider the impact of this acquisition on the sale of physical recordings, which still account for half of music industry revenues. The deal's critics argue that given the substantial increase in market concentration as a result of this acquisition,[11] the deal may result in a price increase for CDs sold to consumers.[12] These concerns are heightened

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provide, Universal/EMI would be able to exercise its blocking position to coerce exclusionary deals and extract higher royalties, advances and other favorable terms by virtue of its market power alone." Bronfman Written Testimony, at p. 8.

[8] According to Gigi Sohn of Public Knowledge, "Incumbent major record labels like Universal Music Group (UMG) have the incentive to stifle new digital distribution platforms because those platforms begin to level the playing field among major labels, independent labels, and unsigned artists. As digital platforms increase artists' ability to build a sustainable career on an independent label or without a record label at all, major labels begin to lose their leverage over distribution platforms and over artists." Response of Gigi Sohn to Sen. Kohl's Follow-Up Questions for the Record, Senate Antitrust Subcommittee Universal/EMI Hearing, ("Sohn QFR Responses") Response to Question 1.

[9] Written Testimony of Gigi Sohn, Senate Antitrust Subcommittee Universal/EMI Hearing ("Sohn Written Testimony"), at p. 4.

[10] Bronfman Written Testimony, at p. 8.

[11] The acquisition's critics argue that this would alter the music industry from one considered "moderately concentrated" to "highly concentrated" under the joint Justice Department/FTC Horizontal Merger Guidelines. American Antitrust Institute Written Testimony, at p. 5.

[12] See Sohn QFR Responses, Response to Question 3. The fact that the record companies' market shares have been relatively stable for many years heightens this concern regarding increased market concentration. No major record

because of the limited space available to sell CDs in retail stores. The advent of digital music distribution has eliminated nearly all of the chain record stores selling CDs. With the exception of a few "mom and pop" local record stores, most CDs purchased today in brick-and-mortar stores are sold in the so-called "big box" national chains such as Walmart, Target, and Best Buy. These retailers have very limited shelf space available for CDs and generally seek to offer current hits and top sellers, leaving little room for inventory of non-top sellers. Obtaining promotional placement in these stores can be crucial to a record label, in what is known as "end cap" and other high traffic space.

The deal's critics contend that Universal/EMI's strong position in top selling hits "would mean that it would be in position to call the shots on physical distribution. It would dictate terms to retailers, including key price and promotional terms. This would inhibit competition from rivals, reduce choice, and potentially increase costs to consumers."[13] Critics likewise argue that independent labels will be crowded out at brick and mortar stores by the increased market power of the combined Universal/EMI.

Universal and EMI dispute these assertions. They contend that the demise of record store chains and the shift to Internet retailing have radically altered the music market and that record companies, including a combined Universal/EMI, have little power over price or retail space. Instead, they contend that the large, big-box chains make inventory decisions based solely on profit per square foot and that they will only stock those albums that sell, regardless of the label.[14] They also argue that the pricing power is in the hands of big-box chains (as well as the Internet retailer Amazon) that sell the large majority of physical recordings today.[15] In evaluating this claim, we urge the FTC to follow the principles set forth in the Merger Guidelines regarding "power buyers." While the Commission should consider "the possibility that powerful buyers may constrain the ability of the merging parties to raise price," it should not merely "presume that the presence of powerful buyers alone forestalls adverse competitive effects flowing from the merger. Even buyers that can negotiate favorable terms may be harmed by an increase in market power."[16] Resolution of this issue under the principles set forth in the Merger Guidelines will be important in determining whether this acquisition raises the risk of price increases to consumers.[17]

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company has seen its market share for total album sales increase or decrease by more than 4.32% in six years. American Antitrust Institute Written Testimony, at p. 5. Under the joint Justice Department/FTC Merger Guidelines, the antitrust enforcement agencies "give more weight to market concentration when market shares have been stable over time . . ." Justice Department/Federal Trade Commission Horizontal Merger Guideline ("Merger Guidelines") ¶ 5.3.

[13] Bronfman Written Testimony, at p. 11-12.

[14] EMI CEO Roger Faxon testified at the hearing that big-box retailers "look at their square footage and say, 'What is my turn? What is my profit retention?' And if music is not providing it, they put something else in."

[15] In the words of Universal CEO Lucian Grainge, "Neither Universal nor EMI set the prices for physical CDs – big box retailers set prices for the music on their shelves. The idea that we could dictate terms to multinational companies like Walmart is not the world I live in." Grainge QFR Responses, Response to Question 5 from Sen. Kohl. The deal's proponents make the same claim regarding sales of digital music, in which they argue pricing power is the hands of online distributors such as Apple iTunes.

[16] Merger Guidelines ¶ 8. The Guidelines also state that "[t]he Agencies examine the choices available to powerful buyers and how those choices likely would change due to the merger. Normally a merger that eliminates a supplier whose presence contributed significantly to a buyer's negotiating leverage will harm that buyer. Furthermore, even if some powerful buyers could protect themselves, the Agencies also consider whether market power can be exercised against other buyers." Id.

[17] It is notable that, in opening its investigation of this transaction on March 23, 2012, the European Commission stated that the combined company "would not seem to be constrained . . . by its customers' buying power . . ." *http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/311&format=HTML&aged=0&language=EN&guiLanguage=EN.*

The parties to the acquisition also argue that they have little power to raise either digital or CD prices because of the problems posed by piracy and the fact that consumers can access music for free on illegal download sites. This argument would seem to turn on the proper definition of the product market affected by this acquisition – that is, whether Universal/EMI could profitably impose a small but significant increase in price because there is a sufficiently large group of consumers who will not obtain music illegally.[18]

The deal's critics argue that experience supports the proposition that piracy is not a significant constraint on music industry price increases. For example, in 2009, Apple iTunes imposed a 30 percent price increase (from $0.99 to $1.29) on most digital singles without any appreciable loss in sales. Although piracy has clearly caused significant declines in music sales in the last decade, the rise of popular legitimate sites such as Apple iTunes has led to more recent growth in legal music purchases.[19] In light of these trends, we encourage the Commission to examine the extent to which piracy would serve to constrain the ability of a combined Universal/EMI to raise prices.[20]

Finally, we urge the Commission to consider the impact of this proposed acquisition on independent labels and new artists. Our subcommittee has long recognized the importance of maintaining the fullest possible diversity in media, and this includes a diverse music industry. Independent record labels are an important avenue for new and varied artists to reach consumers. Our Subcommittee heard evidence of the potential dangers to the survival of independent record labels, including the testimony of Martin Mills of the Beggars Group. Whether this acquisition will likely lead to these effects is an important issue for the FTC to examine.

In sum, we urge the Commission to consider the issues discussed above in determining whether Universal's proposed acquisition of EMI will substantially injure competition in violation of antitrust laws. The Commission should consider whether this deal may help revive the declining EMI record labels to benefit the music industry and consumers. It should also carefully analyze the acquisition's likely effects on the ability of new and innovative digital music services to enter the market, on competition for music sales and prices for consumers, and on the welfare of independent labels and artists.

The music industry has undergone a transformation in the last two decades as consumers access music through new online forms of distribution and as the market faces the challenge of piracy. Yet, in this as in other industries, robust competition remains the key to restraining prices, ensuring new and innovative forms of distribution, and maintaining diversity of choice available to consumers.

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[18] See Merger Guidelines ¶ 4.1.

[19] Overall music purchases increased by 6.9% from 2010 to 2011, and digital track sales increased 8.5%. 2011 Nielsen Music Industry Report. A recent report issued by PriceWaterhouse Coopers predicts increasing digital music sales and subscription services will cause the recorded music market to grow by 17.9% over the next five years. See PricewaterhouseCoopers, *Global Entertainment and Media Outlook, 2012—2016*, at p. 269-272.

[20] Just as with power buyers, it is also notable that, in opening its investigation of this transaction, the European Commission stated that the combined company "would not seem to be constrained . . . by the threat of illegal music consumption (so-called 'piracy')." *http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/311&format=HTML&aged=0&language=EN&guiLanguage=EN.*

Thank you for your attention to this matter.

Sincerely,

HERB KOHL
Chairman, Subcommittee on
Antitrust, Competition Policy
and Consumer Rights

MIKE LEE
Ranking Member, Subcommittee on
Antitrust, Competition Policy
and Consumer Rights