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Determination

Universal Music Holdings Limited and EMI Group Global Limited [2012] NZCC 14

The Commission:	Dr Mark Berry Sue Begg Dr Stephen Gale
Summary of application:	The application by Universal Music Holdings Limited seeking clearance to acquire some or all of the shares or assets of the recorded music businesses of EMI Group Global Limited.
Determination:	Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission gives clearance for Universal Music Holdings Limited or any interconnected body corporate thereof to acquire some or all of the shares or assets of the recorded music businesses of EMI Group Global Limited or any interconnected body corporate thereof, to the extent that the acquisition affects markets in New Zealand.
Date of determination:	21 June 2012

Confidential material in this report has been removed. Its location in the document is denoted by [ ].

The proposal

1. A notice under s 66(1) of the Commerce Act 1986 (the Act) was registered on 16 March 2012. The Notice sought clearance for Universal Music Holdings Limited (Universal or the Applicant) to acquire some or all of the shares or assets of EMI Group Global Limited's (EMI) recorded music businesses (the Acquisition).

The decision

2. The Commission considers that the markets relevant to its consideration of this application are the national markets for:

   2.1 artist discovery services;

   2.2 promotion services;

   2.3 the wholesale supply of recorded music; and

   2.4 third-party licensing of recorded music.

3. The Commission considers that the countervailing power of large retailers, the presence of other major labels and the strength of independent labels in certain markets are likely to be sufficient to constrain the merged entity. Accordingly, the Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in any of the relevant markets.

Procedure

4. Section 66(3) of the Act requires the Commission either to clear or decline to clear the acquisition referred to in a s 66(1) notice within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was agreed between the Commission and Universal. Accordingly, a decision on the application was required by 22 June 2012.

5. The Commission's approach to analysing the proposed acquisition is based on principles set out in the Commission's Mergers and Acquisitions Guidelines.[1]

Analytical framework

6. The Commission uses an analytical framework for assessing a substantial lessening of competition in the context of an acquisition. An important tool in this assessment is the determination of the relevant market or markets. To do this, the Commission identifies the areas of overlap between the acquirer and the target, and then considers what, if any, products and geographic regions, constitute relevant close substitutes from both a customer's and a supplier's point of view.

7. The Commission uses a forward-looking analysis to assess whether a substantial lessening of competition is likely, so an important subsequent step is to establish the

[1] Commerce Commission *Mergers and Acquisitions Guidelines* (2004).

appropriate hypothetical future with and without scenarios, defined as the situations expected:

7.1 with the acquisition (the factual); and

7.2 without the acquisition (the counterfactual).

8. In framing a suitable counterfactual, the Commission bases its view on a pragmatic and commercial assessment of what is likely to occur in the absence of the proposed acquisition.[2]

9. The High Court[3] has noted that:

> Because "likely" means something less than "more likely than not", there may be more than one "likely" counterfactual…. We consider that where there is more than one real and substantial counterfactual it is not a case of choosing the one that we think has greater prospects of occurring….We are to discard those possibilities that have only remote prospects of occurring. We are to consider each of the possibilities that are real and substantial possibilities. Each of these real and substantial possibilities become counterfactuals against which the factual is to be assessed.

10. The Court further noted that: [4]

> If in the factual, as compared with any of the relevant counterfactuals, competition is substantially lessened, then the acquisition has a "likely" effect of substantially lessening competition in a market.

11. Accordingly where there is more than one potential counterfactual, the Commission assesses the possibilities, discards those that have only remote prospects of occurring, and considers each of the real and substantial possibilities as counterfactuals against which the factual is to be assessed.

12. A comparison of the extent of competition in the relevant markets in the factual and counterfactual scenarios enables the Commission to assess the probable extent of the lessening of competition under the proposed acquisition, and whether that contemplated lessening is likely to be substantial.

Recorded Music

Industry Background

13. Both major and independent music labels are active in the recorded music industry. Warner Music, Sony Music, Universal Music and EMI are the major music companies or 'labels' and operate globally.[5] Independent music companies or 'labels' are music companies outside the major labels and tend to be smaller, less well resourced companies with a more local focus.

2 *New Zealand Electricity Market* (Commerce Commission Decision 277, 1996), at p 16.
3 *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 at 116, 118 and 122.
4 Ibid at 122. This view was not challenged before the Court of Appeal.
5 Universal, EMI, Sony & Warner Music are collectively referred to as the 'major labels' throughout these reasons.

14. The Applicant has submitted that the recorded music industry relates to the part of the music industry that discovers musicians, and records and sells their music. In the Applicant's view typically this involves the following steps:

    14.1 Artist & repertoire (A&R): A&R refers to all steps involved in discovering, signing, developing, recording, and promoting an artist. A&R contracts can take a number of forms and involve different agreements on copyright ownership. The suite of services provided by the record company (and its share of royalties) can vary considerably.

    14.2 Manufacture and distribution: The recorded music is manufactured in either a physical format (CDs and DVDs), or digital format (coded as a digital file) and delivered (shipped for physical recordings).

    14.3 Wholesale supply: Once a recording is made (in either physical or digital format), the record company will seek distribution deals with wholesale customers such as The Warehouse, JB Hi-Fi, and Apple.

    14.4 Retail supply: Records are then sold by retailers to final consumers and very rarely, by the recording company directly.

    14.5 Music is made available to third-parties such as radio stations for play through group licences controlled by Phonographic Performances New Zealand (PPNZ).

15. The Commission broadly agrees with the Applicant's submission but acknowledges that there appear to be overlaps between the various stages. The Commission's views on market definition are set out later in this decision.

16. Within the A&R umbrella the major labels and independent labels tend to offer different services. Typically, an artist is discovered and developed by an independent label that also records the artist's music.[6] Independent labels are not, however, typically well placed to promote this music. Therefore an artist may go on to sign with a major label and be rerecorded. Alternatively, the independent label may buy promotion services and third-party distribution services from the major label for their artists.

17. Retailers typically negotiate supply with major labels. This includes independent music that the major labels are contracted to place in stores. The actual pressing and distribution of CDs is often contracted out to third-parties.

18. Promoting music through radio is sold as part of a promotion service and involves 'pluggers' pitching new music to radio content managers. The music company earns returns from airplay but the related licence terms are set by an independent body.

[6] Recording studios are generally hired rather than owned by the independent labels.

Background to the transaction

19. Universal's proposed acquisition of EMI's recorded music business is part of the global split of EMI's operations into two separate businesses.

20. The first transaction (the proposed acquisition) involves the purchase by Universal of the recorded music business of EMI.

21. The second transaction involves the purchase of EMI's music publishing business by a consortium led by Sony Corporation of America and Mubadala Development Company PJSC. That transaction is not considered in these reasons.

22. Music publishing relates to the acquisition, protection, administration and exploitation of the rights in musical compositions. These are the intellectual property rights in the written song, as opposed to any recording made of the song. EMI does not undertake any music publishing activities in New Zealand.

Key parties – The Record Labels

Universal Music New Zealand

23. Universal Music New Zealand (Universal NZ) is the New Zealand subsidiary of the international company Universal Music Group (UMG). UMG is a music content company with operations in recorded music, music publishing and other associated services.

24. Universal's New Zealand based operations primarily provide promotion and distribution services to international artists and labels in New Zealand. Universal also provides services for the discovery, signing, development, promotion and distribution of the recorded music and merchandise of local artists.

EMI Music New Zealand Limited

25. EMI Music New Zealand Limited (EMI NZ) is a wholly owned subsidiary of EMI which is a major worldwide record company with operations in music publishing, recorded music and associated services.

26. Similar to Universal, EMI NZ is involved in the discovery, signing, development, promotion and distribution of the recorded music and merchandise of local artists.

Sony Music Entertainment New Zealand

27. Sony Music Entertainment New Zealand (Sony) is a global music company with operations in music publishing, recorded music and associated services.

28. Sony Music provides local and international artists with a range of services. Locally that includes the discovery, signing, development, promotion and distribution of the recorded music and merchandise of local artists.

Warner Music New Zealand Limited

29. Warner Music New Zealand Limited (Warner Music) is a wholly owned subsidiary within the Warner Music Group of companies (WMG). WMG is a multinational record company with operations in music publishing, recorded music and associated services.

30. Warner Music's recorded music business includes the identification, signing and development of artists, manufacturing and distribution of recorded music, and the promotion and marketing of artists and recorded music.

31. WMG was an unsuccessful bidder for EMI's recorded music business.

Independent Record Labels

32. Independent record labels (independent labels) are labels operating outside the organisations of the major labels.

33. Independent Music New Zealand (IMNZ) is an incorporated society that represents and promotes the interests of New Zealand owned independent recording companies and distributors. The organisation has over 70 members, ranging from small self-releasing artists to larger distributors.

Other parties

The Warehouse Limited

34. The Warehouse Limited (The Warehouse) is one of New Zealand's largest retailers, offering a wide range of products such as music, clothing, technology and gardening equipment.

35. The Warehouse is New Zealand's largest retailer of physical music with 89 stores nationwide. It focuses on top 40 music products and compilations.

JB Hi-Fi New Zealand Limited

36. JB Hi-Fi New Zealand Limited (JB Hi-Fi) is a home entertainment specialist with 13 stores New Zealand wide. JB Hi-Fi stores supply a range of consumer electronic goods as well as CDs and DVDs. JB Hi-Fi is New Zealand's second largest retailer of physical music and it supplies a broad range of music products from both the major labels and independent labels.

Apple Inc

37. Apple Inc is a multinational corporation that designs and sells consumer electronics and computer software. In addition it owns and operates iTunes, a digital platform designed and distributed by Apple Inc. iTunes allows consumers to download, organise and play digital music, videos and applications on electronic devices.

38. iTunes is New Zealand's largest retailer of digital music accounting for approximately [ ]% of all digital music sales.

Radio Stations

39. In New Zealand there are two major radio networks, MediaWorks New Zealand Limited (MediaWorks) and The Radio Network Limited (The Radio Network).

40. MediaWorks operates in 23 regions nationwide and its brands include MORE FM, The Edge, The Rock, and Kiwi FM.

41. The Radio Network operates in 26 regions across New Zealand. Its station list includes Classic Hits, Newstalk ZB, ZM, and Hauraki.

Market definition

42. As there is no overlap in the manufacture, distribution and retail operations of Universal and EMI in New Zealand, the Commission considers the relevant markets for the assessment of this application are the national markets for:

    42.1 the provision of artist discovery services;

    42.2 the provision of promotion services;

    42.3 the wholesale supply of recorded music; and

    42.4 third-party licensing of recorded music.

43. The Act defines a market as:[7]

> a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.

44. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit maximising, sole supplier of a good or service, not constrained by the threat of entry could profitably impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised is defined in terms of the dimensions of the market discussed below.

Applicant's view[8]

45. The Applicant submitted that the relevant market is that for recorded music in New Zealand. The Applicant further submitted that the relevant overlap of the parties' activity in New Zealand is in the A&R and wholesale supply markets.

46. Universal is not directly active in the physical manufacture and distribution of music as it outsources those functions. In addition, neither party has a material presence in the downstream retail market. The Applicant submitted that there are a range of associated services that can be provided by record labels such as merchandising,

7 Section 3(1A) of the Act.
8 Notice Seeking Clearance, 16 March 2012.

concert and event management, and artist management, although none of these services are offered by the Applicant in New Zealand.

Digital vs physical

47. In respect of the wholesale supply market, the Applicant submitted that a digital recording and a physical recording are indistinguishable when played, and therefore highly substitutable on the demand-side. Modern technology also means that a recording can be easily converted by the consumer from digital to physical or vice versa by simply hitting the “import disc” or “burn disc” button on their computer. In addition, most retailers of physical music also sell iTunes gift cards, which enable the bearer to make online purchases of digital content from iTunes.

48. Digital and physical products are substitutable on the supply-side. Most record companies supply both physical and digital recordings, and for record companies that do not, it would be easy for them to offer both formats. Manufacturing costs are low for both physical and digital recordings and Universal stated that it knows of no intellectual property restrictions that may prevent a company exploiting a track in both formats.

Piracy

49. The Applicant submitted that the product market is not confined to legally sourced music and that it is appropriate to consider the impact of music piracy as a price constraining feature of recorded music markets. The Applicant submitted that a ‘highly’ conservative estimate of the value of pirated music puts piracy at 60% market share across physical and digital formats.[9]

The Commission’s view

<u>Product dimension</u>

Artist and Repertoire Services

50. The chain of services provided under ‘artists and repertoire’ (A&R) extends from the discovery of new talent through to the recording and promotion of the album. In particular, these services include discovering, signing and recording new artists, and offering promoting, pressing and distributing services for the final music product. None of these services are functional substitutes for each other.

51. These are services that music companies offer artists where the music companies typically return a proportion of sales revenue to the artist, and as such, these services can be viewed as buying markets (as opposed to selling markets). The music companies can be viewed as buying the skills of the artists.[10] The Commission notes that in regard to buying markets, the relevant question for determining the breadth

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9 The assumptions underlying this figure are (i) the discrepancy between actual market value for the music market in 2010 (NZ$61 million) and the forecast market value (NZ$155 million). This forecast was based on the 2001 market value of NZ$120 million augmented by CPI, the difference in these figures being attributed to the impact of piracy.

10 Payment for these services is often agreed on a percentage of income from song or album sales. [ ].

of a market is whether a hypothetical monopsonist would be able to profitably impose a price decrease, or whether sellers of these inputs have sufficient competitive alternatives to render such a price decrease unprofitable.[11]

52. Although these services are not functional substitutes they may be assessed together where they are offered to artists as a bundle or face similar constraints. The Commission considers that these services can be regarded as being supplied in the following two markets:

    52.1 artist discovery and recording services: in particular, the discovery and development of artists and often the recording of their music[12] (the Commission refers to these services collectively as "artist discovery services"); and

    52.2 promotion, pressing and distribution services (which the Commission refers to as "promotion services").

53. Although each A&R deal is unique to the artist the label is signing, there are typically four main types of deals that are offered by the major labels. They are:

    53.1 Full recording deal: The label funds the creation, development, distribution and promotion of the record and in return holds the full copyright to that recording, paying the artist an agreed royalty on sales and any other agreed revenue streams.

    53.2 Licensing deal: The label pays the artist a set fee and in return holds the rights to promote and distribute the record for an agreed period with the profits going to the label.

    53.3 Pressing and distribution deal: The artist provides the label with the master recording to be manufactured and placed at retailers. The label returns an agreed percentage of the revenue generated to the artist or independent label.

    53.4 360 deal: The label provides the artist with capital and in return receives an agreed percentage of the artist's earnings from all revenue streams.

54. Within this broad range of contracting structures, distinct services can be offered on a stand-alone basis. Payment for these services is often agreed as a percentage of income from song or album sales.[13] Some of these deals focus on recording artists discovered by the music company (such as the full recording deal) and others focus on support services to independent labels and artists who have already recorded music (such as pressing and distribution deals).

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11 If the Applicant were able to lower prices for these services, this cannot be assumed to be a substantial lessening of competition. This is addressed further in the section on competitive effects.

12 Recording studios are often hired by the independent labels when initially recording artists. Artists are generally rerecorded when they sign with a major label in order to improve the quality of the recording.

13 Narrower ranges of services may be paid for directly rather than as a proportion of their sales revenues.

55. In general, only the major labels (and the larger independent labels) provide the full range of services. However, the major labels are not very active in new artist discovery. Rather, pressing and distribution deals account for approximately [ ] of all deals signed by the major labels.[14]

56. Independent labels meanwhile, focus on the discovery of new local artists. IMNZ estimates that independent labels are responsible for approximately [ ] of the discovery and initial signing of New Zealand artists.[15] The Commission understands that independent labels have an 'ear to the ground'[16] and seem to be an important source of new artist discovery for further development by the major labels.

57. The independent labels the Commission has spoken to do not tend to have contracts in the broad categories used by the major labels but instead use bespoke contracts specific to the artist. The services provided by independent labels to artists could include the full suite of services but, in practice, even when promotion services are offered, they tend to be modest. As such, more sophisticated promotion services are often sought by the independent labels from the major labels, and from larger independent labels such as Rythmethod, on behalf of the artists they represent.

58. Independent labels do not have access to the promotion avenues that the major labels do, owing to their relative small size. The major labels meanwhile, are well-positioned to foster relationships with retailers and promotional avenues such as radio.

59. The Commission considers that:

 59.1 artist discovery services are not functionally interchangeable with promotion services;

 59.2 artist discovery services are often provided by independent labels that are not well positioned to offer other services such as promotion services;

 59.3 artist discovery services are increasingly provided to artists as a bundle by the independent labels;[17] and

 59.4 the merging companies (and other other major labels) provide limited artist discovery services in New Zealand.

60. On this basis, the Commission finds that artist discovery services constitute a separate relevant product market.

61. Similarly, in regard to promotion services:

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14 Universal submission, 30 April 2012.
15 Interview with IMNZ, 23 April 2012.
16 "Where there is potential growth is for hits ...I think it is going to be an Independent market where the major labels get involved in distribution deals. So while they will still put money into A&R, it will be via independents ... who have an ear to the ground", interview with [ ].
17 Universal submission, 12 June 2012

61.1 promotion services are not functionally interchangeable with artist discovery services;

61.2 pressing and distribution services (where that entails placement of music at retailers on behalf of Independents) are typically sold as a bundle with promotion available as an add-on (where such deals are often referred to as P&D Plus); and

61.3 the independent labels that offer initial artist discovery services often do not offer promotion services and are not well-positioned to offer such services.

62. Consequently, for the purposes of market definition in this decision, the Commission treats artist discovery services, and promotion services as being in separate product markets.

63. More particularly, promotion largely consists of the plugging[18] of music at radio stations, advertising, marketing, and negotiating for the placement of music on shelves at the retail level (commonly referred to as “distribution”). The most important value the major labels are able to offer is the strength of their relationships in the industry and therefore their ability to get a song into the public domain and make it into a hit.

64. “Pressing and distribution” meanwhile, consists of the mechanism of manufacturing physical music and delivering it to retailers. The mechanism of manufacture and physical distribution is not considered in this merger assessment as there is no overlap between EMI and Universal in this functional level of the value chain.[19]

65. The “distribution” function that is part of promotion, however, is not just the physical delivery of CDs to retail outlets but also the ability of the major labels to convince retailers to carry the music. The ability of major labels to secure retail shelf space is part of promotion services. The price for these services is negotiated between the major label and its customers (the artists).

Wholesale Supply of Recorded Music

66. Record labels supply both international and local repertoire to retailers in New Zealand. Most artists are signed directly to or licensed to a record label (or its affiliates) for New Zealand.

67. Music companies sell to retailers both physical and digital music. Physical music mainly refers to CDs, while digital music is sold over the internet in a digital format such as MP3s.

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18 The major labels have strong relationships with radio stations and hold weekly meetings with content managers to discuss airplay. The radio stations have advised the Commission that [ ].

19 [ ].

Piracy

68. In considering the relevance of piracy to the definition of the wholesale market, what is relevant to the Commission is whether retailers would switch to selling pirated music should the merged entity increase the wholesale price of music. Since most music retailers, and certainly those with the largest share of retail sales, are unlikely to engage in selling illegal products, the Commission does not consider pirated music to be a relevant part of the wholesale market.

69. However, the Commission acknowledges that wholesale prices will be constrained by pirated music if some portion of ultimate customers would switch to pirated music should there be an increase in the retail price of legal music. Should legal and pirated music be fully substitutable for all consumers one would expect to see the price of legal music competed down to zero (or a price that reflects any costs associated with piracy). The number of consumers who view these two sources of music as good substitutes and hence, the extent of constraint provided by those consumers who may see the two sources as substitutes, is unknown. However, in any event, the extent of this possible constraint does not affect the Commission's decision.

Physical versus Digital

70. The wholesale market has different customers (retailers) in the digital and physical space. In New Zealand iTunes dominates digital retailing whereas The Warehouse dominates physical retailing followed by JB Hi-Fi. Physical and digital products tend to be sold differently. A physical retailer such as The Warehouse sells physical products and would not likely switch to digital sales. The same can be said for digital retailers. Digital retailers would not substitute physical products for their digital products should the merging parties increase the price of digital music as they do not distribute physical products.

71. However, music companies wholesale both digital and physical music and therefore would set the wholesale prices of physical and digital music so as to profit maximise over both types of goods. The question of the extent to which ultimate consumers find the two formats to be substitutes would be taken into account in this joint profit maximising decision but is not relevant for the purposes of this market definition except as a derived demand consideration.

72. The digital and physical wholesale markets, which may otherwise constitute separate markets, are considered together for the purposes of this transaction because:

72.1 the same suppliers are present in both the physical and digital markets;

72.2 an increase in the price of one type of product may affect the sales of the other product but the change in sales is borne by the same music company;

72.3 market shares across the digital and physical space are similar across music companies; and

72.4 both physical and digital music markets are dominated by large and important retailers.

Third-Party Licensing

73. An additional revenue stream for music companies is third-party licensing, which constitutes a separate market. This is payment for having music companies artists' songs played over radio, television, advertising, or public performance. [20]

74. Generally, all radio and TV licences are administered by PPNZ, the New Zealand licensing body that represents artists and record companies in the licensing of their music to music users.

75. PPNZ effectively acts as a collective in setting the price for licence fees subject to adjudication by the Copyright Tribunal. If PPNZ raised prices by a SNIPP then users of these licences such as radio stations would be able to appeal to this Tribunal. The merger would not change the bargaining dynamics in this market unless the music companies broke away from PPNZ.

<u>Geographic market</u>

Artist discovery and promotion services

76. New Zealand artists can be targeted by providers in Australia[21] as well as those from other countries. However, this seems to be the exception rather than the rule. The majority of New Zealand artists are represented either by the local branches of the major labels or New Zealand independent labels. The promotion of music is essentially national and mainly carried out by the major labels.

77. The relevant geographic market for artist discovery services is New Zealand. This is similarly the case for the promotion of recorded music.

Wholesale supply of recorded music

78. The Warehouse, JB Hi-Fi and Marbecks are based across New Zealand and sell their products locally. These retailers source from the major labels and, to a lesser extent, independent labels in New Zealand. They also have access to parallel imports of final music products.

79. iTunes, the largest digital retailer, is territory based and sales to iTunes New Zealand are made through the New Zealand music companies.

80. The relevant geographic dimension within which to consider music wholesaling is national.

Conclusion on market definition

81. The Commission considers that the relevant markets for considering the competition effects of the proposed acquisition are the national markets for:

    81.1 the provision of artist discovery services;

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20 [ ], 3 May 2012

21 EMI submission, 26 April 2012

81.2 the provision of promotion services;

81.3 the wholesale supply of recorded music; and

81.4 third-party licensing of recorded music.

Factual/counterfactual

Factual

82. With the acquisition, EMI's recorded music business operations would be purchased by Universal.

Counterfactual

83. EMI has informed the Commission that [ ]. EMI further submitted that [ ]. The Commission therefore considers that without the acquisition, EMI's recorded music would be purchased by a third party. As previously noted, WMG previously made an unsuccessful bid to purchase EMI's recorded music.

84. The Commission notes that a third-party purchase may or may not be by another existing competitor. As such, the Commission considers the most appropriate counterfactual is the acquisition of the assets by an independent third party which is equivalent to the status quo (ie assuming a new entrant acquires EMI's recorded music business).

Competition analysis

Artist Discovery Services

85. The Applicant submitted that post-acquisition, it would continue to face constraint in the artist discovery services market from:

85.1 existing competitors: Sony, Warner Music, independent labels and the threat of self supply;

85.2 potential competition: new entrants; and

85.3 countervailing power: “hot” new acts or successful established artists.

86. The Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the artist discovery services market.[22] The Commission considers that the merged entity is likely to have a relatively small market share, that there are low barriers to entry for potential competitors and the threat of switching by “hot” new or successful established acts is likely to be sufficient to constrain the merged entity. These findings are discussed below.

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22 For there to be a substantial lessening of competition in a buying market, prices (or other dimensions of competition) must be depressed substantially below competitive levels.

87. Industry participants noted that the major labels do not have a significant presence in the market for the discovery of New Zealand artists.

88. As there are many independent labels throughout New Zealand (IMNZ has 98 members) it is difficult for the Commission to obtain accurate data on the market shares of the merging firms for the discovery and recording of New Zealand artists. IMNZ estimated that local independent labels are responsible for around [ ]% of the new talent discovery and recordings.[23]

Existing Competition

89. The Commission considers that independent labels currently provide a significant level of competitive constraint on the major labels in the discovery and signing of emerging, New Zealand based artists. The Commission considers that in the factual, independent labels would continue to provide this constraint on the merged entity.

90. In the factual, the Commission also considers that the merged entity would continue to face robust competition from the remaining major labels. Sony and Warner Music have extensive catalogues of established and emerging artists and actively compete to secure new and established artists.

91. [ ] stated that in New Zealand the artist discovery and recording market is highly competitive. [ ] identified emerging artists tipped for success or successful established artists as having the ability to negotiate terms with multiple labels before signing with the label which provides the most favourable or preferred terms.[ ] stated that five years ago, record labels were immoveable when it came to the terms of contracts but now there would be hundreds of different recording deals each unique to different artists and that was a reflection of the nature of the market and the need to meet artists' needs.

Countervailing power of artists

Contested artists

92. The Applicant submitted that the signing of artists is a highly competitive process and "hot" new artists exercise considerable market power creating fierce competition among the record labels.

93. In this context, the Commission considers a contested artist to be an artist who has shown exceptional talent and potential and in some cases already has a following, making them an attractive acquisition for a music label.

94. When contested artists are looking to sign with a record label, the Commission is of the opinion that competition amongst the record labels is strong. A recent local example where multiple record labels competed for the signature of an artist is [ ]. [ ] built up a strong fan base through social media and live performances. To realise its potential and extend sales it [ ].

[23] Interview with IMNZ, 23 April 2012.

Threat of switching

95. The Commission was advised by a number of parties that artists are able to switch among music labels with relative ease when a recording deal expires[24] or when both parties agree to cancel the deal.

96. [ ] submitted that in the factual, artists' incentives to switch will be diminished due to a decrease in the number of major labels from four to three, and the ability of the merged entity to offer more attractive deals to artists. However, more attractive deals for artists would suggest continued vigorous competition among music labels for artists.

97. The Exponents (a NZ rock band) has released albums through Warner Music, Sony and Universal. Other examples of local artists who have switched record labels include [ ], [ ], the Black Seeds and The Feelers. This switching is not restricted to any particular major or independent labels with [ ].

Self supply

98. Bypassing record labels and opting for self supply is another factor identified by the Applicant. Artists may opt for inexpensive recording options and then market themselves through their own websites and third-party sites such as YouTube, Facebook, Twitter, MySpace, and/or distributing their music directly to online retailers such as iTunes. The Applicant referred to Six60 and Avalanche City as successful New Zealand artists who used direct-to fan commerce and promotion at the start of their careers before entering into distribution deals with major labels.

99. Although artists would appear to have the option to self-supply recordings, it is common for these same artists to rerecord with an independent or major label upon signing a music deal. This may be because of the more sophisticated recording equipment available to the independent and major labels. The Commission understands that self-recording is often used by artists as a 'demo' to increase their chances of being discovered and securing a recording contract. The Commission considers that self-supply of music recording would be a complement to discovery and recording by an independent or major label rather than a significant constraint on the merged entity.

Potential competition

100. The Applicant submitted that barriers to entry into the artist discovery market are low.

101. The Commission agrees that barriers to entry into the artist discovery market are low. As referenced in the application, the Commission refers to the Australian

24 The Commission understands that [ ].

Federal Courts findings in the *Universal Music Australia Ltd v Australian Competition & Consumer Commission:*[25]

> Hill J identified the `essential and distinguishing feature' of the industry as the continued need for new product, which was as much a problem for the major companies as for new entrants. He held there was no significant general barrier to entry into the record industry, as demonstrated by the growth of Independents. New entrants competed with incumbents for artists. They had no less chance of recognising a likely `hit' than incumbents.

Conclusion

102. The Commission considers that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the artist discovery services market as the Applicant and target have small market shares, there are low barriers to entry for potential competitors, and there is likely to be countervailing power for new or successful established acts.

Promotion services for music in New Zealand

103. A relevant question for the competitive assessment is whether the merged entity would be able to substantially reduce prices or service quality, or whether buyers of these services have sufficient competitive alternatives to render any such decrease unprofitable.

104. The Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the promotion services market. The Commission considers that the presence of strong existing competition and the relatively small increase in market share that EMI brings to the merger is likely to result in little difference in the competitive dynamics in the factual and the counterfactual.

Existing competition

105. Owing to the different composition of service packages provided by record labels, the proportion of distribution deal revenues that can be attributed to promotion services is not easily separated from revenues relating to other services such as recording.

106. However, a proxy for the promotional activities of the major labels is their contribution to the current radio playlist of the main commercial radio stations (radio is arguably the most important avenue for new song promotion in New Zealand). The Radio Network estimates that Universal and EMI artists comprises [ ]% of its ZM station playlist, with – EMI bringing only [ ]% to the table.[26] These figures are supported by the third party revenue figures in paragraph 166 which are calculated according to the proportion of airplay a music company receives.[27] While

25 *Universal Music Australia Ltd v Australian Competition & Consumer Commission* [ ] FCAFC 193, paragraph 40.

26 For the week ending 13 April , Interview with Radio Network, 18 April 2012

27 Even without the independent labels and independent artist's share of airplay, EMI's share of airplay is still under [ ]%.

these figures fluctuate as new songs are launched onto the charts and others lose popularity, the merged entity's combined share of airplay was around [ ]% in both 2009 and 2011 with EMI making a small contribution. This is to be expected as EMI's strength is in its catalogue music and the promotion services market (particularly promotion on radio) is primarily for newly released music.

107. The other major labels will continue to provide strong competition in the factual. Both Sony and Warner Music are large international record companies with a wide stable of established and up-and-coming artists across all genres. In addition, both Sony and Warner Music are well represented in the playlists of the key radio stations and in the New Zealand music charts.

108. The Commission considers that post acquisition, existing competitors would likely constrain the merged entity in the provision of promotion, pressing and distribution services. Sony and Warner Music are significant, well-resourced and established music labels with trusted and respected brands.

Independent labels

109. The Commission considers that independent labels do not impose a significant competitive constraint on the major labels for the promotion of recorded music in New Zealand. In fact, independent labels constitute an important customer base for these services.

110. Independent labels do not have the access that the major labels do to physical retailers such as The Warehouse or to prime time radio. A key strength of the major labels is the relationships they maintain in the industry. Independent labels generally have access to digital retailers such as iTunes and streaming providers. However, although this arrangement allows access to independent label's music, iTunes provides limited promotional avenues which tend to be reserved for well known artists.[28]

111. It is common for independent labels to obtain financial support from major labels by entering into joint venture or equity arrangements[29] or to use the promotion services offered by the major labels if they do not have the resources.[30]

112. Although independent pluggers (radio marketers) can be contracted to meet with radio stations on the independent label's behalf, radio stations have much more limited interaction with the independent labels than they do with the major labels. [

28 iTunes holds thousands of songs in its catalogue. The iTunes front page (as the site is entered) is the space for promotional material. There is intense competition for this promotional space on a global basis not just from music companies but from applications (apps) and other entertainment products such as movies. Independent labels have access to genre specific and smaller internet retailers for their digital music and can sell physical and digital music products from their own websites. The market penetration of these sites is limited compared to the larger mainstream retailers.

29 [ ], 3 May 2012.

30 [ ], 27 April 2012.

].[31]

113. Larger independent distributors (such as [ ]), have existing relationships with major retailers and promoters and may provide some constraint on the major labels in this market.

114. On this basis, the Commission considers that independent labels are not likely to provide a significant competitive constraint on the merged entity in regard to promotion and distribution.

Threat of artists switching

115. [ ] have indicated that the majority of recording deals for local artists are promotion and distribution deals, which are generally of two or three years duration and that competition is likely to be high for successful artists when the recording deal expires. The Commission considers that the inconvenience of switching and the likely incentives provided by the incumbent label can be negated by competing labels offering a more favourable package.

Self supply by artists

116. The Commission considers that self-supply is unlikely to discipline the merged entity in the promotion services market.

117. [ ] agreed that artists sometimes bypass traditional record labels to record, promote and distribute their own music, with the benefit being greater control over their musical and creative direction, maintaining an “independent” image and receiving a greater percentage of revenues. However, [ ] submitted that artists who wish to extend the sale of their music will then align themselves with a label to gain access to that label’s established networks in the industry and benefit from their strategic expertise in marketing and promoting music.

118. [ ] submitted that although artists can self release in theory, extensive marketing and publicity are required to generate good sales. It submitted that there are numerous artists on YouTube and other social media platforms who are relatively unknown and will remain so unless they have sufficient talent to be accepted by a major record label.

119. A number of parties also identified recent changes to the level of NZ on Air funding as a further obstacle to local artists successfully entering through self supply.

120. Based on the information provided, the Commission considers that self supply is an option available to artists; however, it is unlikely to provide real constraint on the merged entity. A lack of experience in the marketing and promotion of music and

[31] [

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limited access to the major retailers and radio networks are likely to provide significant barriers to artists achieving high sales.

Potential competition

121. The barriers to entry in this market appear to be high. Access to promotional channels and large retailers is difficult without established relationships with these parties. The Commission considers that it is unlikely that independent labels would have sufficient access to promotional channels to compete effectively with the major labels. As highlighted, relationships are very important in the industry and the major labels have made it clear that this is the cornerstone to their being able to ‘open doors’ for an artist.

Conclusion

122. The Commission is of the view that the other major labels, Sony and Warner Music, are strong competitors and would be able to offer good alternatives to the merging parties’ services.

123. Universal would not gain significant market share in the promotion services market by the acquisition of EMI, as EMI’s market share is relatively low. It is unlikely that a small increase in market share for promotion services will result in a substantial lessening of competition.

Wholesale supply of recorded music

124. The Applicant submitted that post-acquisition, it would continue to face constraint in the wholesale supply market from:

124.1 existing competitors: including Sony, Warner Music, and independent record labels;

124.2 the countervailing power of large physical and digital retailers such as The Warehouse and Apple’s iTunes;

124.3 piracy; and

124.4 the ability of retailers to parallel import.

125. The relevant question for the competitive assessment is whether the merged entity would be able to profitably impose a substantial price increase, or whether music retailers have sufficient competitive alternatives to render any such price increase unprofitable.

126. The Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the market for the wholesale supply of recorded music. The Commission considers that the presence of strong existing competition, coupled with the countervailing power of large physical and digital retailers, is likely to be sufficient to constrain the merged entity.

Existing competition

127. Table 1 sets out the market shares for the major firms in the wholesale supply of digital and physical music market in New Zealand.

Table 1: New Zealand Wholesale Recorded Music Market Shares

	2010		2011	
	Revenue	Market Share	Revenue	Market Share
Universal	$ [ ]	[ ]%	$ [ ]	[ ]%
EMI	$ [ ]	[ ]%	$ [ ]	[ ]%
Merged Entity		***[ ]%***		***[ ]%***
Warner Music	$ [ ]	[ ]%	$ [ ]	[ ]%
Sony	$ [ ]	[ ]%	$ [ ]	[ ]%
Independent labels/Other	$ [ ]	[ ]%	$ [ ]	[ ]%
Totals	$ [ ]	100%	$ [ ]	100%

Source: RIANZ data, Warner Music submission, 27 April 2012

Note: these figures include revenues from third party distribution and as such overstate the market shares of the major labels.

128. Table 1 shows that post-acquisition the merged entity would have a market share in the wholesale supply market of [ ]%. In the factual, the next largest competitor would be [ ] with [ ]%. The three firm concentration ratio resulting from the proposed acquisition is [ ]%. However, these figures do not include import figures[32] and so constitute an upper bound to the merging parties' market share. New Zealand's parallel importing laws allow records to be imported into New Zealand, and some retailers have done this.

129. These post-merger market shares fall outside the Commission safe harbours and could indicate that the merged entity may have enhanced market power post-merger. Whether enhanced market power is likely is assessed below.

130. As previously noted, independent labels can face some difficulty in gaining access to physical retail shelf space due to the promotional and marketing advantage enjoyed by the major labels. This is especially so for non-specialist music retailers such as The Warehouse, which has limited shelf space and a focus on mainstream catalogue and popular albums. The Warehouse [ ].[33]

131. For specialist music retailers such as JB Hi-Fi, there is more scope for independent labels to have access to physical retail shelf space, due to the wider catalogue sold by the retailer.

132. For the majority of independently recorded music, the Commission considers that access to significant retail space is limited, without entering into a distribution

[32] [ ].
[33] [ ].

relationship with one of the major labels, or a large independent distributor such as Rythmethod.

133. Access to digital retailers is by contrast relatively easy, with digital retailers facing no constraints over shelf space. Independent labels can access retailers such as iTunes through the use of digital aggregators and do not need to convince the retailer about the saleability of the album. However, the limited repertoire and fragmented nature of independent labels means that they would provide limited constraint over the merged entity should it seek to increase wholesale prices.

134. The Commission considers that for independent labels, access to physical retail space is limited without the benefit of a large third-party distributor, or an established fan base for the artist. Overall, in the Commission's view, independent labels will provide limited constraint on the merged entity in the wholesale supply of recorded music to physical retailers.

135. The Commission considers that the remaining major labels, Sony and Warner Music, would continue to provide constraint on the merged entity for the wholesale supply of recorded music to physical and digital retailers. Both Sony and Warner Music offer a broad range of new release and catalogue music across a range of genres.

Countervailing power of physical retailers

136. [ ] expressed concerns regarding the physical retailers' ability to countervail a post-merger price increase by credibly threatening not to stock the large music portfolio/must-have songs of the merged entity. To do so, they claimed, would damage the retailers' music business. In particular, they claimed:

136.1 the catalogue of music distributed by the merged entity would become a "must have", limiting the ability of both physical and digital retailers to resist price increases, or exert any countervailing power over the merged entity;

136.2 the merged entity would be able to increase retailer promotion of Universal/EMI product;

136.3 the merged entity would be able to negotiate more favourable access to limited physical shelf space or reduce the shelf space and/or promotion of a competitor's product; and

136.4 retailers who are not specialist music retailers (such as The Warehouse) would be more receptive to exclusive supply arrangements with the merged entity.

137. Physical and digital music sales markets are characterised by a small number of commercially important retailers that sell a variety of other products against which music products compete for space.

138. Wholesale sales of physical music in 2010 totalled about $[ ] million. Of this total, approximately [ ]% was supplied to The Warehouse, [ ]% was supplied to JB Hi-

Fi, and the remainder supplied to Marbecks and smaller independent retailers. The Warehouse is undoubtedly the largest retailer of physical music.

139. Owing to a shift in consumer consumption away from physical music towards digital music, the shrinking demand for physical music has increased the incentive of the remaining physical retailers to exert downwards pricing pressure on music wholesalers. These physical retailers allocate floor space to a variety of products taking into account the margins they earn on each product category. In effect, the different products in the store compete with each other for floor space.

140. The Warehouse, by far the largest physical retailer, expressed [ ]. In particular, The Warehouse stated that [ ].

141. In terms of pricing, The Warehouse [ ]. The Commission considers that if it were faced with an increase in the wholesale price of recorded music, the Warehouse could switch to supply an alternative, higher margin product.

142. The Warehouse [ ].

143. JB Hi-Fi [ ]. JB Hi-Fi stated that [ ].

144. It stated that [ ]. JB Hi-Fi also noted that [ ].

145. The Commission also considers that faced with declining physical sales,[34] record labels face strong incentives to ensure that sales of physical music are maximised for as long as possible and that retailers such as The Warehouse and JB Hi-Fi continue to see recorded music as a viable revenue stream. An increase in margin pressure through an increase in the wholesale price would have the alternative effect, potentially driving retailers out of the physical retail market.

<u>Imports</u>

34 Industry participants informed the Commission that in January 2012, total New Zealand digital music sales were higher than total physical sales for the first time.

146. In 2011, imported music made up [ ]% of The Warehouse's purchases of recorded music. It has [ ]. The Warehouse noted [ ].

147. Imports would not be of New Zealand music. [ ].

148. Physical retailers are able to utilise parallel import channels to source music and thereby to benefit from arbitrage between different country pricing. However, as this merger is taking place on a global basis the Commission considers that any upwards pricing pressure is likely to be felt across the world, although not necessarily evenly. The ability of retailers to use import prices to restrict price rises post-merger will be the same as pre-merger.

149. The Commission finds that music portfolios are important but are not 'must-haves' as far as retailers are concerned and that an increase in market shares would not likely impact the negotiating power of a music company.

150. In essence, large physical retailers such as The Warehouse will be able to resist price increases by the merged entity through punishing the merged entity by [ ].

Countervailing power of digital retailers

151. [ ] expressed similar concerns regarding the digital retailers' ability to countervail the market power of the merged entity as those raised in relation to physical retailers.

152. Apple, through its iTunes store, represents some [ ]% of all digital music sales in New Zealand. [ ].

153. Apple stated that [ ]. iTunes offers the music companies a limited range of pre-set pricing points at which the companies may price their music. Pricing on iTunes is to a certain extent at the discretion of the record companies but only so far as they are able to allocate one of the pre-set price points to a particular song at the retail level. Retail prices on the iTunes store are subject to Apple dictated maximums.

154. Apple further noted [ ]. Instead [ ].

155. The Commission considers that large digital retailers, such as Apple, would also be able to exert countervailing power over the merged entity through their gatekeeper role over key marketing channels such as the iTunes front-page. In addition, Apple could also punish the merged entity by decreasing the visibility of its music on searches or album lists or by focusing on sales of other products such as games, movies or apps.

Digital streaming providers

156. Digital recorded music is typically sold to consumers through two main types of distribution models: digital download[35] or digital streaming.

157. On a digital streaming platform, the customer does not pay for each individual song or album, or usually download a separate copy of the song or album. Instead, the customer has online access to all of the music hosted by the provider in return for paying a monthly access fee. Most streaming providers have a range of subscription options.

158. Digital streaming is a new service in New Zealand with few established providers. The only provider of any significant size, Spotify, entered New Zealand in May 2012. Streaming service agreements with the music companies relating to New Zealand are negotiated at a global level and extend to include New Zealand as an additional territory.[36]

159. The Commission received no complaints from digital streaming providers in the New Zealand market. The streaming providers that the Commission spoke to in the course of its investigation raised no concerns in relation to the proposed acquisition, and efforts to contact potential entrants have largely been unsuccessful.

160. Nevertheless, the Commission has examined whether there would be a material difference in the New Zealand market between the factual and the counterfactual.

161. In this respect, there has been some suggestion that each of the major labels catalogues would be essential to a new entrant digital provider:[37]

161.1 Universal has submitted that without the [ ].

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35 On a digital download platform (eg iTunes), the customer accesses a catalogue of music which they can purchase (either as an individual song or a full album). Once purchased, a copy of the music is downloaded to the customers' device (computer, mp3 player, or mobile phone) and is available to the customer to listen to at their leisure.

36 New Zealand tends to lag behind other markets in the launch of streaming services with providers initially focussing on larger markets such as Europe and North America. Once a sufficient presence is established in these larger markets, providers tend to incrementally seek to extend their services to other territories. [ ]

37 The Commission understands that Google Music, a digital music platform offered by Google Inc. has struggled to gain traction in the market, in part due to the presence of only three of the four major labels (Universal, EMI and Sony). http://www.thepowerbase.com/2012/02/google-music-the-best-service-that-nobodys-using/

161.2 Apple has stated that [ ]. Apple further states that [ ].

162. If this is the case, it suggests that some degree of market power may be present in negotiations with streaming providers already and that further aggregating the industry would not materially enhance market power in New Zealand. The Commission considers therefore, that there would be no material difference between the factual and the counterfactual in this regard.

163. More generally, the Commission considers that foreclosure of digital streaming providers is unlikely in New Zealand in the factual because the merged entity would continue to face strong commercial incentives to maximise the number and quality of legitimate digital revenue sources given the declining physical market and the problems the music industry faces in terms of piracy. Therefore, the Commission considers that there would be no material difference between the factual and the counterfactual in this regard.

Licensing of music to third-parties

164. The Commission has considered the concerns of various market players relating to:

164.1 the likelihood of foreclosure of promotional avenues such as radio to competing music companies by the merged entity threatening to withhold 'must have' playlists should they not obtain relatively more favourable terms; and

164.2 the possible bypass of PPNZ to negotiate higher licensing fees with licence users such as radio.

165. Table 2 sets out the market shares for the major firms in the market for the licensing of recorded music to third parties in New Zealand.

Table 2: Third party licensing market shares

	2009		2010	
	Revenue	Market Share	Revenue	Market Share
Universal	$ [ ]	[ ]%	$ [ ]	[ ]%
EMI	$ [ ]	[ ]%	$ [ ]	[ ]%
Merged Entity		***[ ]%***		***[ ]%***
Warner	$ [ ]	[ ]%	$ [ ]	[ ]%
Sony	$ [ ]	[ ]%	$ [ ]	[ ]%
Total	$ [ ]	100%	$ [ ]	100%

Source: Submissions from the industry parties (note that independent market shares have not been included so the figures are inflated).

166. Over [ ] third party licensing income is from radio – less than [ ] of Universal's New Zealand income. Radio drives sales of the larger physical and digital sales as a promotion channel.

167. In regard to the potential foreclosure of promotional avenues, the Commission considers that the strength of the merging parties in the bargaining process with radio stations and other promotional avenues is based on the strength of their new releases. Again, the market shares in this market vary weekly and at times significantly according to the popularity of songs. However, as mentioned in the assessment of market shares for promotion services, despite such fluctuations, EMI contributes a small amount to the market shares of the merged entity in this market. This is illustrated by the third party licensing revenues received by the major labels. These characteristics of the market mean that the merged entity is not likely to be able to leverage its increased size to foreclose competitors.

168. The Commission also considers that should the merging parties break away from PPNZ, important music promoters such as radio stations, would have sufficient countervailing power to limit such an exercise of market power.

Countervailing power

169. One of the most important promotional avenues for newly released music is radio. The major labels send their radio pluggers to meet with the radio stations content directors every week. In these meetings the pluggers 'pitch' songs for the week and outline their strategies and promotional activities associated with these artists. The music companies in essence "sell" the idea of the song to the radio stations.

170. The radio stations are under no pressure to play the song if it does not fit with the station's 'culture' or if the song is not being demanded by their listeners. Media Works said that [ ]. Media Works also indicated that radio is the number one channel for promoting music sales, and [ ].[38]

171. The radio stations contacted by the Commission confirmed that they would [ ].

172. These channels are also extremely important to the music companies as an avenue for the promotion of their music. It is unlikely that they would sacrifice the promotion of their music for a higher proportion of revenues given that the focus of this area of their business is on promotion rather than income.

Conclusion

173. The Commission is satisfied that the merged entity would not have sufficient market power to dictate terms or increase prices to third-party licence holders. There is sufficient countervailing power in the third-party licensing of recorded music market to constrain the merged entity.

[38] Interview with Media Works, 13 April 2012.

Determination on Notice of Clearance

174. Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission gives clearance for Universal Music Holdings Limited or any interconnected body corporate thereof to acquire some or all of the shares or assets of the recorded music businesses[39] of EMI Group Global Limited or any interconnected body corporate thereof, to the extent that the acquisition affects markets in New Zealand.

Dated 21 June 2012

Dr Mark Berry
Chair

[39] As described in the Sale and Purchase Agreement dated 11 November 2011 attached as confidential Appendix A to the Notice seeking clearance dated 16 March 2012.