Mergers and bargaining power: back to the future? Insights from the *Universal/EMI* merger

The decision to approve the acquisition of EMI's recorded music rights by Universal has recently been published by the European Commission. Following a Phase II investigation, the acquisition was approved subject to commitments, which included the divestment of the Parlophone label.[1] On the same day as the Commission adopted its decision, the FTC issued a press-release stating that it would not be challenging the deal in the US.[2]

Both the European Commission and the FTC emphasised during their respective investigations the high degree of product differentiation which characterises the recorded music industry: a consumer who wants to purchase a track by a particular EMI artist (say, the Beatles), will not be content to purchase a track by another artist on a different label (say, Sony's Bob Dylan). There is thus no direct competition which the merger would have eliminated between tracks belonging to different labels (nor, for that matter, to the same label). The FTC in addition underlined the different relative strengths of Universal and EMI's portfolios: while Universal was significantly stronger in new releases, EMI's repertoire relied much more heavily on its back catalogue.

While product differentiation and the different focus of the parties' portfolios led the FTC to clear the deal, the European Commission went on to develop a novel theory of harm based on the effect of the transaction on the new entity's bargaining power: the Commission acknowledged the lack of substitution between Universal and EMI's song titles at the consumer level, but nonetheless concluded that the merger would have likely increased the bargaining power of Universal towards digital music platforms. In particular, the Commission considered that by increasing its portfolio, Universal would have been able to extract more favourable terms from digital platforms (such as iTunes or Spotify). At the core of the theory was therefore a concern that a larger company can extract more rent from bilateral negotiations as a result of its size. Much of the controversy in the case arose around whether the assumptions underlying the theory of harm were consistent with the features of the market and whether the theory was properly validated.

We expand below on the reasoning behind the Commission's theory of harm, and consider the limitations of its application to the case. While we believe that a bargaining framework can be useful for capturing the essence of commercial negotiations in some industries, there are also reasons to be cautious in applying theories of harm based around bargaining theories, and there are pitfalls to be avoided when empirically testing such theories.

Critique of the Commission's theory of harm

Two fundamental critiques can be formulated with respect to the Commission's theory of harm. First, the applicability of the theory to the music industry appears doubtful given commercial realities in the music business. Second, there is no clear link between the Commission's theory and consumer harm.

Did the theory of harm fit the facts of the recorded music industry?

The theory of harm posited that, by simply increasing its size, the combined entity would have enjoyed greater bargaining power. While such a proposition may appear intuitively appealing, the economic literature is clear that "size" does not in itself *necessarily* lead to greater bargaining power: the size of a buyer or seller may affect its bargaining position in a negotiation, but the direction of the effect is in principle ambiguous and depends on the specific features of the market under consideration.[3] It cannot therefore be simply presumed that size increases bargaining power: it is necessary to show that the facts of the market are consistent with this proposition.

To support its conclusions, the Commission found inspiration in the labour market literature which describes bargaining outcomes between firms and labour unions. In this specific context, a positive impact of size on bargaining power indeed often occurs. This can be illustrated by means of a simple example, which considers whether workers enjoy more bargaining power when they negotiate collectively with their employer:

Suppose that a firm employs two workers who both produce the same product. To be concrete, assume that the firm generates a cash flow of €5,000 per month when it employs one worker and a cash flow of €8,000 when it employs two workers. Note that the incremental value created by the second worker that is hired (€3,000) is smaller than the incremental value created by the first worker (€5,000). In this example, the threat of losing one worker puts an income of €3,000 at risk for the employer (corresponding to a reduction in cash flow from €8,000 to €5,000). The threat of losing both workers, however, puts an income of €4,000 per worker at risk for the employer (€8,000 divided by the number of workers). For this reason, the workers' threat of leaving the company is significantly more powerful when the two workers bargain collectively over their salary than if each worker negotiates individually. In such a setting, the bargaining power of the seller (here: workers selling their labour) therefore increases with size because of decreasing marginal benefits.[4] *This result would be reversed if the incremental value of a second worker was higher than that of the first employed worker.*

In *Universal/EMI*, the Commission transposed this reasoning to a setting in which there is a buyer (a digital platform) negotiating with several suppliers (the music providers). Following the logic of the above example, a key condition for the Commission's bargaining

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[1] Case COMP/M. 6458 Universal Music Group / EMI Music. The sale of Parlophone Label Group to Warner Music Group (Case COMP/M. 6884) was approved by the Commission on 14 May 2013. CRA advised Universal Music Group throughout both proceedings in front of the European Commission.

[2] Federal Trade Commission, Statement of Bureau of Competition Director Richard A. Feinstein *In the Matter of* Vivendi, S.A. and EMI Recorded Music, September 21, 2012.

[3] See, e.g., Henrik Horn & Asher Wolinsky, *Worker Substitutability and Patterns of Unionisation*, 98 ECON. J. 484 (1988). In particular, a key condition for a party's bargaining power to increase with its size is that the other party values this additional size less than proportionally (technically, the benefit function is concave).

[4] Note that the defining characteristic of decreasing marginal benefits is therefore not that losing two workers is more damaging for a firm than losing one worker (an obvious proposition), but that the damage per worker lost *increases* as more and more workers threaten to leave. Also note that throughout this example, we assume a constant marginal opportunity cost of labour for illustration purposes.

theory of harm to be relevant to the recorded music setting is that *the value of a label's repertoire to a digital platform must increase less than proportionally with the size of the repertoire.* Or in other words, that a platform's marginal benefit of adding an additional label's repertoire is decreasing as more repertoires are added.

Whether this fundamental assumption held true in the case of recorded music should have been empirically validated. In particular, for the theory to provide meaningful predictions about the effects of the merger the Commission should have shown that recorded music shared some key features with labour markets – where the incremental benefit of adding additional workers may become smaller and smaller, the more workers are hired by a firm. Indeed, it is often reasonable to assume that firms exhibit decreasing returns to scale and that workers are substitutable, so that the marginal value of workers is decreasing. As a result, workers can achieve better outcomes when they negotiate collectively through a union.

However, it was hard to see how such a framework could be deemed consistent with the facts of the music industry. Indeed, digital platforms are likely to exhibit *increasing* returns to scale, at least in some range, precisely because tracks are *not* viewed as close substitutes by consumers, and platform competition means that it is important for platforms to feature the songs even of a smaller major. It was therefore unclear how adding the repertoire of a major to its existing portfolio could have generated decreasing marginal benefits for a platform.

On the contrary, the breadth and range of tracks that a digital platform can offer is a critical element of its success, and it is thus important for digital platforms to obtain content from all significant rights holders. Indeed, contrary to a theory of diminishing marginal benefits, a digital platform that offers only the repertoire of one major would be unlikely to be successful in the market. Yet, according to the Commission's theory a platform offering only the repertoire of EMI (for example) should be able to generate higher profits per EMI track than a platform offering the repertoire of all majors. In our view this was not credible: such a platform would be unlikely to be successful against rivals offering a wider repertoire, such as iTunes or Spotify.

The fact that digital platforms require a broad repertoire, and that both Universal and EMI are necessary to operate successful digital platforms, implies that the parties act more as complement than substitutes, and their combination is thus unlikely to cause unilateral effects. This was explicitly acknowledged by the FTC, which indicated that "*interactive streaming service must carry the music of each Major to be competitive. Because each Major currently controls recorded music necessary for these streaming services, the music is more complementary than substitutable in this context, leading to limited direct competition between Universal and EMI.*"[5] Overall it thus remains hard to see how the Commission's theory of decreasing marginal benefits was relevant to the case at hand.[6]

[5] FTC press release, op. cit.

[6] Note that the theory of decreasing marginal benefits was also inconsistent with the argument mentioned in the decision according to which the repertoire of all majors, including that of Universal, is a "must have" for digital platforms (e.g. paragraph 430). If access to Universal's repertoire is indeed indispensable for a platform to operate profitably, then the loss of access to Universal's repertoire would destroy the commercial value of that platform (or, at a minimum, seriously jeopardize it). In such a scenario, a hypothetical *additional* loss of EMI's repertoire (after losing Universal's) could logically not add much more damage to the platform. Such a conclusion would be inconsistent with the assumption of decreasing marginal benefits.

Absence of consumer harm

A further point of controversy was the lack of a clear link between the Commission's theory of harm and actual harm to consumers. The Commission's theory focused on how the pie was shared in negotiations between recorded music companies and digital platforms, but did not go further to investigate potential anticompetitive effects on downstream consumers.

While the Horizontal Merger Guidelines of course clarify that the concept of "consumers" in European competition law encompasses intermediate as well as final customers, this consideration of intermediate customers in horizontal mergers rests on the presumption that harm to intermediate customers will be passed on to final consumers. Given the difficulties in determining the extent of this pass-through in practice (intermediate inputs may be sold in numerous markets, and assessing pass-through may be empirically challenging), the focus on direct buyers serves as practical shorthand for the consideration of ultimate consumers. Intermediate buyers are therefore only a proxy for ultimate consumers. In the case at hand, however, they may not be. Lack of pass-through in the recorded music industry may, for instance, easily arise as a result of the competition digital platforms face downstream with each other and from illegal downloads.

As the Commission itself recognises in the technology transfer guidelines, a focus on upstream market shares inappropriately ignores the competitive pressures that upstream producers face as a result of downstream competition.[7] Ignoring downstream competition is likely to overestimate the market power of an upstream supplier, because the willingness to pay of its purchasers may be materially constrained by downstream competition. Importantly, an upstream analysis of the recorded music industry which ignores the competitive constraint exerted downstream by the massive increase in pirated music risks substantial errors in assessment, and hence again appear disconnected from the realities of the music industry.

The Commission's theory—and also its empirical validation— were silent on the degree (or even possibility) of pass-on to final consumers. Why the Commission would worry about a theory that can only identify the effect of bargaining power towards intermediate buyers, however, is unclear and appears to be at odds with policy statements which emphasize consumer (rather than customer) harm.[8]

Empirical validation of the theory

In order to validate its theory of harm, the Commission investigated whether there was a positive relationship between a record company's size and the prices (or margins) obtained from digital platforms. To conduct such an exercise, the analysis of hard data is essential to avoid relying on unsystematic responses from a market test: while price differences are bound to occur across firms and customers, any unsystematic comparison risks highlighting differences that are not representative (all the more so as contracts are particularly complex in this industry and terms may be difficult to interpret in isolation). The Commission therefore collected extensive sales data from market participants (i.e. record companies and digital platforms) to econometrically test whether there was a positive

[7] European Commission, Guidelines on the application of Article 81 of the EC Treaty to technology transfer agreements (2204/C101/02), paragraph 23.

[8] See, for instance, J. Almunia, EU merger control has come of age, Brussels, March 2011.

relationship between a record company's size and the prices (or margins) obtained from digital platforms.

Yet, in addition to questions about the accuracy of the data collected by the Commission, there were more fundamental methodological issues with the Commission's empirical analysis, which called into question its conclusion that there was a positive relationship between a record company's size and prices (or margins).

First, the Commission's methodology compared prices across record companies without taking into account differences in their repertoire. However, a price comparison for differentiated products across companies that does not control for product specificities is likely to result in a biased relationship between size and price. Indeed, larger companies may have higher prices than smaller ones not because of their size but because they offer a more attractive product. In fact, a larger company may be more successful precisely because it offers a more attractive product.

In *Universal/EMI*, we found that empirically controlling for repertoire characteristics removed any positive relationship between size and prices (or margins), which invalidates the Commission's finding that larger record companies obtain more favourable terms from digital platforms because of their size.

Second, the Commission investigated whether there was an *average* relationship between size and prices (or margins) across companies, but did not specifically address the question of whether this relationship applied to Universal or EMI. This question is relevant since finding that e.g. small companies charge more than large ones on average does not necessarily imply that an increase in the size of the merging parties would lead to higher prices (especially if the parties are already considered "must-have" pre-merger). In other words, it is the range of the size increase resulting from the merger that matters to assess the impact of the merger and not an average relationship between price and size across all record companies.

In *Universal/EMI*, there was no positive relationship between size and price (or margin) for a given record company. In particular, we found that neither Universal nor EMI charged higher average prices in countries or on platforms where they were larger. Such a finding is inconsistent with the conclusion that Universal would enjoy more bargaining power as a result of its increased size post-merger.[9]

In sum, one should be cautious before concluding that a seemingly positive relationship between size and price is indicative of the effect of increased bargaining power, in particular if the fundamentals of the industry appear to be at odds with the underlying assumption of a bargaining theory of harm. The Commission's finding of an apparently positive relationship between price and size (not controlling for differences among repertoires) in no way answers the relevant question for the competitive assessment, i.e., whether Universal will likely be able to increase prices post-merger.

Conclusion

In *Universal/EMI*, the Commission developed a novel theory of harm based on the impact of the transaction on the merging parties' bargaining power. This theory was however inconsistent with the facts of the music industry and, in contradiction to the FTC's analysis, failed to recognise the complementary nature of music portfolios. As a result, the application of the Commission's theory in this case in effect amounted to the re-surfacing of older *portfolio* theories of harm, in which the Commission had considered that the combination of weak substitutes ("commercial complements" in the parlance of the Commission) would bring about anticompetitive effects.

While a bargaining framework can be useful for capturing the essence of commercial negotiations in some industries, any bargaining theory of harm should clearly identify why the bargaining position of the parties would be improved in the specific circumstances of the case. It is thus essential to check that the underlying assumptions of such theories apply to the case at hand, and that the theory is properly validated by market facts. Concluding too quickly that size equates to bargaining power – tempting as it may be – creates the risk of over-enforcement towards mergers that are not in any way anticompetitive, or that may even be pro-competitive. This is in particular the case when the parties' products do not act as close substitutes, or are in fact complementary to each other.

[9] Similar results were obtained for small and large platforms, which invalidates the Commission's claim that smaller platforms would be particularly harmed by the transaction. One may in any case question why Universal would have any incentive to limit the development of new and innovative digital distribution models that would allow to monetise the sale of digital music in a context of rampant internet piracy, and given that more competition between platforms would have enhanced Universal's bargaining position.

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