Analyse the structure of an industry economics essay

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The oligopoly refers to the market structure in which a small number of firms hold the dominating power within the industry. This leads to a highly concentrated market. The music recording industry can be considered an oligopoly as this market is dominated by a small number of firms (major record labels) . 80% of the music recording industry market is held by 3 giants: French owned Universal Music Group (UMG), Japanese owned Sony Music Entertainment (SME) and U. S owner Warner Music Group (WMG). The EMI group used to be one of the industry also, but was recently bought and merged with UMG in September 2012, thus narrowing the market yet again as this purchase gives UMG 31% control of the entire industry (The Economist, 2008) . All of these firms offer similar kinds of products and/or services. This analysis will aim to establish the extent to which economic theory can help us understand the main underlying drivers that determine market structure and firm conduct. In an annual survey taken by Music & Copyright, it’s been revealed that three of the four major labels-Universal Music Group, Warner Music Group, Sony Music Entertainment, and EMI-suffered a decline in global market share.

The music industry has been shrinking for the last 10 years. According to Mintel, in 2007 the pre recorded spending has fallen by 29% (Mintel, 2008). Whilst the recorded music industry sales have declined, advances in technology and new business strategies adopted by firms have caused the volume in music consumption to increase. However, revenue profits within the music industry have been falling leaving a 12% loss in profits over the course of the past 5 years (Mintel, 2008). The decline within the industry has caused a labels major and minor to struggle to stay solvent. this has caused

many firms to exit the market or merged with others; Bertelsmanns Music Group and Sony Music Entertainment, EMI and Universal Music Group.

Economies of Scale

Within the music recording industry there is a lack of product differentiation as despite the differentiation in target markets and consumers, the end product is essentially the same: recorded music. This therefore makes the industry very competitive as each firm is competing to attract custom with the same product. within the music industry, firms such as UMG and Sony use their artists to attract custom. This at times is difficult for firms a there is no loyalty to brand within the music industry as many have little knowledge or interest in who produces their music.

The music industry rarely sees a change in price as currently each of the three dominating producers adopt an interdependent strategy. the non-price activity within the sector keeps prices at a constant as if any of the firms were to decrease their prices on music sales for example, they risk antagonising the other competitors and they would follow suit and reduce and meet the prices of the other in order to remain a competitor. Therefore rather than lose money from price wars, firms adopt a non collusive strategy which causes the pricing to stick.

For a price reduction below P, the share of the market demand curve is relevant as the countermoves by the rival will keep the market share of the firm constant. For price increases above P, the firm goes alone and thus the relevant demand curve for the firm is on its own demand curve, price increases are ignored by other firms but price decreases lead to a lowering

of prices by competitors the firm will face a kinked demand curve with the kink at the current market price of P

In this graph is the individual demand curve and the firm market share. It is believed that if an oligopolistic reduces price, they expect the competitors will follow suit, while no competitors would follow if prices were raised.

Source: Lecture 5-Imperfect Competition Maurice Starkey Sheffield Hallam University (2012)

The kinked curve indicates that if companies were to change the pricing of their product it would have little effect on demand. This would therefore give no on firm a competitive advantage and only reduce the value of the market. On the other hand, if for example Universal decided to increase the prices of its CD's the demand would also decrease and leave them at a disadvantage, so they would not only lose custom but also money. therefore each firm looks to create profit elsewhere by investing money in areas such as the advertising of their artists. A fantastic example of this is in the surge in popularity for live music festivals. In the UK fans spent £1. 45bn on gigs in 2009 – up 4% from the previous year, according to songwriters' body PRS For Music (The Guardian , 2011).

The kinked demand curve model has been criticised for several reasons. For example, there are other perfectly valid reasons as to why prices remain so rigid such as catalogued prices (such as products on ITunes), reluctance to disappoint customers as this would lead to a drop in demand, and a fear that constant price cuts may trigger a price war. The graph does not indicate how the firm arrived at the kink in the first place. We can speculate that mutual

interdependence among the firms and price rigidity are two typical features within an oligopolistic market. Although firms are rivals , they are mutually interdependent. No firms want to resort to a price change a this would harm the business hence the fact that price competition is not really that significant in the oligopoly market.

The most significant aspect of the solution of an oligopoly situation is the presence of kink in the demand curve of the firm. The kink shows that price reduction by a firm is followed by its rival.

When demand conditions change the price may still remain stable. the demand for oligopoly meets the marginal cost curve it also cuts a new marginal revenue curve in the gap. Therefore making the OP price the same in the firm.

Source: Lecture 5-Imperfect Competition Maurice Starkey Sheffield Hallam University (2012)

Many economists speculate that price fixing was indeed caused by Oligopoly itself. Collusion has been seen by many firms as a form of structure and security for the industry. This is because companies will have set a constant price to ensure a maximisation in profits and reduce competition. Sony, Vivendi (Owners of Universal), Warner Music and EMI all colluded in the early 2000's to keep download prices high, whilst preventing consumers from burning purchased songs onto CD's. According to the plaintiffs, Sony, EMI, Warner and Universal colluded to set an " artificial price floor" for music downloads, negotiating in turn with licensees and partners (Sean Michaels, 2011). As a result each were fined millions.

This graph shows how the cartel works. The cross indicates the fixed price in which the firms have agreed on.

Source: Lecture 5-Imperfect Competition Maurice Starkey Sheffield Hallam University (2012)

The dominant, “ Big Three” record companies within the music industry use the learning curve effect in order to determine the cost advantages. Consequently, these companies have built a network of resources which causes a competitive advantage within the industry, especially as smaller independent labels are unable to generate the means to apply such resources leaving them at a disadvantage when trying to survive in an environment of declining sales. The “ Big Three” also have more consumer knowledge and larger amounts of capital, which allows them to market their artists better. The learning curve effect suggests that the costs for the work force within the industry will decrease whilst profits will increase. The learning curve makes market entry difficult, low product differentiation, and moderate economies of scales. However it does remove any barriers the curve presents thus making the threat of entry for the music industry is high. The demand curve is downward sloping as the main competitors do in fact have control over the market.

Source: http://wikieducator. org/Learning_Curve_Effect

Market Barriers:

One of the most significant market barriers to the music recording industry is ownership and control. the current market is dominated by 3 major players UMG, SME and WMG of whom control just over 80% of the industry. This

dominance makes it difficult for other smaller firms not only to compete in sales but also in terms of pricing. the big three would be the firms who set prices and trends. the only positive aspect of being a smaller independent label is that the production and adopting of innovative practices and distribution methods are easier.

A clear example of predatory acquisition came just recently with the UMG takeover of EMI. EMI was the fourth largest of the ' big four' and is a British owned multinational music company with headquarters in London. Owned by Citigroup and has a revenue of $1. 65 billion in 2009. It was taken over by Citigroup in 2011 when it was in more than $4 billion in debt. In 2011 Citigroup announced a deal to sell off the music part to Sony and the publishing business selling to UMG for a total $4. 1 billion (A. E. S. , 2011). This acquisition by UMG makes it the most powerful player in the music industry by a mile. with the dwindling number influential competitors within the sector, it raises concerns that the music industry may slowly becoming a monopoly.

Competitive Advantage

To survive companies are choosing to merge to produce " diverse portfolios in entertainment industry including computer and video games and film." (Strasser 2003) Synergistic practices also aid music companies in gaining greater revenue. This cross promotion as allows the industries such as UMG to product the maximum amount of revenue. Vertical integration is also another perfect example of labels such as SME use their franchises in the gaming and film industry to fuel synergistic practices to promote and sell

products. As they are vertically integrated into their firm, the potential for internal synergy is enormous.

Sony is a multinational conglomerate corporation which aims to use ‘ vertical integration’ within their company. They do this by having complete control of where their products are distributed and producing their own physical copies of music such as CD’s and by producing music software and devices such as the walkman in the late 90’s. This means that they have control over the distribution of their products and have to pay no expenses to outside companies. However as the music industry has changed drastically with the increase of downloading music through online stores such as Itunes, Sony now has to distribute through other corporations such as Apple. For example, Sony Pictures Entertainment (SPE) releases Quantum of Solace in the cinema, DVD and Blu-ray, then SME release Alicia Keys’ soundtrack simultaneously and then the console game would be available on the Sony Playstation 3 which is funded by Sony Computer Entertainment. In addition, the volume of digital downloads are ever increasing. Another huge profit making practice is tours and festival appearances which have aided companies such as Sony. Other media convergences which Sony has profited from include those from SycoMusic. In 2008, 70% of Sony’s UK music earnings were made by SycoMusic (FAME, 2011)

Profitability:

No firm within the music industry has made supernormal profits in the past 5 years. This lack of profit is due to both the negative economic environment where consumers are choosing to substitute music with other forms of entertainment and internet piracy.

According to FAME in 2011; the Universal Music Group made a profit margin loss of -6. 32% and a loss of return on capital of -6. 11%, the Sony Music Entertainment made a profit margin of 3. 40% and achieved 2. 87% in returns on capital, The Warner Music Group made a profit margin of 2. 68% but made a huge loss in return of capital with -31. 00% (FAME, 2011). These results suggest that profitability within this industry over the past year has fallen to its lowest in the past few years. These low results also suggest that the industry has become less sustainable and in order for competitors to survive, they must adapt to the demands and preferences of the consumer.

However, The Warner Music Group was the only major label to see an increase in GMS with . 02 percent (FAME, 2011). Collectively, independent labels saw a 2 percent increase in GMS, putting them at 25. 2 percent (FAME, 2011) . Despite a . 08 percent deficit in global market share, Universal Music Group still earned the most revenue through sales, publishing, and licensing. One reason for Warner's success in the past year may be due to the fact that out of the three major players , it holds the smallest conglomerate. Therefore one could assume that a greater investment in actual recorded music has gained profit. One can also speculate that the other main competitors, Universal and Sony did not invest as greatly as they have other factions which generate a greater profit within the entertainments industry such as video gaming and film.

As we can see there are many factors which contribute to the success and failure of the music industry . Whilst the industry as a whole is in decline due to an unsavoury economic climate, firms are slowly starting to adapt to the changes in demand in order to make and profit and try and stay in business

and make a profit. Companies are starting to offer differentiate products which relate to their staple product of recorded music such as live music and exclusive streaming rights for example. the kinked curve rightly reflects the rigid pricing in this particular sector as firms look to make the maximum amount of profit without delving into illegal practises such as collusion. By taking an interdependent stance firms are able to observe their competitors and try and keep pricing as stable as possible. The market barriers to the music industry however are so difficult to overcome that it is more and more difficult for smaller firms to become viable rivals to the Big Three. with this in mind, the control these three companies hold in the music industry make it Oligopoly as these firms influence the market pricing, eliminate or merge with potential threats and use vertical integration in order to develop profit.

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