Olipology and price fixing in the music industry

ASSIGN BUSTER

What is Oligopoly?

An oligopoly arises out of a market which is dominated by a small number of sellers, also known as oligopolists. The oligopolists dominate a substantial portion of the market and are known to be mutually dependent. The mutual dependency is determined by the ability of one seller to influence the decision of the others in the market (Begg and Ward 2009).

Bhagwati (1970) clarifies that traditional oligopoly theory was derived the assumption – each firm maximizes profits and each firm concerns with the repercussions of its action on the rivals. The latter assumption distinguishes oligopoly from competitive theories. Perfectly competitive structure assumes ‘ a cut in price enables higher sales and raise in prices decline sales’, whereas an oligopolistic firm is conscious of the impact of its decisions on the economic behaviour of the rivals (Bhagwati 1970).

Each firm also believes that a price raise will not be followed by rivals but a price cut would be. This is represented in the “ Kinked Demand curve” developed by Sweezy (Riley 2006).

Source: Adapted from tutor2u. net (2010)

Common examples of oligopolistic industries are oil, banking, retail (grocery, clothing), music etc.

Main economic features of an oligopoly:

An oligopoly is characterised by factors such as barriers to entry, product differentiation, interdependent decision making, competition and collusion etc.

Barriers to entry:

Stigler (1965), defines barriers to entry as “ a cost of producing (at some or every rate of output) which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry”. Barriers may arise out of natural causes such as factors outside the control of an entrant or by strategic causes created by incumbents.

Natural barriers:

A primary barrier to entry is economies of scale. In the long run, Minimum Efficient Scale (MES) is the point of efficiency where a firm produces the required level of output to meet the demand, at an average cost. As shown in the diagram below, it takes a larger plant to attain MES at a certain cost and a smaller plant will not be able to produce at MES. The costs of production will rise (Begg and Ward 2009).

Source: Begg and Ward (2009)

Strategic barriers:

Branding may prevent new entrants when the MES is low enough to attract new players. When an incumbent spends more on product branding and advertising, its long run production costs are higher, thus the MES is shifted towards greater quantities of output. This in turn affects new entrants (Begg and Ward 2009).

Sunk costs also deter entry/exit and the market appears not contestable. Sunk costs are huge costs invested into the business, which cannot be

regained on exit (Begg and Ward 2009), such as on brand development or huge equipments which are scrapped on exit. An entrant may ignore the pre-entry price and profit levels with barriers to entry, but will infer the post-entry equilibrium price and profit levels. Salop (1979) states that the incumbent may deter the equally efficient entrant by displaying sunk costs, which make his own exit uneconomical.

Therefore, if expected profits are negative, the entrant is deterred and the no-entry profits accrue to the incumbent.

Key economic theories of price fixing:

The oligopolist will aim at fixing a price which promises maximum profits or covers expected costs and resulting in sustainability in the long run (Rothschild 1947). Therefore the directions that industries take in an oligopolistic situation would be to either compete or collude with other firms.

Fierce competition reduces industry profits. Firms use strategies such as lowering prices or increased advertisements to grab market share. This is a loss to the firms and a gain to consumers.

A Cartel occurs when firms get into a formal collusive agreement to share profits and hold significant market shares and therefore set the prices at the profit maximization level (Sloman et al 2010). Cartels are formed for the mutual benefit of members. The industry profits are maximized and consumers are at loss. This is because the cartel may result in higher prices or monopoly markets.

For instance, Nokyo is a Japanese agricultural cartel, controlling the rice trade. Nokyo's umbrella dominance included Zenno, the business arm controlling significant percentages over fertilizers, agrichemicals, and rural petroleum, feed and farm markets.

For instance, in selling 60kgs of semi-controlled rice for ¥21000, deductions will comprise of handling charge of 2. 0 percent at the local Nokyo branch, handling fee of 0. 6 percent charged by the Keizairen [Nokyo's prefectural association], and Zenno's handling fee of 0. 4% all borne by the farmer and included in the consumer's price. The cartel is permitted and supervised by the Government (Bullock 1997).

Non-price competition occurs when the cartel players try alternative ways of competing against one another such as product differentiation, where the firm tries to maximize profits with a unique product or zone based monopolies where each firm covers different regions to maximize sales.

Tacit collusion occurs where there is a market leader and other firms in the oligopoly follow the leader's pricing statements. The market leader is an established firm with greater influences over prices.

Game Theory is a decision-making process where one player's choice must affect the interests of other players. The payoff is the accrued result on the choice made (Begg and Ward 2009).

In the table below, the game would be advertising dilemma for Sony and EMI. The decision is a choice between advertising heavily and moderately and the pay offs are listed.

The dominant strategy is to choose the decision which results in best possible outcome, whereby EMI would choose cell B and Sony would choose cell C.

Nash equilibrium is the choice of optimal decision when the opponent's behaviour is known or is trusted. Here EMI would chose to moderate if it knew Sony would moderately advertise and therefore pick cell D and there is no incentive to move from this position.

Maximin is picking the least bad among the worst decisions when the opponent behaviour is favourable, in which case, EMI and Sony choses A. Maximax is picking the best possible outcome when opponent is not favourable, which is B for EMI and C for Sony.

It is apparent in this case that the dominant strategy is also Maximax. Therefore, the dominant strategy is the best strategy for the firm.

Oligopoly in the Music Industry

Let us consider the music industry. The music industry is an oligopoly, with the " Big Four" accounting for 71. 7% of the world market share for retail music consumption.

By applying the N-firm concentration ratio, which is a measure of the total market share attributed to the N largest firms, the music industry is thus an oligopoly with 4 firms holding market share between 50%-80%, and therefore, medium level of concentration (AmosWEB 2010).

What are the barriers to entry in the music industry?

Cost barriers: Natural Barrier

Caves (Lewis et al 2005) stated that risk is high where 10% of products account for 90% of turnover and nobody knows the reasons for success.

Therefore, when record companies buy major artists, they bear the financial risk with 90% of the artists that are not successful. Success of artists has a direct impact over the revenues generated and it is seen that 20% of the revenues are re-invested in Artists and Repertoire (A&R) (BPI 2009) which oversees development of new artists.

Major costs are also observed in marketing the music with six figure dollar investments.

For instance, Ged Doherty of Sony BMG estimates it costs more than £1m to break a pop act and over £700, 000 to break a rock act in the UK alone (IFPI 2010). Established artists’ advances go as high as US$1. 5m.

High artist development costs therefore remain a constant barrier. Firms will also have to maintain successful collaboration with bigger artists which generates continuos revenues for new artists.

Price-fixing in the Music Industry

Firms are largely affected by threats of piracy, free music exchanges over the Internet, low-cost retail prices etc. and therefore, they resort to common practices of price-fixing to maintain competitive advantage and profit maximisation.

Minimum Advertised Price (MAP): Strategic Barrier

Minimum Advertised Pricing is a supplier’s pricing policy that does not permit resellers to advertise prices below a specified amount. It can include the resellers’ retail price as well.

In August 2000, Vivendi, Sony, Berteslmann, Warner and EMI Group (henceforth called “ Big Five”) along with three retailers Musicland Stores, Trans World Entertainment and Tower Records were accused of using MAP (BBC News 2002).

A second case in 2008 involved Starr et al v. Sony BMG Music Entertainment et al. Prices were fixed by creating joint ventures for distributing songs through MusicNet, launched by BMG, EMI and Warner Music and Pressplay, launched by Sony and Vivendi’s Universal Music Group and through restrictive license agreements. The wholesale price was “ an agreed wholesale price floor” of 70 cents per song. The case was filed on behalf of people who download songs over the Internet (Reuters 2010).

Hence, MAP is an advantage to suppliers since it prevents discount rivals creating a barrier for entrants. It also enables retailers to recoup marketing costs for new products since manufacturers agree to provide advertising subsidies which enables vertical integration for growth.

Game Theory: Revisited

When Napster entered the peer-to-peer music file sharing market over the Internet, it carried a strong appeal. The Big Five filed a suit against Napster in December 1999, claiming that the “ free service” cut into CD sales.

Revisiting the game theory discussed above, let us consider strategies that Bertelsmann and the Big Five (excluding Berteslmann) would employ. When the Big Five agrees to eliminate Napster, but Berteslmann cheats on the agreement and merges with Napster, it is a Maximax and dominant strategy for Bertelsmann. If the Big Five (excluding Berteslmann) decide to merge and cheat Bertelsmann, it is a Maximax for the Big Five (excluding Berteslmann).

At this stage, Bertelsmann broke ranks with the Big Five and cheated over the oligopoly to merge with Napster. It announced to loan Napster $50 million (£31 million) to develop a file sharing system and to retain 58% interest in Napster when the service was developed (McCourt and Burkart 2003).

Conclusion:

It was thus observed that the music industry is an oligopoly which holds market dominance and prevents new entrants with significant entry barriers. It is evident that the industry oligopolists employ price-fixing strategies for profit maximization and other competitive advantages. The extent to which record companies continue to retain this dominance will be determined by the continued challenges faced by the incumbents and the potential entrants.