From Napster to Distribution Networks

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Initial Reflections on Napster 1

• Courtney Love’s math:
  – Economic characteristics of artists
    • capital constrained and risk averse
    • Market for talent very competitive
  – Recording companies offer
    • economies of scale in distribution and advertising
    • deep pockets for advances
    • ability to spread risk
  – Recording companies have
    • monopsony buying power in market for talent
    • oligopoly in market for distributed music
    • ability to segment market and price discriminate

Initial Reflections on Napster 2

• Market for recorded music - a vertically related industry
• Artist-Music Co-Recording Co-Distribution Channel
• The effect of the internet on this market
  – Marginal Distribution costs drop to virtually zero (38% costs of CD).
  – Napster in competitive market for internet service provision.
  – Drastic innovation with possibly a large effect on recording companies.
  – However this effect is debatable given willingness to pay for quality.

Distribution Networks

• The internet is a distribution network.
• Other industries with distribution networks:
  – Electricity
  – Telecoms
  – Water
  – Gas
  – Railways
• The basic economics of these industries share similarities with the economics relevant to Napster.
**Liberalisation of Distribution Networks**

- Formerly:
  - State-owned (even the internet)
  - Vertically integrated
  - Monopolies
  - Heavily regulated by government
- Now:
  - Privately-owned
  - Vertically disintegrated
  - Open to competition
  - Re-regulated

**Public vs private ownership**

- Origins of SOEs, MUNIs and government trading departments running distribution networks
  - Desire to bring network externalities
  - Lack of capital in private sector
  - Wasteful competition
  - Lack of compatibility between private systems
- Benefits of private ownership
  - Objectives for industry have changed (to efficiency)
  - Capital, labour and product market competition
  - Competition and private ownership linked
  - Less government of intervention

**Economics of vertically related markets**

- Distribution is part of a vertically related market
- Benefits of VI
  - Risk sharing
  - Lack of hold up possibilities
  - Incomplete contracts
  - Foreclosure
- Benefits of Disintegration
  - Problem of what price to charge for use of monopoly network supplying a competitive segment eg. BT to Mercury
    - The need for access pricing: ECPR (Baumol and Willig): \( P-c_m = \text{access charge; } P = \text{final price, } c_m = \text{cost of monopolist in competitive segment.} \)
  - Problem of coexistence of vertical integration and vertical separation remains with asymmetric information.

**Competition and Innovation in disintegrated networks**

- Well designed competitive markets in the competitive segments of vertically disintegrated industries can exist (e.g. electricity generation, international phone calls).
- These markets create normal pressures to innovate and facilitate new entry (e.g. Virgin into railways).
- New products emerge and bundling of services (e.g. water, telecoms, energy).
- Ideas transfer more easily between industries as cross ownership allowed (e.g. electricity and gas, content and infrastructure).
- Re-integration may emerge where this is beneficial (e.g. electricity generation and supply, BT back into mobile).
Re-regulation of Distribution Networks

- Private ownership of monopoly distribution networks implies the need for regulation of prices and quality of service.
- In most advanced countries specific independent regulatory agencies are tasked with carrying out this function.
- In the UK economic regulators such as OFCOM (once OFTEL), OFGEM, OFWAT carry out this function.
- A central part of their work involves setting RPI-X price controls on monopoly network tariffs for fixed periods of around 5 years.
- In setting regulated prices regulators need to make value judgements about efficiency and equity trade-offs.

Economic Questions raised by Napster

- Are property rights allocated efficiently or fairly?
- How are the basic economics of copyright, the internet and network industries related? (Lecture 3)
- Has the market been designed for the benefit of incumbents? (Lecture 4)
- What sorts of market structures promote innovation? (Lecture 5)
- How can the market power of incumbents be regulated? (Lecture 6)
- What corporate strategies could incumbent firms play faced with innovation in liberalised markets? (Lecture 7)