

*First European Conference on*

**DIGITAL DISTRIBUTION AND THE MUSIC INDUSTRY**

("DDMI Europe 2000", held at the Olympia Conference Centre, London, 22-23 May, 2000)



**INTRODUCTION**

**M**usic industry delegates from around the world seem agreed that we are on the cusp of one of the great transitions of music history. It's now over 120 years since Thomas Edison first made his memorable recording of "Mary Had A Little Lamb", and all subsequent developments in music industry have been evolutionary transitions in the *formats*, or "containers" of music: from wax cylinder to shellac disc, then long-playing vinyl record to compact cassette and compact disc - with all sorts of new formats now being predicted. Possibly, we may see the demise of the physical product altogether, to be replaced by direct access to music anytime, anywhere, via the internet, television, or even a mobile phone.

Many of the present structures, conventions, terminologies and paraphernalia of the music industry will change in the next five years, as music is increasingly delivered in intangible streams of digits and electrons. Before long, every single piece of music ever recorded will exist on remote computer servers, or so-called "celestial jukeboxes".

The major record labels, however, continue to frustrate the rapid spread of technology, and it's the new "dot.coms" - the new music technology companies - who are leading the way, generating the greatest excitement, and producing some striking innovations.

In his welcoming address, Paul Schatzkin (General Manager, *songs.com*, USA), expanded further on his conception of digital distribution being a phenomenon which involves taking music out of its containers. He stressed that existing industry practices, with all their concomitant terminology, just do not suffice in the digital age. Indeed, internet entrepreneurs find themselves hampered by the vocabulary of the past whenever they try to understand or explain the future delivery of music.

Just as broadcasting created the mass audience, so the internet is creating unlimited "channel space". There can be little doubt that the whole of the recorded music catalogue (and indeed, the whole of mankind's written corpus) will ultimately exist in digital form on remote servers. It is then just a question of access. Entrenched corporate efforts may be trying to hold back the tide of change (to secure them more time to adjust to new business circumstances), but the technological genie is out of the bottle, and the digits won't go back in the box.

### *THE MUSIC INDUSTRY IN THE DIGITAL WORLD*

The first keynote speech saw Jason Olim (President and CEO, *CDNOW*, USA) insisting that the future of music is in the hands of the *consumer*, and no longer the large corporations. The major labels are being led by innovative digital distributors. The "personal celestial jukebox" is clearly on the way.

Within five years, the way we use and consume music will be completely different. 50-60% of US computer users have already downloaded music from the internet. Trading MP3 files is now a way of life for many young people. 73% of US college students swap at least one MP3 file over the internet each month<sup>1</sup> (mainly via the internet site Napster). Furthermore, the growth in broadband should help to drive the growth in digital distribution. Likewise, the proliferation of portable devices<sup>2</sup> and CD-R's should spur growth in the download market.

The numbers do the talking. In 1999, the value of internet digital download sales in America was approximately 1 million US dollars. By 2004, these sales are anticipated to be worth about 1 billion US dollars - a thousand-fold growth rate over five years.<sup>3</sup>

#### Benefits of digital distribution to *producers* of music may be listed as follows:

- Lower overhead costs for digitally distributed music
- Reduced barriers to entry for producers of music
- Lower cost of production
- Broader array of products (and no warehousing)
- Reduced distribution costs
- Singles sales regain viability<sup>4</sup>

<sup>1</sup> This may be likened to digitally trading cassette tapes. Source: *Webnoize* survey (June, 2000).

<sup>2</sup> The advantage of these devices is that they are small, portable, and tracks don't skip.

<sup>3</sup> Source: Forrester Research.

<sup>4</sup> Major labels often lose money on singles and make most of their profits from albums. Manufacturing costs are much the same for CD singles as for CD albums, the latter of which sell for around 4 times as much as the former.

Benefits of digital distribution to consumers of music may be listed as follows:

- Greater selection (and "exclusive tracks" can be carried)
- Immediate gratification
- Convenience
- Reduced costs
- Greater portability
- New applications (playlists, etc) and greater flexibility

Olim believes that record labels will continue to support artists. He sees labels as playing a vital role in future music distribution, although at the same time many artists may themselves also choose to distribute music. Retailers should also continue to distribute music, though "bricks and mortar" retailing will increasingly yield to online distribution and delivery.

Olim's innovative digital download company, *cdnow.com*, founded in 1994<sup>5</sup>, currently offers 70,000 downloads for sale. The website is updated weekly, with all genres of music being represented, from classical to heavy metal. Olim recommends that companies like his should aim to supplement their profits by adding extra value to the downloads (i.e., extra tracks and interviews for a small additional cost). He also points out that for material in copyright, music providers are, of course, obliged to obtain licences from record companies and other copyright owners, and that music which is downloaded is not legally recopiable.

Digital subscriptions may, in the long run, supersede the "pay-as-you-go" method of downloading. While Olim accepts that many computer users in America pirate recordings for free at the moment, he believes most people would prefer to download legitimately if a reasonable subscription fee were introduced. According to a recent survey, the average American consumer spends US\$100 per year on recorded music, and the majority of US college students state that they could afford up to US\$15 per month for an internet music service (especially if access were unlimited).<sup>6</sup>

Olim is convinced that the traditional "music industry" is no longer in control of events. Consumer demand will fundamentally change the way that music is delivered, and producers of music must, in future, respond effectively to this consumer demand.

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## *EMERGING INTERNET DISTRIBUTION ENVIRONMENTS*

Digital music labels will be the "new media companies" of the future, according to Robert Madge (CEO, *Madge.web*, UK). Nevertheless, Madge accepts that existing labels may well be among these companies if they can adapt to the new internet environment. As his own company was founded to facilitate the streaming of audio and video content over the web, Madge's principal concern is these internet environments and their distribution capabilities. As the century progresses, Madge believes that radio, TV, film, music and news will all appear in brand new guises.

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<sup>5</sup> For further details, see: Jason Olim, Peter Kent & Matthew Olim, *The CDNow Story* (Top Floor Publishing, 1999) [ISBN 0966 103262].

<sup>6</sup> Source: *Webnoize* survey (June, 2000).

The digital world may well be one in which companies merchandise a "music lifestyle" directly to their customers: a world in which business is generated via multiple revenue sources - no longer just from music (or even primarily from music). Perhaps the most important point to note is that *digital distribution forces companies into a completely new business model*.<sup>7</sup> Rather than simply relying on payment for downloads (which could be very cheap, or even free), a prime source of revenue in future might lie in marketing the information many internet companies will hold on consumers. It is the company that collects user data, or consumer profiles - the company that owns the "customer's preferences" - that should be able to generate a larger share of revenue through sales of this valuable information to interested parties (other businesses).

Madge argues that one good thing has come out of large-scale internet music piracy. The industry is being forced to accept the power of new technology, and to learn about customers, and how to win them. Thanks to the internet, marketing information has become more focussed, sophisticated and accurate than ever before. With the youth population raring to go into the digital age, piracy is teaching the new media companies the ways to operate in future. Customer loyalty is primarily to artists, who can have a direct link to their fans and customers. The status of artists could be the key to the nature of music in future, for artists have an appeal beyond their music. It may be less a case of "the music industry" in a few years' time, and more one of "the musician business".

Dot.coms are showing the way forward. Indeed, they have as their powerful "co-conspirators" the whole of the telecommunications industry, which is also looking to find faster and better ways of streaming music. The future is entirely digital - from first to last. Music can be created digitally<sup>8</sup> and consumed digitally, flowing all the while through a seamless infrastructure. The challenge for service providers is to deliver content in a manner that is "bullet-proof" (secure), and to be able to cope with vastly increased numbers of users in the next few years.<sup>9</sup>

*"The only thing you don't know is history you haven't read".*

- Harry S. Truman

If there is an enormous amount of content on the future web, there will be a greater need for *directories*, and music will be no exception. *Listen.com*, a directory of digital music, provides just such a service. Kevin Kiernan (USA) the company's Director of Label and Artist Relations, pondered the nature of the online music revolution. If the world-wide-web took off in the mid-90's, 2000 would seem to be the year in which online music is set to win mass approval. It is a phenomenon driven by grassroots energy.

*MP3.com* is the world's no.1 music site, and there is more demand than supply of digital downloads at present. The major record labels have largely ignored this demand up to now, though many have established so-called "new media" divisions, and all the major labels should finally be online by the end of this year (2000)<sup>10</sup>. Kiernan believes that the billions of people who will soon be online may be likened to peasants of old "milling round the castle walls" - ready to storm the bastions of traditional recorded music companies if they cannot get what they want. The surprising thing is that, despite demand, there is very limited "e-commerce" in music at the moment.<sup>11</sup>

<sup>7</sup> This concept is expanded upon in later speeches.

<sup>8</sup> Ricky Martin's "Livin' La Vida Loca" was *Billboard's* first no.1 single to have been entirely recorded and mixed using a computer. It reached the top of the US singles chart on 15<sup>th</sup> May, 1999.

<sup>9</sup> Hence the development of secure "overnets", which by-pass the public internet.

<sup>10</sup> The "major labels" comprise around 70% of the US recorded music market.

<sup>11</sup> Regarding the sluggishness of the major labels, and their relative inactivity considering the potential of the internet, Kiernan cites the example of *amazon.com*, an internet company not predicted to affect book and music sales much at first. Yet in the four years from 1996 to 2000, Amazon's growth rate has been staggering, and Amazon now occupies a significant market position.



While Kiernan concedes that a populist revolution won't annihilate the majors (and vice-versa), he insists, like other industry commentators, that the old economic models just don't translate into the new digital world<sup>12</sup>, and far-reaching changes will have to be made. Artists may well become their own "brand", especially big artists (e.g., *Prince.com* is anticipated). In the digital world, products can be sold through a variety of sites and by a variety of means. *Content (and context) is king* on the internet, and thus the number of "navigation" sites should grow as the content of the internet becomes more bewildering.<sup>13</sup>

Kiernan concludes that the best is yet to come, and that we will end up subscribing to a "celestial jukebox" one day. Independent internet labels should be aggressive in order to stay ahead of the majors, who are slow to get on the bandwagon. Entrepreneurs should try out radical pricing forms until they find those that suit their new business models best. Finally, while at present there is more free content on the internet than some care to admit, Kiernan argues that digital music entrepreneurs should not be so distracted by the issue of internet piracy that they forget to nurture their own businesses.<sup>14</sup>

### ON THE CONCEPT OF "CELESTIAL JUKEBOXES"

The old product-based world is going to lose out to a service-based music industry, Jim Griffin contends (Co-chair, *Evolab*, USA).<sup>15</sup> He characterises the digital age as the era of the "friction-free Gutenberg".<sup>16</sup> "Digital delivery", Griffin argues, is a more appropriate term in the new technological era than "digital distribution", because distribution implies a "push" by an aggressive company, while delivery implies a "pull" by the increasingly empowered consumer.<sup>17</sup> Before long, we should be able to "pull" music anywhere, and serving the consumer's needs will be of paramount importance to all companies.

Significantly, we may not need to "possess" music in future, and the whole rationale for 20<sup>th</sup>-century consumerism may become obsolete. The concept of the "consumer" itself may disappear, because the process of downloading, or accessing, music, never reduces the number of copies of a product in the world. In fact, there are no longer any mass-produced copies of products at all - the "original" just "exists".

So the future is likely to be one of *access*, not possession. "Connectivity," Griffin insists, "reduces our need to store anything." We don't download the newspaper every morning - we merely access the parts we want. Once there are enough "digits" in the world, a central storehouse of music will come into being. The rising level of digitization in the world is symptomatic of the fact that this is not science fiction.

<sup>12</sup> Old economic models such as the "paid-for publishing" model.

<sup>13</sup> The top three websites in the world at the moment are: 1) *aol.com* 2) *yahoo.com* 3) *microsoft.com*.

<sup>14</sup> Microsoft estimate they lose about 40 billion US dollars per year to software piracy, a figure which is roughly equivalent to their profits. Microsoft is, therefore, the most pirated software in the world - yet Bill Gates still manages to make a living!

<sup>15</sup> Jim Griffin is also CEO of Cherry Lane Digital, and former Director of Technology at Geffen Records (1993-98).

<sup>16</sup> Johannes Gutenberg is remembered for being the first in the Western world to print using movable type. In about 1455, in Mainz, he produced his famous Bible, the first complete book extant in the West. If Gutenberg's process revolutionised the dissemination of the printed word, Griffin believes that "celestial jukeboxes" will do the same for music, but with seemingly effortless (and dramatically increased) efficiency.

<sup>17</sup> This is not to say that marketers won't be targeting you highly accurately if they know you buy very similar products to the ones they sell. Internet gatekeepers want to know your most intimate needs and desires for this very reason.

Since the very process of digitization is "out of control", we may not be able to "control" music - as the major record companies have thus far tended to do. When we can no longer control a product (i.e., if there are no effective "security guards"), the price to the consumer usually becomes marginal - which is to say, just what it costs to deliver. Griffin sees the whole situation as a moral dilemma. When all human art, science and knowledge exists in digital form, what *moral* right will companies or copyright owners have to discriminate against those people throughout the world who cannot afford access to this shared human treasure?

The question, then, is how will artists make a living in future if their music is delivered at marginal cost? Griffin draws a striking analogy. When it was initially proposed to broadcast football matches over the airwaves in the 1920's, the idea was opposed at first, because it was feared that no-one would go to watch football any more. Today, of course, broadcasting is very much a *part* of match economics - in some cases, the most important part. "Radio," Griffin claims, "was the Napster of the 1920's".<sup>18</sup>

Although individuals or companies may not be able to charge *per unit* in the future, there is never going to be truly *free* music. *The new economics of digitization will drive the future.* Radio didn't destroy the recording industry, any more than it destroyed football. In 1925 the industry adapted from acoustic to electric, and in the 1990's from electric to digital. With broadband wireless coming in 2001, there is no reason why music can't be delivered over a cell-phone.<sup>19</sup> Griffin's contention is that as music becomes ubiquitous, and access very cheap, or even free (up front), we may not need to "transact" so much in future, merely to "relate". He means that with content as the lure, internet site gatekeepers will find their audiences a more profitable resource than just selling product. Such a philosophy is all about making music "feel free", while generating income as a gatekeeper to an audience. Marketing information can, and must, become much more accurate, Griffin feels.

Customer relations with internet companies will be all important in the future, therefore. Griffin bases much of his argument on the fact that even existing models of digital distribution cost too much (especially "customer support"), and that we still need new, faster, cheaper, delivery models. The linchpin of his argument is that if music is always available, the public do not need to store it. "*Art need never die.*" Record companies will no longer have to "kill off ten albums for every new one".<sup>20</sup>

The question for the future is: do we restrict digital content according to the size of one's wallet; or, should we broaden access to intellectual property, finding new and more economic methods of delivery, as well as better and fairer revenue models, in the interests of the well-being of all humanity?

**M**usicBank.net (UK) is an example of a website which allows "uploads" as well as "downloads", and will market/distribute recordings on your behalf. It could be said to provide the artist with an "unfiltered environment", because it bypasses the traditional record company A&R (Artist and Repertoire) Department. The site's founders aim to give complete control to its artists in relation to which tracks to hold, and which to delete, give away or sell.

<sup>18</sup> Napster, an internet site which facilitates the swapping of MP3 (downloadable music) files, recently lost an action brought against it in the United States by the band Metallica. Napster was ordered to stop operating its site in such a way as to permit the free flow of copyrighted music, so breaching existing copyright law.

<sup>19</sup> Japan should have this facility (using 128k. wireless) before the end of the year 2000.

<sup>20</sup> Physical distribution costs presently necessitate record companies pursuing policies of writing off albums that don't justify their distribution costs. Once such costs exceed return, a product is scrapped.

The main financial concern with such websites relates to the fact that many of them are mainly advertising maintained at present, and it is unclear whether their business models will work in the longer term. Some industry commentators believe such sites will only survive if they can target customers extremely accurately, and build databases of fans. Besides selling downloads, such sites may then also be able to charge for access to databases - depending on who controls these.<sup>21</sup>

## DIGITAL DISTRIBUTION AND THE LAW

**M**ark Haftke (e-commerce and media lawyer, UK), confirms that analogue copyright laws cannot satisfactorily be applied directly to digital transmissions. At present, copyright law in relation to digital transmissions is unworkable, for it allows certain uses, but not others. The issues are complex and wide-ranging. The worldwide playing field is not level enough to cope with the internet, so issues of international conflict arise. Moreover, it is doubtful that present legislation can be enforced. It certainly does not make economic sense to litigate against internet copyright infringements on a "case by case" basis. A new international copyright framework must ultimately be created, and scores of anomalies resolved. New technology is set to revolutionise copyright law.

The internet has, in fact, already created *de facto* copyright applications. "Fair use" clauses in the US have been interpreted to permit 30-second sound clips being transmitted over the internet, although British law does not currently recognise such use as legal. Depending on where you reside, copyright law, in the digital context, remains contradictory. All the *exceptions* to copyright law, as well as all the *rights*, need to be standardised worldwide. For example, if downloading a piece of music while crossing borders, that music may be licensed for use in one country, but not another.

Haftke points out that there is no provision in copyright law, in any unlicensed circumstances, to make private copying of copyrighted music legal. It is therefore not surprising that Napster's activities were not long ignored by those seeking to uphold existing copyright law.<sup>22</sup> On the other hand, there is cause to fear a "too secure future": if internet sites are able to control digitized information in a completely secure manner, "infinite copyrights" are effectively created.

There are all sorts of other anomalies. In physical form, a mechanical royalty is paid when a CD is pressed. In digital form however, two royalties are required - one "mechanical" and one as a "performance". (In the digital context, few can agree when a mechanical is a performance, and when a performance is a mechanical!) This double overhead - dubbed "spatial prejudice" - is ultimately passed on to the consumer. The law cannot even cope with the number of copies that must be made between computer servers before the music reaches the consumer!

There is a clear dichotomy between analogue and digital when it comes to copyright. As a physical good, analogue products are subject to "exhaustion of copyright" (the physical good loses its rights on resale). This may not apply digitally, however. Strictly speaking, digital broadcasts become illegal after initial transmission, as internet transmission rights are presently treated like cable programmes. Further, any potential consumer may unwittingly breach parallel import laws on receiving a transmission. The complications are endless.

By working together, collection societies such as BMI, SESAC and ASCAP have taken some tentative steps towards creating a part-workable system. The *Digital Distribution Memorandum of Understanding* (DDMOU), agreed in Cannes this year (2000), attempts to provide internet music licences for several countries, with rates paid relating to the country of download. Yet this memorandum does not begin to cope with the complexity of copyright law in the digital age.

<sup>21</sup> While also taking into account the provisions of the Data Protection Act.

<sup>22</sup> The Recording Industry Association of America (RIAA) remains in litigation with Napster.



## *SOME PIRACY, ECONOMIC AND COPYRIGHT ISSUES*

A few music industry representatives took pains to dispel the myth that internet piracy was any worse than physical piracy. Of more concern, according to Berni Lee (UK rep., *AudioSoft*, Switzerland)<sup>23</sup>, is the fact that web entrepreneurs seem to view the whole economic problem too "simplistically", especially when they say that we will just have to find new ways of deriving revenue - at least in this transitional period. 90% of revenues at present are still derived via existing "legal" copyrighted means (through licensing and royalties, etc.), and the transition to a new economic model will take time.

Furthermore, there are some commentators who believe that the biggest hurdle will be winning over all but the younger generation to adapt quickly to new digital download formats. In other words, there may be a lengthier transition period than the executives of many high technology companies would like to think, before we finally arrive at the new music economy, especially if there is slow consumer take-up. The critical element for the new technology companies is whether they will be able to survive economically (without consuming vast amounts of capital) until the general public adopts such new technology.<sup>24</sup>

Ultimately, new licensing methods may evolve to adapt to the new digital environment, but again, this will take time. *Napster.com*, for example, has speeded up the internet music revolution while, by contrast, the major record labels have been trying to slow things down. The most innovative new technology companies may (often not deliberately) be caught in the trap of breaching existing "analogue"-designed copyright laws.



## *NEW MEDIA SOLUTIONS*

With one million visitors per month, *peoplesound.com*, which was only founded in June 1999, is now Europe's leading digital distributor. All music offered is original, and features the best work of new bands and artists (some 7,000). Paul Levett (founder and VP Technology, UK) views the benefits of his site as being for three main categories of people:

<sup>23</sup> Founded in 1996, *AudioSoft (audiosoft.com)* "is the worldwide leader in global copyright management for music on the Internet, helping to assure accurate royalty distribution to music copyright holders. The company's copyright and data reporting system captures, organises and delivers information about music usage on the Internet."

<sup>24</sup> Outside the music industry, the collapse of *boo.com* is a case in point. Technological problems were not dealt with quickly enough, and many potential customers found the site too difficult to operate.



### 1) CONSUMERS

- Active navigation through a confusing array of record launches

### 2) RECORD LABELS

- An improved success rate in finding and managing commercially viable artists (= more efficient A&R)
- Vastly more efficient marketing channels to promote artists, get to know customers and their local geography. Huge and detailed databases have been built up (information for which the music industry will pay a premium as a marketing resource). *At present, revenue from these databases forms the basis of peoplesound's business model.*

### 3) UNSIGNED ARTISTS

- Some revenue, and economical distribution of their work
- Artists get heard, their product is "tested" in the marketplace, and they have the opportunity to be taken up by bigger labels

Levitt points out that, for him, these structures comprise an *additional* music industry tool. They do not negate existing industry structures, but support them, greatly increasing their efficiency. Nevertheless, Levitt believes that the "fragmentation" of the music industry will continue in future.

### NOTE PEOPLESOUND'S NEW BUSINESS MODEL:

#### SOME REVENUE from -

- Advertising;
- Sponsorship; and
- e-commerce (custom CD's);<sup>25</sup> *but*

#### CORE REVENUE from -

- Artist testing;
- Marketing;
- Synchronisation and Syndication (*e.g.*, working with the advertising agency Proctor & Gamble to provide cutting-edge music for advertisements);
- With an intention to move into Music Publishing (rather than becoming a "label").

Peoplesound's core revenue is thus generated *business to business*, not *business to consumer*.

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<sup>25</sup> Much of the music available through *peoplesound.com* is free: "Artists and bands submit their best original music, on a non-exclusive basis, to *peoplesound.com*. We create an individual web page dedicated to their music offering free instant play and MP3 download tracks and the opportunity to buy custom-made CDs, either of a single band or as part of a compilation."

## WEB MUSIC STORES

Some of the biggest and most innovative "music store" players (both traditional and new technology) may be listed as follows:

- HMV (483 stores) & TOWER RECORDS (both off & online) - representing sales worth US\$2 billion
- CDNOW (4 million customers on the internet)
- AMAZON.COM (Music Department now profitable)
- MP3, GETMUSIC, LISTEN, EMUSIC & SONGS.COM (digital downloaders)
- NAPSTER & GNUTELLA (unofficial downloading sites)
- MUSICMAKER.COM & CDUCTIVE.COM (providing custom CD's - small at present)
- VALLEY MEDIA (and other "fulfilment" houses)
- ALLMUSIC.COM, DISCOVERMUSIC, etc.

Colin Miles (Executive VP, *Net Megastore*, Singapore) points out that retailers of physical CD product remain dominant at the moment, even online. The "retail" scene, off and online, is changing fast, however. Singapore-based Net Megastore, which has been trading since October 1998, now operates Asia's largest online music provider (*discvault.com*), besides having offline facilities, or "convergence kiosks" (which permit downloading), situated in a variety of "bricks and mortar" stores.<sup>26</sup> The great advantage of digital music kiosks is that they can be placed anywhere - from a McDonald's restaurant, to your local supermarket.

Although online music is growing - and indeed booming, especially in Asia - music margins remain small, which is why Net Megastore operates on a typically *volume-driven* model. Moreover, the success rate of dot.coms is not high: many "burn out" in today's fiercely competitive business environment.

Several "bottlenecks" are still causing problems as far as digital delivery is concerned:

- Multiple audio file formats exist at present, and an industry standard is awaited
- Likewise, industry standard security systems, and coherent digital rights management systems, would assist business greatly
- "Territory-based" licensing and copyright issues are causing confusion in the new "borderless" global economy<sup>27</sup>

Net Megastore also provides "own label" facilities, and holds contracts to build 70 online music stores for its clients. Indeed, the company plans to build some 1,000 online music stores by 2002! Much of Net Megastore's revenue comes from:

- 1) setting up and administering websites; and
- 2) logistics.<sup>28</sup>

Net Megastore also possesses a powerful "one-to-one" marketing database, which is a great asset both to it, and to its business customers.

<sup>26</sup> These "convergence kiosks" are soon to be installed in HMV stores.

<sup>27</sup> Internet trial licences have recently been proffered by the Mechanical Copyright Protection Society (MCPS).

<sup>28</sup> Net Megastore has a large stake in logistics in the region. Because logistical costs are so heavy with regard to physical product, Colin Miles believes that simple economics dictates that digital downloading must ultimately come to supersede physical distribution.

## NEW PRICING STRUCTURES

The central problem of pricing recorded music in an online world lies in how to maintain "value" if music becomes, or seems, "free" in future. New industry pricing structures must take into account the costs of new technology, which are still far from cheap (at least in relation to starting up).

It is the hype surrounding MP3 websites such as Napster, argues Mia Garlick (intellectual property & recording agreements lawyer, Australia), that is indicative of the younger generation's "hacker mentality and entitlement philosophy". She feels that the digital age in which young Western people are presently growing up invests them with little respect for propriety rights.<sup>29</sup> Against this background, a battle for customer attention is currently raging between *online* and *traditional* retailers.

Positive aspects of the digital impact on costs may be listed as follows:

- Production costs are lower
- There is a lower risk of project failure (costs are lower overall, and consumers are more accurately targeted, so with less outlay than in traditional circumstances it should be easier to recoup costs)
- Marketing is better targeted and more customised
- The efficiency of distribution is greatly improved (indeed, distribution channels are completely different)
- Inventory risk is lower (little or no warehousing)
- The transaction cost for foreign sales is potentially decreased

Before looking at the digital impact on revenue one needs to appreciate that the standard (existing) royalty structure is derived from:

- album sales
- singles sales (traditionally regarded as having promotional value only)
- foreign sales
- record club sales, etc.
- synchronisation rights for advertising, television and film<sup>30</sup>

By way of contrast, the digital impact on revenue may be listed as follows:

- The concept of albums and singles becomes increasingly irrelevant (music can be tailored to customer or business use)
- Standard reduced royalties are no longer justifiable
- The reprioritisation of revenue streams is likely (e.g., synchronisation revenue is becoming more important than album sales)
- There is a new online use of recorded music
- Restrictions on giveaways will become increasingly irrelevant

<sup>29</sup> Added to this, the fact that credit cards cannot be used by under-18's to pay for online music further fuels internet music piracy. It is precisely this age group that most uses MP3.

<sup>30</sup> All minus packaging and giveaways in respect of physical sales - which need not apply in the digital context.



Garlick suggests that three main types of new business model are emerging, which she characterises as:

- 1) the Equity Model;
- 2) the Subscription Model; and
- 3) the Hybrid Model.

An example of the Equity (or "break even and profit") Model is provided by *garageband.com*. On this website, downloadable music is given away for free, although the most popular new band of the month do get a recording contract, and traditional sales, or sales via digital distribution, are then pursued.<sup>31</sup> The major labels ideally seem to favour a "flat rate" Subscription Model for their digital downloads, and may well be introducing this system before long (it is currently under consideration by Universal and Sony). The Hybrid Model covers all those websites which depend on a variety of revenue streams. Such sites usually offer a mixture of free (short-sample) and charged music (either downloadable, or the still-dominant physical product), but they have other revenue sources, including advertising and consumer profiling (e.g., *cdnow.com*). All of these new business models are tending to move further and further away from the old-style "singles/album" revenue model.

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## THE INDEPENDENTS

Most independent record companies tend to confront the issues of the digital age with a "practical, bottom-line focussed" aim, according to James Bethell (CEO, *Ministry of Sound Digital*, UK). Executives of these companies are pragmatic music lovers who intend to use the internet to try to "leap frog" the competition. Independents have the advantage of being much more flexible, and quicker to adapt to new circumstances, than the majors (who have used the internet mainly for marketing purposes thus far).<sup>32</sup>

The internet is currently perceived by outsiders as "glamorous", cutting edge and "powerful", and independents have spent millions on webmarketing. Yet, Bethell stresses, the impact of the internet on consumers remains limited at the moment. *The greatest benefit for artists and companies has come from using downloads to market tracks: this, it seems, is the way to get tracks heard.*

### There are lessons to be learned from the experience of the Independents:

- 1) the internet is *not cheap*: setting up and maintaining an efficient website costs serious money - at least at present;
- 2) downloads don't get you chart positions, and they still lack retail presence;
- 3) small companies should avoid setting up an expensive office.

With regard to *distribution*, "archive" material (much vaunted as an ideal internet revenue source) is not selling much, and big releases are still important. Furthermore, despite a "global" web presence, labels are selling only marginally more internationally.

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<sup>31</sup> In contrast to this, dedicated physical product sites such as *amazon.com* have been characterised as mere "digital shopfronts".

<sup>32</sup> The internet's biggest success to date has been as a marketing tool.

While Bethell admits that internet digital distribution has the potential to become big, it remains problematic at the moment. The technology still "sucks", Bethell maintains, and is often too expensive for the smaller independents. This situation is a cause of much frustration, but the worst technical problems should be ironed out by next year (2001).

In order to succeed, independents will almost certainly have to form strategic partnerships, as the major labels have done with the telecoms.<sup>33</sup> In terms of *revenue* for independents, the internet has been very disappointing. Costs are still high, while prices are being driven down generally, partly through the ubiquity of digital technology itself. Ground rules, or *business models*, seem to change every six months, and methods of digital distribution may themselves change in the future. Smaller music companies should heed the note of caution that Bethell sounds here.

### *NEW OPPORTUNITIES FOR TRADITIONAL RETAIL*

The music industry was long ago established around the notion of selling of "sound carriers", as exemplified by traditional recording contracts. But with digitization, we may not need *individual* sound carriers. Indeed, the redundancy of the pre-recorded product has been predicted.

According to George Hargreaves (MD, *The Cyber Record Co.*, UK), the digital revolution will change the face of music retailing as we know it. All over the world, the more sophisticated retail stores are already beginning to change their layouts as they make way for such innovations as customised in-store pressing of CD's (the old-style sound carriers). More radically, however, some stores are now beginning to install space-saving digital kiosks, which ultimately look set to replace the sprawling physical rack system.<sup>34</sup> The new face of music retail will be all about selling convenience and fast service, much as McDonald's does with hamburgers.

The world-wide-web seems to have created a "gift economy", and the concept of the free flow of data over the internet, which emerged during the last few years, has invaded the sphere of music, too. The swapping of internet music files was initially embraced for A&R purposes - for bands to get noticed - but today the trend has gone much further than originally intended. In this atmosphere, it is not surprising that MP3's offered for sale at full price are selling poorly. Current price expectancy with regard to digital downloads may be likened to the atmosphere prevalent during the US retail price wars of 1994-6, after which the government introduced Minimum Advertised Pricing (MAP).<sup>35</sup> The introduction of MAP helped to stop music being used as a loss-leader, and the same may happen in relation to digital downloads.

Like other industry commentators, Hargreaves maintains that the "adversary" at the moment is our old economic models, and an unwillingness on the part of both the transnational record companies, and the older public, to change over to the "new economy". Because of the present climate of uncertainty as to the future of retail, W.H.Smith, for example, is reducing its exposure to CD's and videos.

<sup>33</sup> Having said that, many independents are unclear about whom to form such partnerships with, in order to gain the greatest advantage.

<sup>34</sup> Half a dozen companies are presently competing to supply these kiosks. Once the changeover is complete, retailers should never again have to carry "dead stock".

<sup>35</sup> This is similar to the concept of the Recommended Retail Price (RRP) in other countries.

# **MUSIC BUSINESS JOURNAL**

ISSN 1473-6233

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*General Editors*

*Featuring articles from around the world  
on the global music industry*

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