Strategy For The Music Industry

Marivi Magsino – Valcourt
December 23, 2004
Loyola Marymount University
MBA Integrative Project- Final
Dr. Rachelle Katz

TABLE OF CONTENTS

ACKNOWLEDGEMENTS…… i

I. INTRODUCTION…….. 1

II. LEGAL BATTLES IN THE MUSIC INDUSTRY…….. 2
- Overview of Copyright for Musical Works and Sound Recordings…… 2
- Copyright Infringement……. 4
- Fair Use…… 4
- A Historical Case - Sony v. Universal…… 5
- Peer to Peer – One Down, Many More To Blossom…… 7
- Suing Your Customers…….. 8
- Anteing Up In The Digital World..…… 9
- Legal Advocacy Groups…… 12
- Issues On The Table……. 13

III. ECONOMICS OF THE MUSIC BUSINESS…….…… 19
- An Oligopoly Of Music…….. 19
- Diagram A - Activity In The Music Industry…… 22
- Diagram B - Traditional Economic Of The Music Industry…….. 23
- A Powerful Shift…….. 26
- Diagram A2 - Activity In The Music Industry……. 27
- Diagram B2 - New Economics Of The Music Industry…… 28

IV. MARKET ANALYSIS……. 32
- Ignoring The Hand That Feeds…… 32
- Music Consumer Analysis…… 34
- Consumer Portrait……. 38
- Music Industry Analysis…… 39

V. STRATEGIC DEVELOPMENT…… 52
- Create Value For The Customer……. 53
- Develop Music Differently…… 55
- Cultivating A New Business Model……. 62
- New Model For The Music Industry…… 64

VI. CONCLUSION…….. 65

ENDNOTES…….. 66

APPENDIX
- Legal Advocacy Groups……. A1
- Consumer Music Survey Results……. B1
- Music Industry Survey Results…….. C1

ACKNOWLEDGEMENTS

I would like to thank my husband, Keith and my daughter, Audrey for their love, patience and tremendous support. Also, to my sister, Tisha, who talked me through the tough times and kept encouraging me to stay on target. To the Magsino and Valcourt families and my friends at Bayside District Corporation, thank you for all your enthusiasm and many nights of babysitting.

I also want to thank all the professors who taught me at Loyola Marymount University. It has been a privilege spending the last four years with you. I especially am grateful to Dr. Rachelle Katz, Dr. Richard Doyon, Dr. Jeffrey Gale, Dr. Arthur Gross-Schaefer, Dr. Elaine Reardon and Dr. Jeff Thies whose specific teaching subjects were applied to this paper.

Thank you to all the folks who took the consumer survey – your honesty counts.

This paper could not have happened without the help, knowledge and insight of music industry experts – past and present. Thanks to all who took out the time to set up meetings, talk on the phone, take my survey and meet with me. Your contributions were truly valuable. Some insiders have asked to remain anonymous and to the rest, I share my gratitude: David Brewster, Chris Clark, Mark Cohen, Gail Countryman, Russ Crupnick, Pat Daly, Antone Desantis, Mindy Espy, Jay Frank, Joy Feuer, Jim Griffin, Keith Holzman, R. Wayne Jackson, David Levin, Melanie Levy, Mike Manley, Amanda Marks, Catherine Moore, Charles Muselli, Renee Nahabidian, Rita Gardin Parker, Laura Schooler, Phil Schuster, Derek Sievers, Elizabeth Smith, Sue Tanner, Tess Taylor, Andrew and Karen Thomas, Mark Tindle, Don Van Cleave, Mike Weaver and Sebouh Yegparian.

INTRODUCTION

The music business is in trouble. Through management's entrenched thinking and inability to consider future scenarios they have backed themselves into a corner and are fighting to survive. The industry has not acted strategically or thought about growth and now new technology in the form of P2P software has threatened the core of its business. Stale business practices and a disregard for consumer needs has devalued music's economic worth. Rather than advocate change, the corporate machine ignored potential threats and denied its own near extinction and now is stalling its development with misguided litigation. Some consumers have had enough and are vowing to use the Internet to obtain their music for free forever. Other consumers just want to be treated fairly and purchase music at an acceptable price.

This paper is about change. In order to strategize, the industry needs to study its environment so it can figure out were it is and where it wants to be. A look into the legal environment reveals several issues that will impact the business. Examining the economics illustrates how digital distribution changes the activity and responsibilities of various industry players. Studying the market forces and market data shows the shift of power between buyer and seller.

"I fought the law and the law won"
Written by Sonny Curtis and Performed by The Clash

LEGAL BATTLES IN DIGITAL MUSIC

The United States Copyright Office is a department of the Library of Congress that has been functioning since 1897. Throughout the centuries, the Copyright Office has worked to strike a balance between protection of original works and the public's right to fair use. Over the past decade, the impact of technology has caused those in the legal world to turn to the standard copyright laws for answers. But how can you fight the law if there is no law that addresses your issue? The courts handle this challenge by referring to past cases. Lobbyists and special interest groups handle this situation by working with Congress to amend or create new laws. In light of the digital music industry, there is a great battle going on to amend current copyright law as well as introduce bills that may become law. It is important to pay attention to the current debates and proposals because the decisions will dramatically shape the future of the industry.

Overview of Copyright for Musical Works and Sound Recordings

The United States Copyright Act protects "original works of authorship" that are fixed in a tangible form of expression. The fixation need not be directly perceptible so long as it may be communicated with the aid of a machine or device.[1] The Act protects the "expression" of a creative work not the idea of it. For example, the idea of love cannot be copyrighted but the way it is expressed can. Love has been expressed musically in thousands of ways. Take a look at some of these lyrics and you can probably hum the tune:

a) "Love, ageless and evergreen"
b) "Can't buy me love"
c) "Could it be I'm falling in love, with you, with you, with you…"

a) "Evergreen" by Barbara Streisand b) "Can't buy me love" by The Beatles c) "Could it be I'm falling in love" by Spinners

Copyrights registered with the US Copyright Office help to protect composers of musical works and owners of sound recordings for a finite amount of time. After a copyright expires, the work enters the public domain. Musical works are original creations owned by the composer, who can be an artist or songwriter. A sound recording is considered a separate entity from the musical work contained on it. A series of recorded sounds are fixed to a physical phonorecord such as cassette tape, video, DVD or CD. The owner of sound recordings is usually a record company but can also be an artist.[2]

Composers of musical works are provided the rights to:

- reproduce the copyrighted work in copies or phonorecords*;
- prepare derivative works based upon the copyrighted work;
- distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
- perform the copyrighted work publicly;
- display the copyrighted work publicly.

* (phonorecords are current or future physical formats of a musical work - ex.) cassette tape, video, CD or DVD.)

Owners of sound recordings have the rights to:

- duplicate actual sounds on sound recordings;
- duplicate and distribute new arrangements or versions;
- sell or distribute sound recordings to the public;
- perform the copyrighted work publicly by means of a digital audio transmission.*

* (recent 1995 amendment from the Digital Performance Right in Sound Recordings Act – DPRSA)

In addition, owners of sound recordings have the ability to sue parties who illegally copy and sell their recordings.

Copyright Infringement

Chapter 5 of the Copyright Act describes what is actionable as copyright infringement.

(a) Anyone who violates any of the exclusive rights of the copyright or who imports copies of phonorecords into the United States in violation of section 602, is an infringer of the copyright or right of the author, as the case may be.
(b) The legal or beneficial owner of an exclusive right under a copyright is entitled to institute an action for any infringement of that particular right committed while he or she is the owner of it.
(c) For any secondary transmission by a cable system that embodies a performance or a display of a work which is actionable as an act of infringement.
(d) For any secondary transmission by a cable system that is actionable as an act of infringement.
(e) With respect to any secondary transmission that is made by a satellite carrier of a performance or display of a work embodied in a primary transmission and is actionable as an act of infringement. [3]

There are several exceptions that are outlined including the exception of fair use.

Fair Use

In general the United States Copyright website states that "fair use of a copyrighted work, including such use by reproduction in copies or phonorecords or by any other means specified by that section, for purposes such as criticism, comment, news reporting, teaching, scholarship, or research, is not an infringement of copyright." [4] Section 107 also sets out four factors to be considered in determining whether or not a particular use is fair:

(1) The purpose and character of the use, including whether such use is of commercial nature or is for nonprofit educational purposes;
(2) the nature of the copyrighted work;
(3) amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
(4) the effect of the use upon the potential market for or value of the copyrighted work.

The distinction between “fair use” and infringement may be unclear and not easily defined. There is no specific number of words, lines, or notes that may safely be taken without permission. Acknowledging the source of the copyrighted material does not substitute for obtaining permission. Because of the ambiguity that lies between “fair use” and infringement, the argument of fair use arises often and is open to interpretation and arguments.[5]

A Historical Case - Sony v. Universal

A roller coaster ride of decisions took the Sony vs. Universal case through various courts. Universal argued that Sony was in violation of copyright infringement because Sony manufactured and distributed video tape recorders or VTRs that were used by people to copy television shows and other copyright material.

The District Court found that there was no copyright infringement stating [n]oncommercial home use recording of material broadcast over the public airwaves was a fair use of copyrighted works and did not constitute copyright infringement, and that petitioners could not be held liable as contributory infringers even if the home use of a VTR was considered an infringing use. [6] The 9th Circuit Court of Appeals found that there was copyright infringement. Then, the Court of Appeals reversed, holding petitioners liable for contributory infringement and ordering the District Court to fashion appropriate relief.” [7] Finally, the Supreme Court reversed the Appellate Court to agree with the District Court that there was no copyright infringement stating the sale of the VTR's to the general public does not constitute contributory infringement of respondents' copyrights. Moreover, the Act expressly provides that the sale of a "staple article or commodity of commerce suitable for substantial non-infringing use" is not contributory infringement. *35 U. S. C. ß 271*(c).
Like so many other problems created by the interaction of copyright law with a new

technology, "[there] can be no really satisfactory solution to the problem presented here, until Congress acts." *Twentieth Century Music Corp*. v. *Aiken, 422 U.S., at 167* (dissenting opinion). But in the absence of a congressional solution, courts cannot avoid difficult problems by refusing to apply the law. We must "take the Copyright Act . . . as we find it," *Fortnightly Corp*. v. *United Artists Television, Inc., 392 U.S., at 401-402,* and "do as little damage as possible to traditional copyright principles . . . until the Congress legislates." *Id., at 404* (dissenting opinion)."[8]

The Sony v. Universal case was a win for fair use. This decision cast in 1984 has – twenty years later – become THE CASE that many arguments and proposals have referred to and cited. New technology and copyright law are actually old friends who have previously met, argued and resolved their differences. Does the Internet and digital space really differ from past encounters? Author, Michael Einhorn, wrote in 2002 that copyright rules were written for an analog world not a digital world. Copyrighted files (including music) can be ripped (extracted), downloaded and streamed onto the Internet. "Digitalization" has enabled distribution of unauthorized and unprotected works and copying between hard drives. The cost of prosecution is prohibitive to most individuals and companies. Einhorn believed that there was a great disparity between current technology and the copyright laws that govern works.[9] But in the recent case of MGM v. Grokster (2004), Judge Sidney Thomas comments, the introduction of new technology is always disruptive to old markets, and particularly to those copyright owners whose works are sold through well established distribution mechanisms. History has shown that time and market forces often provide equilibrium in balancing interest, whether the new technology be a player piano, a copier, a tape recorder, a video recorder, a personal computer, a karaoke machine or an MP3 player."[10]

Peer to Peer – One Down, Many More To Blossom

Peer-to-Peer (P2P) is a term for technology that allows computer file sharing. Various individuals and companies have created software that enables a computer to search and share files from other 'software happy' computers. Since the development of P2P technology, two landmark cases have been decided.

A&M et. al. v. Napster

Major record companies sued Napster for copyright infringement. Judge Patel ruled for the plaintiffs and found Napster liable of contributory and vicarious infringement. The three elements required to prove a defendant liable under the theory of contributory copyright infringement are: (1) direct infringement by a primary infringer, (2) knowledge of the infringement, and (3) material contribution to the infringement. Three elements are required to prove a defendant vicariously liable for copyright infringement: (1) direct infringement by a primary party, (2) a direct financial benefit to the defendant, and (3) the right and ability to supervise the infringers. Judge Patel stated that Napster violated distribution and reproduction rights and knowingly encouraged and assisted infringement of plaintiff's copyrights. Napster was enjoined and immediately ordered to shut down. Napster technology used a central computer to track its users and find songs that were available for download. The ruling for the plaintiffs was a victory for record companies and bought them some time to deal with this major technology shift. But tech savvy innovators learned from Napster's downfall and developed new versions of P2P technology that worked within the law.

Metro-Goldwyn-Mayer Studios et. al. v. Grokster, Streamcast and KaZaa

Motion picture, record company and music publisher plaintiffs sued Grokster, Streamcast and KaZaa. Plaintiffs argued that these software manufacturers should be held liable for the illegal acts of its users claiming that the companies knew about the copyright

infringement and contributed to this activity. Judge Steven V. Wilson, United States District Court granted summary judgment for the defense on April 5, 2003. The 9th Circuit Court of Appeals unanimously affirmed the District Court's decision on August 19, 2004. The victory for P2P is a great signal of encouragement for these software developers. Michael Weiss, chief executive of StreamCast, stated, " Not only is today's ruling a victory for our fellow developers, a victory for American innovation and, perhaps more importantly, history will prove this to be a bigger win for the entertainment industry."[11] Mitch Bainwol, CEO of the Recording Industry Association of America (RIAA), stated "This decision does nothing to absolve these businesses from their responsibility as corporate citizens to address the rampant illegal use of their networks. We will continue to pursue legislative solutions and legal actions to address the ongoing illegal activity facilitated by Grokster and other P2P services."[12]

Suing Your Customers

The RIAA's reaction to P2P remains an emphatic cry of 'make it stop'! In order to protect the interests of their members' property, the RIAA filed lawsuits against over 3,400 individuals who used P2P services to illegally download copyrighted material. This big stick approach has been met with major criticism from digital frontrunners and people within the industry alike. "Suing your customers is not a winning business strategy. Industries have a completely different strategic relationship with customers than they do with rivals. And this sort of strategy does not play well in the court of public opinion."[13] One record retail representative said, "Suing our customers was the dumbest thing the Industry has done."

After years of development, several companies now offer consumers licensed music through timed download, permanent download and streaming technology but the RIAA continues to file lawsuits using the 'John Doe' tactic. "There is an incredible array of legitimate digital distribution models serving today's music fans," said Cary Sherman,

President, RIAA. “For these new business models and those in the future to succeed, there must be a return on the investment in art. That’s why it’s essential that we continue to send a clear message that stealing copyrighted works is against the law and has consequences. The lawsuits have been extraordinarily effective in providing a measure of deterrence and educating the public about the law and the availability of great legal alternatives.” [14]

But has the music industry ever thought about being a music consumer or stepped into the shoes of a music consumer? Has the industry really ever treated its customers well? Taking a step back, it looks like consumers have put up with a lot of bad business - years of inflated CD prices, exorbitant concert ticket prices laced with many surcharges and now thousands of lawsuits filed against the very people who just want to listen to music in the first place. Is there any wonder why the public is disgruntled with the music industry?

Anteing Up In The Digital World

In 1995, the Digital Performance Right in Sound Recordings Act (DPRA) amended the Copyright Act by allowing sound recording copyright owners the right to be paid public performance royalties for digital audio transmission (“webcasting”) and digital phonograph delivery (downloads). In other words, for the first time, record companies would get paid for the use of their copyrighted material in this manner. In July of 2002, the Librarian of Congress set the final decision of rates and terms for webcasting and ephemeral recordings (see table next page).

Summary of the Determination of the Librarian of Congress on Rates and Terms for Webcasting and Ephemeral Recordings [15]

Type of Service	Performance Fee (per performance)	Ephemeral Fee
Simultaneous Internet retransmission of over-the-air AM or FM radio broadcasts	.07	8.8% of performance fees due
All other Internet transmissions	.07	8.8% of performance fees due
Non-CPB, Non-Commercial Broadcaster	.02	8.8% of performance fees due
Non-Commercial Simultaneous Internet retransmissions of over-the-air AM or FM broadcasts	.02	8.8% of performance fees due
Archived programming subsequently transmitted over the Internet, substituted programming and up to 2 side channels	.02	8.8% of performance fees due
Transmissions on any other side channels	.07	
Business Establishment Service (background music service)	Statutorily Exempt	10% of Gross Proceeds
Minimum Fee for Business establishment Service (background music service)		$10,000
Combined Minimum Fee for all other Services (Performance and Ephemeral)	$500 for each license	$500 for each license

*View actual chart at http://www.copyright.gov/carp/webcasting_rates_final.html

The outline of statutory “webcasting” fees has helped to structure a portion of music sales in the digital space. But what about music that is legally accessed over the Internet through limited/timed downloads, streaming and permanent downloads? Should the licensing costs being set by the government or should the costs be negotiated in the marketplace? This question is currently up for debate and requires a quick view of licensing.

Composers and publishers issue various license for their musical work as listed:

Mechanical License

- Recorded, reproduced and sold in physical format (tapes, C D s, DVDs)
- Recorded and sold as a permanent download
- Used as a segue in a radio or television show
- Sampling

Synchronization or Synch License

- Used in film, television, video or video games
- Used in commercials (advertising)

Performance License

- Performed publicly on radio, television, concerts, webcasting, Internet, clubs, retail stores or other form of media

Sheet Music License

- Sold as sheet music

Compulsory Mechanical License (This form of license only exists in the United States and Australia)

- Once a composition is published (sold to the public), publishers or composers must issue a compulsory mechanical license to record companies. The record companies must pay a statutory or negotiated rate to publishers for each recording sold and paid for by consumers.

As previously stated, music that is "webcasted" is subject to a statutory fee and treated under a performance license. But some contend that the application of statutory rates has stunted the growth of webcasting. The recent history of the webcasting license indicates that even where legislation allows for negotiation between parties in determining the rate, the final result is highly susceptible to lobbying interest and may put significant restraints on the expansion of the market.[16] Now, there are many lobbyists that are arguing about how a mechanical license should be applied to streaming, temporary and permanent downloaded music.

Legal Advocacy Groups (See Appendix A for specific members)

There are many lawyers, lobbying groups, civil rights activists and technology frontrunners that have a vested interest in amending the copyright act or creating new copyright laws. The beauty about a true democratic process is that everyone has a say. The main constituencies involved with the process that is playing out in Washington D.C. are as follows:

RIAA – Recording Industry Association Of America is a trade organization that represents the United States Recording Industry. www.riaa.com

DiMA – The Digital Media Association. DiMA is a national trade organization devoted primarily to the online audio and video industries, and more generally to commercially innovative digital media opportunities. www.digmedia.org

CERTA - Coalition of Entertainment Retail Trade Associations consisting of DiMA, Interactive Entertainment Merchants Association (IEMA), National Association of Recording Merchandisers (NARM), National Association of Theatre Owners (NATO), and Video Software Dealers Association (VSDA). CERTA represents over 3,000 entertainment retailers and exhibitors who operate more than 50,000 movie theaters, home video and music stores, video game stores, online music sites, and other retail entertainment establishments. www.digmedia.org

EFF – Electronic Frontier Foundation. Based in San Francisco, EFF is a donor-supported membership organization working to protect our fundamental rights regardless of technology; to educate the press, policymakers and the general public about civil liberties issues related to technology; and to act as a defender of those liberties. Among our various activities, EFF opposes misguided legislation, initiates and defends court cases preserving individuals' rights, launches global public campaigns, introduces leading edge proposals

and papers, hosts frequent educational events, engages the press regularly, and publishes a comprehensive archive of digital civil liberties information at one of the most linked-to websites in the world: http://www.eff.org.

P2P United – P2P United is the unified voice of the peer-to-peer ("P2P") technology industry's leading companies and proponents. (P2P technology consists of software that allows individual Internet users to efficiently search for and exchange information stored on users' computers.) P2P United represents and champions the P2P industry and technology to policy makers, opinion leaders, the media and the public in the United States, Europe and around the globe. www.p2punited.org

Issues On The Table

Section 115 of the Copyright Act

Section 115 has to do with mechanical licensing of music. In this section, a compulsory mechanical license is required when music is sold. As previously described, publishers issue a compulsory license to record companies (owners of sound recordings) who in turn must pay a statutory or negotiated rate for the use of the musical work. The statutory license applies to the making of the phonorecord, and only with respect to the musical work. But in 1995, with the passing of the DPRA, the owners of sound recordings were granted an expansion of rights that allowed the performance of the copyrighted work publicly by means of a digital audio transmission and the right to digital phonograph delivery (DPD) of BOTH sound recordings AND musical works (as long as it received permission from copyright owners). DPRA defines a DPD as follows: A "digital phonorecord delivery" is each individual delivery of a phonorecord by digital transmission of a sound recording which results in a specifically identifiable reproduction by or for any transmission recipient of a phonorecord of that sound recording, regardless of whether the digital

transmission is also a public performance of the sound recording or any non-dramatic musical work embodied therein. A digital phonorecord delivery does not result from a real-time, nonintegrated subscription transmission of a sound recording where no reproduction of the sound recording or the musical work embodied therein is made from the inception of the transmission through to its receipt by the transmission recipient in order to make the sound recording audible.[17]

The introduction to the CERTA website states that on April 28th, 2004 CERTA launched on Capitol Hill, as more than 40 member companies visited thirty-five Congressional offices to promote Congressional action to curb piracy of entertainment content. CERTA urged Members of Congress to expand consumer education initiatives, promote anti-piracy enforcement, and support innovative and legal businesses that offer alternatives to piracy. CERTA members specifically promoted modernization of music publishing laws, particularly Section 115 of the Copyright Act, which is a key initiative of DiMA and NARM.[18]

Section 115 of the copyright law was written over 100 years ago to prevent monopoly and foster creativity. It was meant to streamline the process of getting permission from every copyright holder if someone wanted to mechanically reproduce a song. Today, the main question is should the compulsory license be applied to digitally transacted music. Music publishers say yes and online music companies say no. The contention comes down to payment as well as administrative time.

Jonathan Potter, the executive director of DiMA, recently testified to the Senate about his organizations' stand: Unfortunately, Section 115 is not very useful to online services, because (i) the licensing process is unworkable for digital music services; and (ii) its ambiguous scope causes uncertainty, risk, and excessive double-dip royalty payments. Potter continues to say that applying the license is dysfunctional due to outdated systems,

pricing standards that do not work with the digital model and overly harsh penalties. There also are disagreements on if and how the license should be applied to on-demand Internet radio, subscription services and various types of download options. [19]

Remember copyright holders of musical works and copyright owners of sound recordings, have distinctive rights in the analog world. But with the passing of DPRA, some believe these rights have become commingled in the digital space. Part of the problem with applying this license is defining a reproduction in regards to a digital phonograph delivery. Mary Patterson, the register of copyrights, frames the issue: In 1995 when Congress passed the DPRA, its intent was to extend the scope of the compulsory license to cover the making and distribution of a phonorecord in a digital format - what Congress referred to as the making of a digital phonorecord delivery. Since that time, what constitutes a "digital phonorecord delivery" has been a hotly debated topic. Currently, the Copyright Office is in the midst of a rulemaking proceeding to examine this question, especially in light of the new types of services being offered in the marketplace, e.g. 'on-demand streams' and 'limited downloads.' *See* 66 FR 14099 (March 9, 2001)…Under the expanded license, a service providing DPDs can in effect become a virtual record store if it is able to clear the rights to the sound recordings. More importantly, the DPRA allows a copyright owner of a sound recording to license the right to make DPDs of both the sound recording and the underlying musical work to third parties if it has obtained the right to make DPDs from the copyright owner of the musical work. See 17 U.S.C. §115(c)(3)(I), S. Rep. No. 104-128, at 43 (1995). The difficult issue, however, is identifying those reproductions that are subject to compensation under the statutory license… The critical question to be decided is whether an on-demand stream results in reproductions that reasonably fit the statutory definition of a DPD, and creates a "phonorecord by digital transmission of a sound recording which results in a specifically identifiable reproduction by or for any transmission recipient," as required by

law. Unless it does so, such reproductions cannot be reasonably considered as DPDs for purposes of Section 115, no matter what position private parties take within the four corners of their own agreement. What is more clear is that the delivery of a digital download, whether limited or otherwise, for use by the recipient appears to fit the statutory definition, since it must result in an identifiable reproduction in order for the recipient to listen to the work embodied in the phonorecord at his leisure. "[20]

Technology is moving so fast that laws created five years ago need clarification. There are many ways to obtain music digitally - stream, on-demand stream, limited/timed downloads or permanent downloads. And there will probably be more options in the future. A simple table provides a brief overview of where record companies and music publishers stand on the issue:

	Permanent Downloads	Limited Downloads	Streaming	On-Demand Streaming
Record Company	Agrees compulsory license comes into play but argues that compulsory license is not consistent with global policies.	Believes entire process is subject to compulsory licensing	Believes that because this form of delivery is licensed as public performance, it should be exempt from statutory license	Believes entire process is subject to compulsory licensing
Music Publishers	Believe that copies made and DPD require compulsory license	Believe that copies made and DPD each require compulsory license	Believe that this form of delivery should be subject to statutory license	Believe that copies made and DPD each require compulsory license

The copyright office has addressed legal and technical issues associated with Section 115 and has provided several options to the Senate to review. As of this writing, no decisions have been made on the issue.

There is no question that Section 115 needs clarification and a streamlined process, but it is important to keep in mind that a balance between copyright holders of musical works and sound recordings must be met. The law should not be amended so there is an advantage to any one party and it is vital that the copyright office balance the interests of

music publishers, record companies and artists while supporting the development of on-line music trade.

Inducing Infringement of Copyrights Act of 2004, S 2560

On June 22, 2004, Senator Orrin Hatch and members of the Senate Judiciary Committee proposed a bill that would make it a federal crime to "induce copyright infringement". In the Senator's own words: Senator Leahy and I introduced S. 2560, the Inducing Infringement of Copyrights Act. The Act provides that the courts can impose secondary liability upon those who intend to induce copyright infringement. We developed this approach with the help and support of leading technology companies. We want to continue to work with interested parties to make refinements that will help us achieve the bill's intent. The approach taken in S. 2560 is intended to have three key attributes. First, S. 2560 is technology neutral…Second, S. 2560 uses a proven model for structuring secondary liability…And third, it is our intent that S. 2560 change the law of contributory liability only for a very narrow class of defendants." [21]

The actual bill reads as follows: (1) In this subsection, the term 'intentionally induces' means intentionally aids, abets, induces, or procures, and intent may be shown by acts from which a reasonable person would find intent to induce infringement based upon all relevant information about such acts then reasonably available to the actor, including whether the activity relies on infringement for its commercial viability.(2) Whoever intentionally induces any violation identified in subsection (a) shall be liable as an infringer. (3) Nothing in this subsection shall enlarge or diminish the doctrines of vicarious and contributory liability for copyright infringement or require any court to unjustly withhold or impose any secondary liability for copyright infringement.[22]

There are many people against the bill including members of the Electronic Frontier Foundation. EFF states on their website: the Induce Act is a nasty, brutish stick in the hands

of the wrong plaintiff…Under the Supreme Court's ruling in Sony v. Universal (the Betamax VCR case), devices like the iPod and CD burners are legal as long as they have legal uses —what the Court called "substantial non-infringing uses." This has been the rule in the technology sector for the last 20 years. Billions of dollars and thousands of jobs have depended on it. Industries have blossomed under it… Now Senator Hatch and his allies want to tear down that rule and substitute a new one with the Induce Act. With it, the fact that a device or product has legal uses, even lots of them, is irrelevant. Filing a lawsuit under the Induce Act is like dropping a litigation bomb on any company that gives users products that have even the slightest potential to assist in copyright infringement. Technology companies will avoid being innovative, and investors will avoid supporting new technologies for fear of being sued out of existence based on the possible conduct of their customers. If this bill had been law in 1984, there would be no VCR. If this bill had been law in 1995, there would be no CD burners. If this bill had been law in 2000, there would be no iPod. If this bill becomes law in 2004, we may lose those devices and many more that we haven't even begun to imagine."[23]

As I write this, there is a major lobby from the Consumer Electronics Association (CEA) as well as from Google, Yahoo and Verizon requesting a new draft of the bill. The Senate Judiciary Committee is not expected to vote on the bill during its current session.

"Money, money changes everything"
Written by Tom Gray and Performed by Cyndi Lauper

ECONOMICS OF THE MUSIC BUSINESS

An Oligopoly Of Music

For years, the music business has been an oligopoly. The market has been dominated by the 'majors'. The 'majors' are record label groups that have their own distribution networks and their sales account for 75%-80% of the pre-recorded music market share. In the mid-1980s, there were six major distribution companies – BMG, WEA, EMI, Sony, Uni and PGD. Each distributor had labels that provided product under its umbrella. For example, BMG distributed Arista and RCA, WEA had Warner Brothers, Elektra and Atlantic (hence WEA), EMI moved Capitol, SBK and Chrysalis, Sony sold Columbia and Epic, Uni (Universal) had MCA, A&M and Geffen and PGD consisted of Polygram, Mercury and Deutche Grammaphone. Keep in mind that these are just some of the dozens of record labels that produced product for distribution.

Over the past 15 – 20 years, the industry has gone through mergers, acquisitions and divestures. Universal merged with Polygram to create Universal Music. Then, Universal was sold to the French telecom company, Vivendi to become Vivendi Universal. And now, Vivendi Universal has sold most of its entertainment assets including its movie and television units to GE/NBC while still retaining a 20% stake. This leaves Vivendi Universal still holding on to its music unit, Universal Music Group, with possible plans to sell. EMI has been for sale for several years but regulation and other issues have prevented a change of hands. AOL/Time Warner divested from music by selling Warner Music to Edgar Brofman and other private

investors. And BMG is in the process of merging with Sony to create a new company called Sony-BMG. So as of October 2004, the 'major' record industry landscape consists of Sony/BMG Music, Universal Music Group, EMI and Warner Music Group. The former three are publicly traded companies while Warner Music Group is privately held and considered the biggest 'indie' or independent record label.

The balance of the industry is made up of independent record companies. These companies are able to develop product that caters to a niche market. Indies can sign and develop bands that have been passed over by the major labels. The independents don't have the bargaining power of majors but are able to sustain their business by keeping down overhead and marketing costs. But the indies run a higher level of risk. If a record does not sell enough units to cover its investment, it is very difficult for indies to recover from those costs.

The recent mergers, acquisitions and divestures indicate major economic changes in the music industry. But before we study the changes, we first need to take a look at the traditional activities and traditional economics of the industry. The music industry is made up of so many facets that books have been written on the subject but for the sake of this paper, I have provided a simplified list:

- Record companies invest in an artist's sound recording, manufacture product and market and promote sound recordings to the public.
- Distributors maintain inventory, ship product to retailers and support sales campaigns.
- Artists (may) write music and own musical works, record music, tour (perform live), manufacture and sell merchandise as well as market and promote their art.
- Traditional (brick & mortar) retailers stock product from record distributors and then sell sound recordings (CDs) to consumers providing customer service and pricing.

- Music publishing negotiates, licenses, collects and distributes fees for musical works used in TV, film, compilation projects and sampling. Publishers also collect and distribute mechanical royalties for records sold.
- Performance rights companies monitor airplay of radio, TV, stadiums and clubs for public performance of musical works and then collects and distributes fees to artists and publishers.
- Concert promoters book artists for live performances, promote and advertise the show and then sell tickets and other items (food, drinks, etc.) to concertgoers. Promoters pay artists generally by either a flat fee or a percentage of ticket sales.

Diagram A shows the activities of the music industry starting with the artist (left) and moving to the consumer (right). Diagram B shows the economics of the music industry beginning with the consumer (right) and moving back to the artist (left). The main focus of this paper targets the areas highlighted in yellow – artist, record company, distributor, retailer and consumer.

Diagram A - Activity In The Music Industry

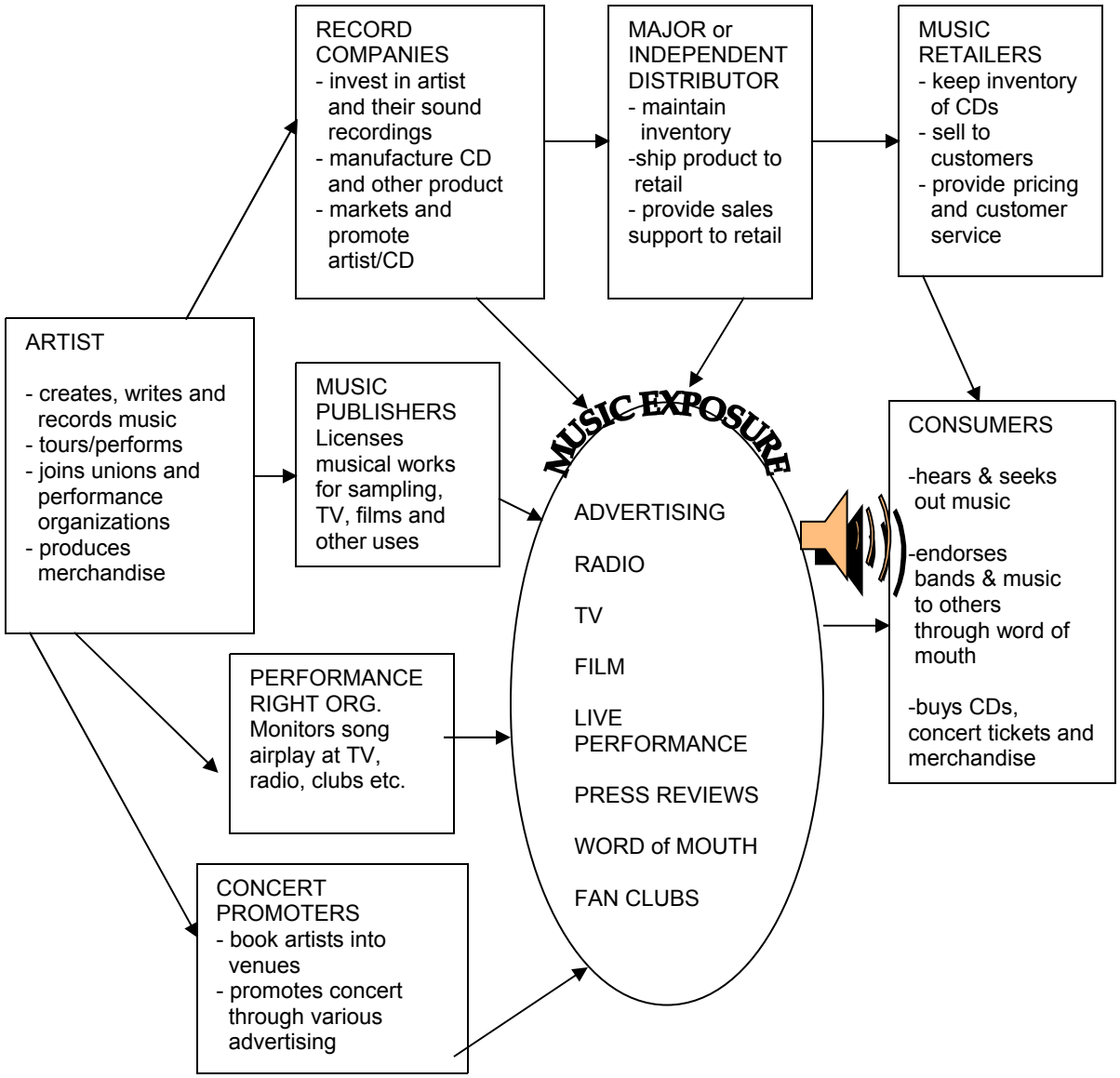
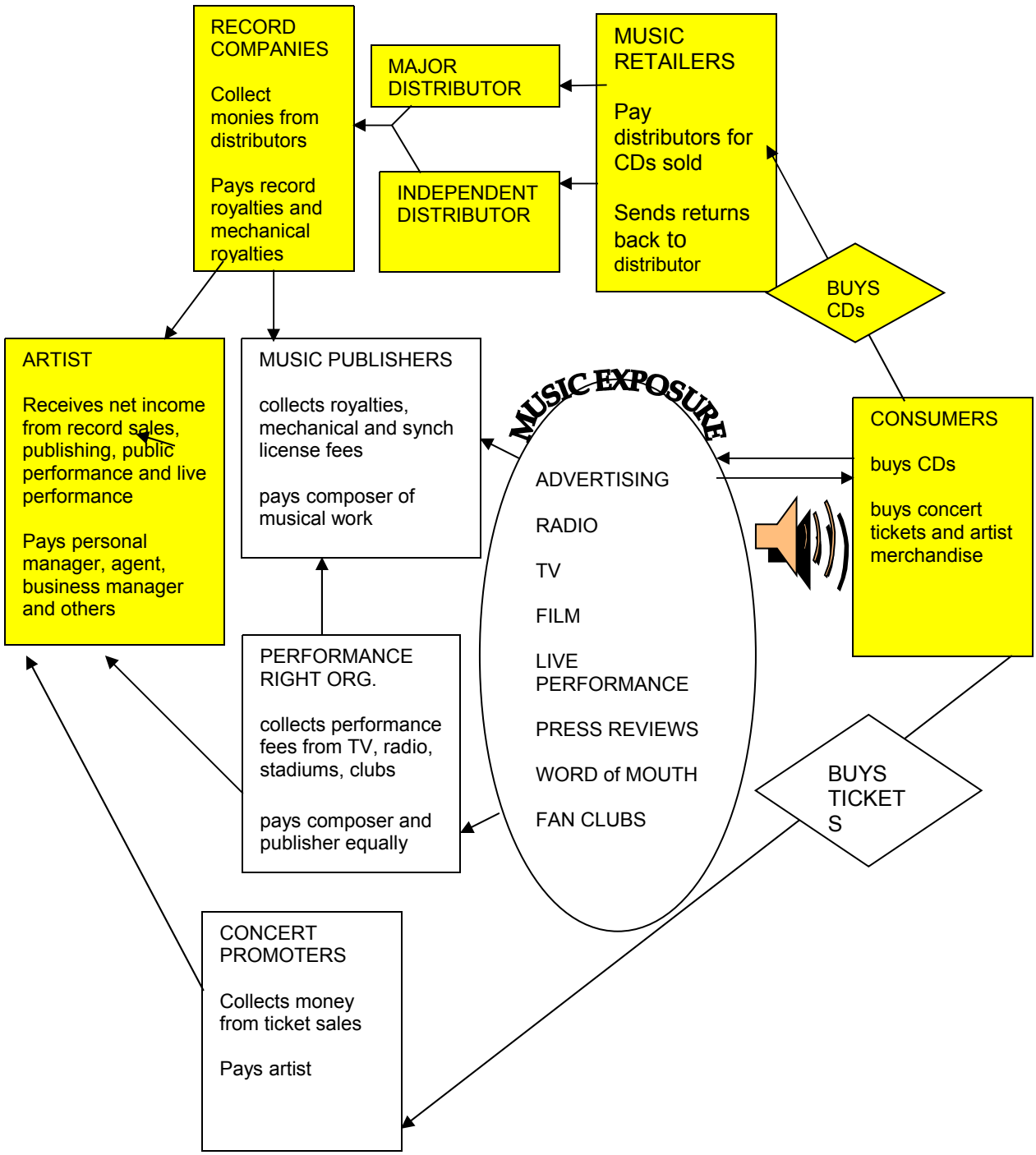


Diagram B – Traditional Economics Of The Music Industry



Burke explains the record company market as having high minimum efficient scale (MES)[24]. Economies of scale that cause MES to be high exist in manufacturing, distribution, marketing, finance and speed to market. The size of a major record label enables it to have a quantity advantage in manufacturing and distribution, a bargaining advantage for placing advertisements, a reduced exposure to risk when investing in new or developing artists and systems that create a speed to market of CDs necessary for the short product life cycle.

Majors have been able to maintain their oligopolistic status through economies of scale previously discussed but also because they have more resources to bid on new artists, provide attractive advances (of royalties) to an artist and invest in the recording process. Therefore, young talents are wooed by the deals offered from majors in comparison to deals offered by independents. But majors also act very competitively when it comes to new talent and their motives have been criticized for not being in the artist's best interest. Majors may sign or bid up for new artists in order to prevent cannibalization of sales from its current roster thus preventing the competition from gaining any market share.[25] The record companies use various tactics to de-prioritize a record, putting minimal effort behind the roll out, marketing, and promotion of the project. Therefore, a project gets lost in the shuffle and eventually the artist gets dropped from the roster. Of course, record companies usually deny this practice arguing that it already cost the companies money. Sunk costs during the bidding or signing phase are a fraction of the actual commercialization of an artist. In order to move the artist to the next phase, the record company faces recording costs and marketing costs that can significantly impact its bottom line.

EMI and singer, Mariah Carey offers a prime example of the bidding and commercialization issue. Mariah Carey sold millions of records while she was signed to Sony Music. She then left Sony and a bidding war to sign her ensued among all the major labels. In 2001, Virgin Records – a division of EMI – signed Mariah Carey for $80 million (U.S.) over 5 years. This was one of the most expensive contracts in record company history. Virgin released the soundtrack to *Glitter,* a movie starring Carey. The album was a disappointment, only selling 2 million (compared to sales of 20 million at the height of Carey's career) and the movie did very poorly at the box office. By January 2002, with Internet piracy and a slump in record sales industry-wide, EMI decided to cut its losses. *BBC News* reported that at the time Carey was signed, the label was criticized for paying over the odds for the singer, which some critics saw as a fading star. In recent months, Alain Levy, the head of recorded music at EMI, has been looking to cut costs. [26] EMI/Virgin paid Mariah Carey $28 million to end her recording contract. After reviewing the cost involved, it was prudent to pay Carey now instead of investing in the commercialization over five years with adjustment for inflation.

Baumol's "cost disease" describes productivity lag in the arts. Baumol points out that costs rise relative to the economy mainly due a continuing increase in wages but productivity improvement lags behind.[27] In the case of Mariah Carey's recording process, Virgin would have been faced with years of wage increases for songwriters, producers, studio musicians, back up singers, engineers etc. and the end result would be the same, 12 to 15 completed songs. So while the old adage of "you can't rush art" holds true, record companies can stop a recording artist in her tracks by paying out contracts, dropping bands or suspending artists' careers with years of 'development'.

A Powerful Shift

The ability to find and download songs with ease through the use of a computer put the music industry in a panic. The traditional economic model started to break down with the advent of this technology.

Traditionally, record companies would capitalize on the popularity of one song by making the song available only through a purchase of a full length CD. So if a consumer heard a song on the radio and went to a record store with the intention to purchase that one particular song, she would be faced with one choice - a full length CD. The CD usually contains 12 – 15 tracks and costs $15 to $18.

Napster was able to change the music transaction experience overnight. With the creation of a file sharing program, music fans were able to hear songs that interested them, and then, instantly download songs that they liked best onto their hard drives. Market power shifted from the sellers (record companies) to the buyers. It was a dramatic change. Music fans had options and they did not have to put up with limited format, high prices or stale record store environments. The record industry sued Napster and they were eventually ordered to shut down - but the business has never been the same.

Previewability is probably the most important revolution in recent music. Despite what the RIAA would have you believe, the shifts the industry has witnessed haven't been a matter of *quantity* as they've been a matter of *quality*. People are making their purchasing decisions less on the basis of hype and blind faith and more on the basis of what they actually enjoy listening to.[28]

This power shift literally rocked the economic foundation of the industry. 'Previewability' has minimized a consumers search costs. The use of Internet music sites and peer-to-peer software has created a virtual supply of music not limited to

physical shelf space or under-stocked inventory. Consumers are able to purchase music a la carte or on a song-by-song basis with a comfortable average price point of 99 cents per track. And most importantly, the Internet allows the consumer the power to become educated about the product (in this case the song or artist) before her investment and therefore, decides with confidence to make the purchase.

If we take a look at our activity (A2) and economic model (B2) with the assumption that consumers will obtain music via the Internet, there are some interesting changes. Certain industry players take on new roles while other activities shift to on-line music companies and a few responsibilities even get completely eliminated.

Diagram A2 - Activity In The Music Industry

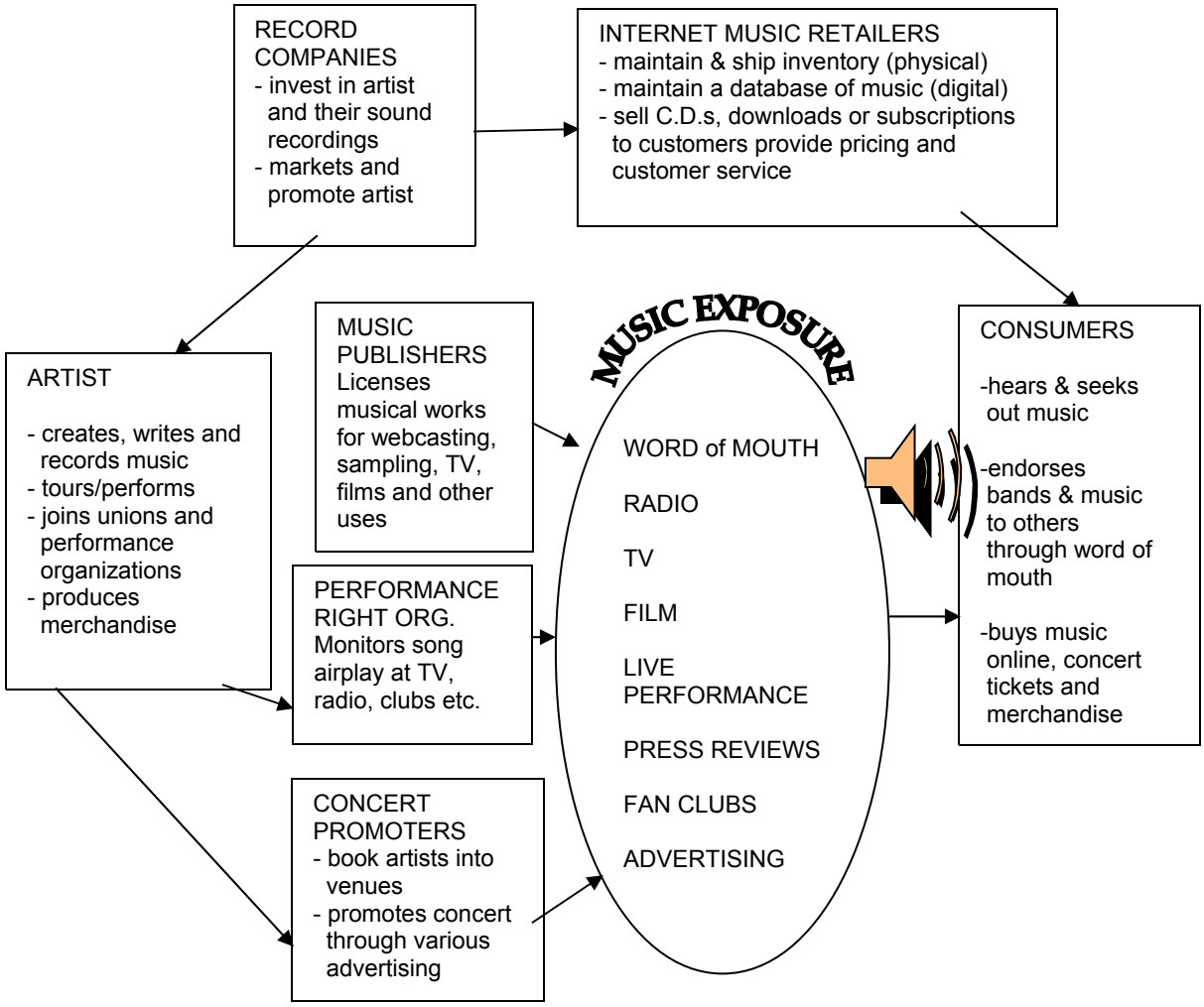
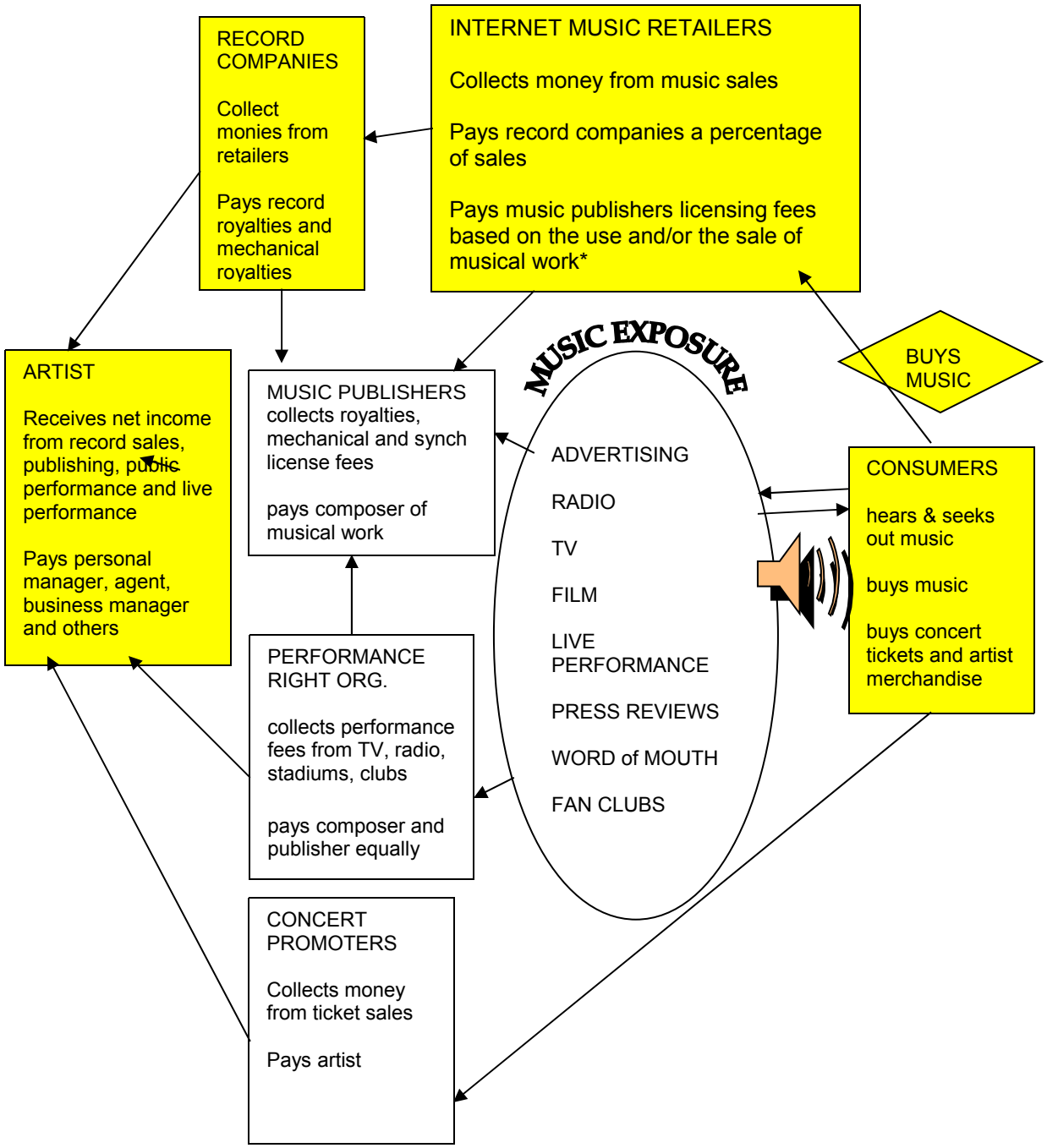


Diagram B2 – New Economics Of The Music Industry



*Note: Currently, there is a debate on whether compulsory licensing should be expanded to digital phonograph deliveries of sound recordings in addition to the musical work. The outcome will affect online music companies' payments to copyright holders.

Recording companies retain the role of investing in an artists' sound recording

as well as marketing and promoting the artist. But the role of manufacturing and distributing (if a major) physical records is basically eliminated. The major labels have consolidated their manufacturing and distribution arms since the volume of CD sales overall has decreased. Artists deemed superstars in the past, garnered sales of 10 million but now popular artists sell only 3-4 million. The London-based EMI Group announced on March 30, 2004, that the manufacturing portion of the 40-year-old facility in Jacksonville (Illinois) would close by the end of May, putting 434 employees out of work. The manufacturer of compact discs, DVDs and cassettes will be contracted out to Cinram International Inc., which has a manufacturing plant in Richmond, Indiana. EMI said the warehouse and distribution center at the 375,000-square-foot facility in Jacksonville will remain open, with approximately 150 employees to remain on the job. [29]

Traditional music retailers for the past years have also gone through consolidation. Best Buy acquired Musicland (Sam Goodys) but closed many stores. Transworld closed its Coconuts outlets and shut down most of its Wherehouse acquisition. The company remains in the market with some FYE outlets. Meanwhile, Tower Records has filed for bankruptcy protection.

Online retailers take on the manufacturing (in some cases), distribution and sales of music. Music retailing sites such as Rhapsody and I Tunes music "manufacture" or format the music files, distribute the file via their database and then sell the song using Internet based transactions. Customers have many choices on how to purchase music whether it be streaming, on-demand streaming, limited download or permanent download.

Burke explains that digital distribution of music creates a low minimum efficient scale by eliminating the need for manufacturing, reducing the per unit cost for

distribution online and marketing more efficiently with the use of consumer profiles. As sales of music shift offline to online it will cause a de-concentration in the record company sector and Indies (independent record labels) will be able to bid for talent in a level playing field. Artists will vertically integrate; starting their own record companies and the Majors ability to offer more to an artist compared to an Indie is greatly reduced. Artists will outsource functions provided by record companies and create a different industry composition. [30]

In fact, there are currently many artists who have vertically integrated their business, including Ani Difranco's label, Righteous Babe and Jimmy Buffet's label, Margaritaville. By operating their own record labels, artists fund their studio records themselves without going into debt to a large corporate record company. Also, artists control any promotional and marketing costs instead of experiencing exorbitant charge backs from a major. All revenue generated by sales goes directly to an artist.

Digital distribution creates more buying power for consumers. Burke points out that there is a reduction of 'search cost' for the consumer (buying unknown product and time spent listening). With music services such as I Tunes, there is a tremendous increase of music titles available to consumers and an increase of consumer choice. Due to the ease of searching and previewing songs combined with an acceptable market price, consumers will probably purchase a wider variety of music and actually spend more money per year on music purchases than in the past.

If the industry is paying attention and reshapes their business practices to become more efficient in a digital marketplace, money is there to be made. Heilbraun examined Baumol's cost disease and offered suggestions on how to increase productivity. First, increase capital per worker, improve technology, increase labor skills, provide better management and create economies of scale as output

increases.[31]

There are indications of Heilbraun's plan taking shape at Universal Music. According to Business Week Online, Universal's CEO, Doug Morris, is focused on strengthening his executive team with industry veterans including Sylvia Rhone (Elektra), Tommy Mottola (Sony), Polly Anthony (Epic) and Jimmy Iovine, currently with Interscope/Universal. "There has never been a company like this," says Morris, "I want to stockpile talent." Universal also plans to complete $300 million in costs cuts including marketing and video shoot budgets. In addition, parent company Vivendi is said to be offering CEO, Doug Morris a five-year deal worth $70 million.[32] Cutting costs and retaining talented managers is necessary but management alone can't increase productivity if they continue to run the industry using an antiquated mindset.

Record companies need to dramatically change their business process and create a unique position in order to thrive in the marketplace. Companies need to evaluate the internal and external environment to develop a clear strategy. One factor to examine is the album format. If the album format does go away, what would change? I think it would cause a domino effect starting with artist advances, the studio recording process, the artists' approach to creating/delivering music to a label, the 16-week record release schedule, "going for adds" at radio, shipping to retail as well as the promotional tours and more.

Early online consumer reports indicate that consumers are song oriented. As discussed, the buyer now has more power in the music marketplace. Through the use of the Internet there will be an increase of per song sales (not albums). This should be taken as an opportunity for the music industry and not a threat.

"Ch -ch,- ch,- ch, changes (turn and face the strain), ch-ch-changes
Oh, look out you rock n' rollers" – Written and Performed by David Bowie

I. MARKET ANALYSIS

Ignoring The Hand That Feeds

The music industry has alienated its customers thru its business practices and its legal actions. For years, record companies only offered full length CDs for sale – leaving customers with no other option – a force feeding, if you will, of music. Record retailers have created unfriendly shopping environments with rude and unhelpful staff. The high price of CDs have made customers feel ripped off and have made them believe the music was not worth the money paid. The music industry's publicly played out legal actions against Napster, P2P companies and its own music fans, further disillusioned customers who view major record companies and the RIAA (trade group) as big, bad and the ultimate in corporate greed.

The industry has marketed to its consumers using mass-market tactics - methods that are not cost effective in today's marketplace. Record companies have invested money and human resources in support of this approach. Radio promotion teams work around payola (an old business practice of paying stations to play a song on the radio that is now deemed illegal) yet spend a tremendous amount of time entertaining radio program directors with sushi dinners and concert tickets in hopes of getting a song played on the radio. Millions of dollars and thousands of man-hours are dedicated to making videos that have a slim chance of getting airplay on MTV or VH1. Meanwhile, music television channels and radio stations across the country play music or videos that satisfy advertisers - not the music fans that tune in. *Fortune* recently reported on Clear Channel CEO, Lowry Mays' position. Ask Mays about what he does for a living and you won't hear much about

musicians or how to bring up ratings or who's the best DJ. Those things don't interest him much. Truth is, Mays isn't that passionate about what goes out over the airwaves. As long as his broadcasts sell ads, he's happy. "If anyone said we were in the radio business, it wouldn't be someone from our company," says Mays, 67. "We're not in the business of providing news and information. We're not in the business of providing well-researched music. We're simply in the business of selling our customers products." [33] In addition, record company sales departments work to take product orders, fluff up end cap displays and execute expensive promotional events at thinning music retail outlets. These efforts are not the most useful way to market to the current music consumer. *Purple Cow* author Seth Godin enlightens us: Virtually all breakthrough acts in the music business now are the result of blind luck (and a little talent). A band (brand?) captures the interest of a small group of sneezers, who tell their friends, and suddenly they've got a hit. Rather than accepting this, though, the music industry tries to manufacture hits the old way.[34]

As previously described, the market power has shifted from the sellers (record companies) to the buyers with the advent of digital downloading. The industry needs to quickly change its thought process and develop a business model that will keep up with consumer behavior and consumer demand. Godin continues his critique of the major record companies stating: For years, the record business has been dominated by a few major players, and they work hard to follow each other's lead. The (major) labels have similar pricing, merchant policies, contracts, and packaging, Each label avoids criticism by sticking with the pack. But when the market changes – when technology reshuffles the deck – the record labels are all in trouble. With no practice leading, no practice trying the unknown, they're trapped, panicked, and in serious trouble. Their trade organization, the RIAA, is spending millions of dollars lobbying Congress to get legislation to keep the world just the way it is. In the long run, of course, they'll fail. You can't keep the world the way it is, even if

you buy the influence of Congress.[35]

I believe that if record companies examine their environment and are willing to change and adopt a new strategy, success and profits are attainable. It is an exciting time of change and a time of great opportunity. In order to develop a strategy, we will first examine the music consumer using primary survey data and other published source materials. Then, we will analyze the music marketplace using 4 Ps, S.W.O.T. analysis, Porter's Five Forces and a scenario analysis created from primary survey data and interview sessions from industry executives. The conclusion of this section will recommend general strategic initiatives to create a sustainable business model centered by digital delivery and new technology.

Music Consumer Analysis

The music consumer is continually growing in taste, knowledge and sophistication. In order to gather primary data, a music consumer survey was conducted in the summer of 2004 with 41 participants resulting in the following (see Appendix B):

Age & Gender

- The pool consisted of 56.1% Male and 43.9% Female. The age majority fell between 25 – 30 years (34%) followed by 31 – 35 years (24%) and then 36 – 40 years (19.5%) with the remaining falling between 21-25 years or above 40. No one who took the survey was under 21 years of age.

Music Source

- Consumers find out about music in various ways and responded that FM Radio (78%) and Word of Mouth (73%) are the best sources. Trends of other music sources include Television (39%), Magazines (37%), Internet music sites (34%) and Internet Radio (26%).
- The #1 source for finding out about music is FM Radio.
- Consumers are most influenced to purchase music when they hear a song on the radio or when they hear the music itself (party, club, from a friend).

CD Format Still Viable

- The majority of consumers report that they buy music in CD format (78%) while the remaining (22%) do not. 46% report purchasing a CD within the past month.
- Best Buy and Tower (19%) were tied for the #1 place to buy a CD noted for price, selection and convenient location. Online stores such as Amazon.com (15%) came in second notably for convenience.
- The average highest price paid for a single full length CD is $14.00(USD)
- The average price that consumers view as a fair price for a single full length CD is $11.00(USD)

Downloads Rising

- 49% of those surveyed download music through the Internet with the majority male ranging 21-30 years.
- I Tunes (55%) is the #1 site for downloading music followed by Kazaa (45%).
- 25% of music downloaders paid $9.99(USD) for a full length.
- 45% of music downloaders paid $0.00 for a full length.
- 55% of music downloaders believe a fair price for a full length download is $10.00 (USD)
- 40% of music downloaders believe a fair price for a single download is $0.99 (USD)
- 50% of music downloaders have downloaded music within the past month.

Got MP3 Player?

- The majority of consumers surveyed (66%) do not own an MP3 player while the minority (34%) own an MP3 device.
- The average spent on an MP3 player is $306 with 64% owning an iPod brand.

In addition to the primary data collected, published information was gathered from

various sources to further study the music consumer.

Demographic

- The RIAA reported that the majority (26.6%) of music consumers are over 45 years followed by 15-19 years (11.4%) and 35 – 39 years (11.2%) and that
- Females lead music consumption at 50.9% with males at 49.1%.[36]
- The NPD Group reported that the average physical music buyer is 35 years with 46% male and 54% female and that
- The majority of people who download music files fall between 26 – 35 years with 56% male and 44% female. [37]

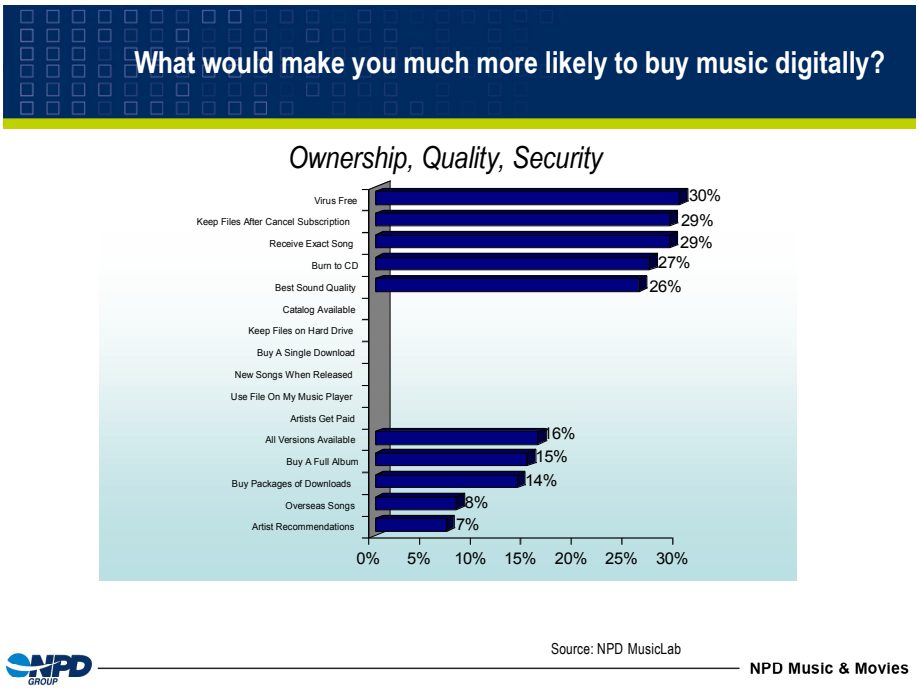
Behavioral

- NPD reports that 45% agree with the statement "It doesn't matter where I buy my music"
- 8 out of 10 digital music consumers also report purchasing physical product.[38]
- Consumer spending on recorded music in 1996 was $57.47 (per person per year USD) with an estimated growth of 13.7% to $66.59 by 2005. [39]
- The RIAA 2003 Consumer Profile indicates a shift of what format is being purchased and where music is being purchased.[40]

	1994	2000	2003
CD	58.4%	89.3%	87.8%
Cassette	32.1%	4.9%	2.2%
DVD/Audio	NA	NA	2.7%
Digital Download	NA	NA	1.3%

	1994	2000	2003
Record Store	53%	42.4%	33.2%
Other	26.7%	40.8%	52.8%
Internet	N/A	3.2%	5.0%

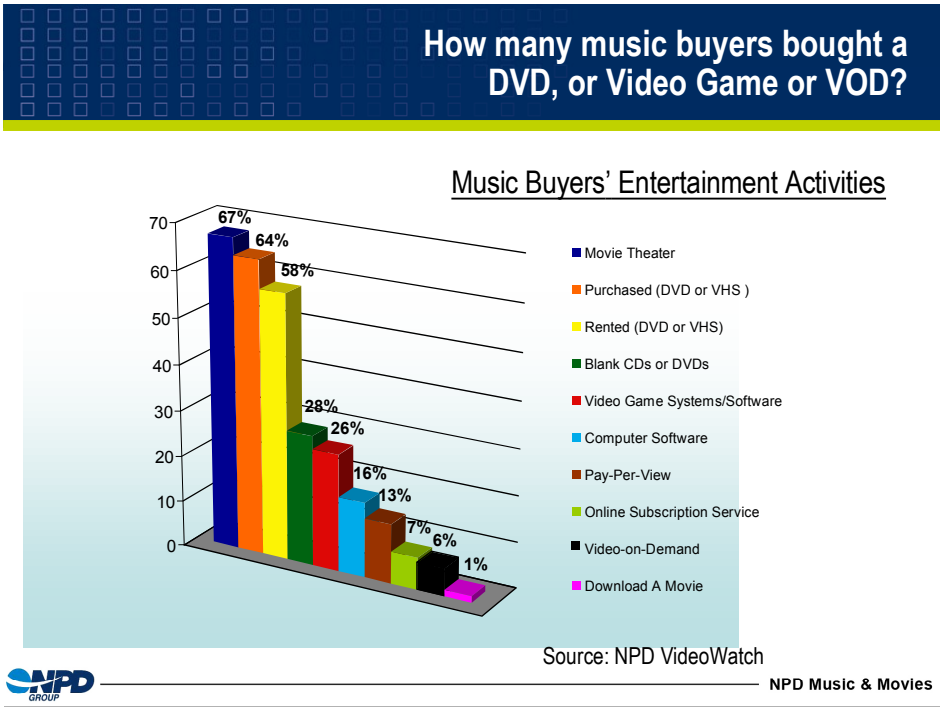
- NPD Group question shows that consumers value security and ownership if buying music digitally (see slide).



Slide used with permission from The NPD Group

Psychographics

- NPD Group reported that music consumers enjoy many forms of entertainment and that 52% of video game buyers also bought music.



Slide used with permission from The NPD Group

Consumer Portrait

Today's music consumers straddle both worlds of 'old school' CD purchasing and 'new school' downloading. Most consumers buy music on CD format after hearing a song played on the radio. Those who purchase CDs, consider themselves music collectors who feel the need to own physical pieces of music because they probably grew up collecting 45s and albums on vinyl. They also seem to appreciate the product as a whole – it's not just the music but the band, packaging, photos and overall artistry that they enjoy. But the consumer is indifferent as to where they purchase music and cites convenience as the strongest reason for purchasing at a store or online. Some of these 'old school' consumers are crunched for time and do not want to invest in learning new skills required for downloading or burning music.

The 'new school', downloading consumer tends to be primarily younger (25 – 36 years) and male (56%).[41] These consumers are tech-savvy and own computers with access to the Internet. The purchase or downloading of music is driven by hearing a song or by word of mouth not necessarily by being a fan of a particular artist. Music is viewed more as a commodity as there is indifference to who created the music. Music downloaders both purchase music and trade music with the use of P2P technology. These consumers also will be driven by the need to fill up new devices such as mobile phones and MP3 players with music and will actually spend a higher amount of money per month on music compared to 'old school' consumers.

In the future, both groups will exist but the 'new school' consumer will grow exponentially as the number of traditional music buyers plateau as they get older. If the price of CDs drop and distribution systems and purchase options grow, the CD market on a unit basis will expand. Digital downloading will be the primary source of

obtaining music but it is imperative that the industry develops customer loyalty and re-accesses a consumer value to music; otherwise sales will continue to slide and the darknet (a collection of networks and technologies used to share digital content)[42] and P2P will play a bigger role.

Music Industry Analysis

4Ps

Product

- Musical artists
- Physical format of recorded music -Compact Discs
- Digital format of recorded music - Music Files

Price

- $18.00 full length CD, $9.99 full length digital format
- $0.99 for one song digital format
- $0.00 or free due to P2P downloads or CD burning

Place/Distribution

- Major label owned distribution arms
- Independent distributors
- Digital delivery

Promotion

- Radio airplay
- TV/video play
- Internet
- Touring
- Publicity
- Traditional and Online advertising and promotions
- Licensing
- Partnerships

SWOT Analysis

Strengths

- music catalog
- developing artists
- marketing artists
- selling millions of product

Weakness

- antiquated business methods
- entrenched management
- not consumer oriented
- insular industry

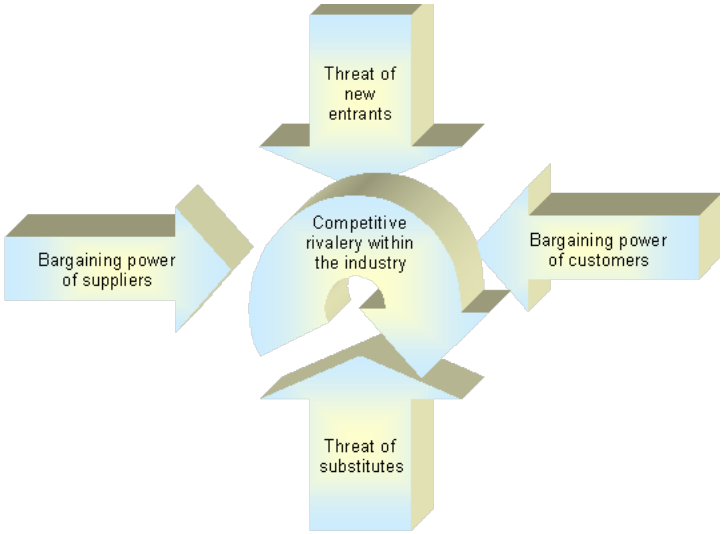
Opportunities

- build up music database
- develop new, sustainable talent
- create best practices and efficiencies

Threats

- illegal downloading
- darknet
- consumer hatred
- slow to adapt
- limited vision

Michael Porter's Five Forces



Industry Rivalry

The former "Big Six" (MCA, Polygram, Capitol, Warner Brothers, Columbia/Sony and BMG) have consolidated down to four companies - Universal, EMI, Warner Brothers and a currently merging Sony/BMG. The merger and acquisition activity over the past few years has beefed up company assets or music catalog at the great cost of human resources and cancelled artist contracts. Reuters reported that more than 2000 jobs at Sony BMG's worldwide operations were to be cut because of the merger.[43] The landscape now consists of less major record company players probably resulting in more independent systems releasing records.

Threat of New Entrants

With the shrinking of major record labels and major distribution systems in addition to the decrease of music retailers comes the entrance of new companies providing music. Since these companies won't be modeled after a record company, it would be incorrect to label them as indies so I will refer to them as new music

companies. There also are new entries on the B-to-B and the B-to-C level with online companies (I Tunes, Rhapsody, the reborn Napster etc.) taking over the distribution or digital delivery of music as well as the sales of music to consumers via the Internet.

Suppliers

Traditionally, suppliers of the industry include CD manufacturers and print houses (for artwork and CD booklets). Currently, CDs are still the mainstay of the music industry with 95% of music sold in this traditional format compared to music downloads that make up 5%. In addition, the sales of blank CDs are up. The bargaining power of CD manufacturers and print houses will decrease as the market moves towards digital orientation and affordable household color printers.

The new suppliers to the industry will be technology companies. Music files and other information will have to be maintained and housed. Record companies will need to invest in the infrastructure to build and protect their data or song banks.

Customers

As discussed, customers now have more bargaining power than ever. They are able to preview songs before purchase. There are also many options of how customers want to purchase music whether it is limited download, permanent download, streaming or on demand.

Substitutes

Entertainment companies are competing over disposable income dollar. Wallet share is very important and other forms of entertainment have grown appealing to consumers including video games, movies, DVD rental, pay-per-view, sporting events and live theatrical entertainment.

General Industry Statistics

Statistics show that record companies entered the marketplace from 1997 - 2002 at a rate of approximately 3% per year over five-years. Over the same period, revenues increased an average of 7.5%, payroll an average of 10% and number of paid employees grew by 7% respectively each year over five-years. From 1998 – 2003, operating revenues grew approximately 3% and inventories increased 5.5%, finished goods increased 4% and materials, supplies and fuel increased an average 12% each year over five-years.

NAICS 5122 Sound Recording Industries[44]

	1997	2002
Establishments	2935	3468
Revenue	$11,139,881	$15,530,395
Payroll	$ 1,111,653	$ 2,280,342
Paid Employees	21, 514	32,862

Sound Recording Industries Estimated Revenue and Inventories: 1998 to 2003[45]

	1998	2003
Operating Revenue	$11,403	$13,804 (millions)
Total inventories	317	402
Finished goods and w.i.p.	266	320
Materials, supplies, fuel etc	51	82

The original “Big Six” have consolidated down to four with publicly held Universal, EMI and the now merging BMG/Sony. AOL/Time Warner sold its majority stake to private investors and Warner Records is now a privately held company. The major record labels are scaling down and that has given an opportunity for Independents to gain market share. In North America, Universal leads with 27.9% followed by Independents at 18.2%. But in the global market, Independents edge out Universal with 25.3% vs. 23.5% respectively.

2003 Global and Regional Market Shares by Record Label.[46]

	Global	North America (US & Canada)
BMG	11.9%	15.5%
EMI	13.4%	10.5%
Sony	13.2%	12.1%
Universal	23.5%	27.9%
Warner	12.7%	15.8%
Independents	25.3%	18.2%

As discussed in previous sections of this paper, advancements in technology - with the use of computers and the Internet - creates a more level playing field for music sales and consumerism. More companies that deal in music or new music companies probably will enter the market due to less barriers to entry in the digital space. As the use of the Internet increases for buying and trading music, there will be less physical inventory to carry and materials, supplies and fuel used for manufacturing of physical product will be significantly reduced.

Business Trends

Record companies or music companies will need to plan and create clear strategies that emphasize sales in the digital space. According to PricewaterhouseCoopers, the U.S. market for recorded music will grow from an $11 billion industry to $14 billion industry by 2008 – the fastest growing among all global territories. The dollar amount from sales of physical albums will plateau over the next five years although album unit sales will improve due to lower prices. Music videos are also expected to grow due to the DVD format. Technological advances in both distribution (broadband Internet access mobile communications, convergence and portability) and devices (digital TV, radio, video gaming devices, iPod and other MP3 players) will support digital music sales. The distribution of music will explode growing over 100% over the next three years and reaching an estimated $2.2 billion

or 16% of entire music sales by 2008 (see slide).[47]

Global Entertainment and Media Outlook: 2004 Š 2008

Trends Š Recorded Music

RECORDED MUSIC MARKET (US$ Millions)

United States	2003	2004	2005	2006	2007	2008	CAGR
Albums	$11,397	$11,297	$11,410	$11,344	$11,273	$11,196	
Percent Change	-7 %	-1 %	1 %	-1 %	-1 %	-1 %	-0.4 %
Singles	$57	$61	$60	$60	$59	$59	
Percent Change	33 %	7 %	-2 %	0 %	-2 %	0 %	0.7 %
Music Videos	$400	$410	$441	$473	$506	$540	
Percent Change	39 %	3 %	8 %	7 %	7 %	7 %	6.2 %
Digital Distribution	$ 71	$ 171	$ 347	$ 837	$ 1,535	$ 2,187	
Percent Change	446 %	141 %	103 %	141 %	83 %	43 %	98.5 %
Total	$11,925	$11,939	$12,258	$12,714	$13,373	$13,982	
Percent Change (%)	-6 %	0 %	3 %	4 %	5 %	5 %	3.2 %

PricewaterhouseCoopers Page 8

Slide used with permission from PricewaterhouseCoopers

PricewaterhouseCoopers also reports that an improved economy combined with higher prices for digital downloads will add to the growth of recorded music (see slide next page).

Slide used with permission from PricewaterhouseCoopers

Global Entertainment and Media Outlook: 2004 Š 2008

Trends Š Recorded Music

DIGITAL DISTRIBUTION

United States	2003p	2004	2005	2006	2007	2008
Singles						
Downloads (millions)	25	70	125	300	600	800
Avg. Price (US$)	$0.99	$0.99	$0.99	$1.10	$1.15	$1.20
Dollar Sales (US$ millions)	$25	$69	$124	$330	$690	$960
Albums						
Downloads (millions)	1	3	8	20	35	60
Avg. Price (US$)	$9.99	$9.99	$9.99	$10.10	$10.15	$10.20
Dollar Sales (US$ millions)	$10	$30	$80	$202	$355	$612 %
Subscriptions						
Subscribers (millions)	0.3	0.6	1.2	2.5	4	5
Monthly Fee (US$)	$9.95	$9.95	$9.95	$10.15	$10.20	$10.25
Annual Spending (US$ millions)	$36	$72	$143	$305	$490	$615 %
Total Digital Spending (US$ Millions)	$71	$171	$347	$837	$1,535	$2,187

Sources: PricewaterhouseCoopers LLP, Wilkofsky Gruen Associates

PricewaterhouseCoopers Page 12

Scenario Analysis

Scenario analysis helps to assess the external environment of factors that are out of the company's control. It focuses on uncertainty and develops an imagination of future possibilities. Scenario analysis is not predicting the future – it is more preparation for the future. A survey of eighteen music industry executives was conducted for the scenario analysis in which they ranked factors and answered questions about the current and future status of the music industry (see Appendix C). The steps for developing the scenario include listing drivers, developing concepts and identifying factors that create the critical uncertainties for the scenario matrix.

Drivers – S.T.E.E.P.

Social

- Purchasers of music are older with average age of 35
- Downloading of music for free using P2P technology
- More purchasing via Internet or online services
- Consumer indifference as to where music is purchased

Technological

- Use of Internet by consumers to preview music
- Increased speed readily available with use of broadband
- Portability and wireless technology opens up music options

Environmental

- Digital download results in a decrease of waste from packaging and decrease of fuel and pollution usually used for trucking product
- Music industry business environment is consolidating – record labels, radio networks, retail outlets
- Entertainment industry is using the Internet more for marketing and sell thru

Economic

- Consumers are spending more on entertainment and leisure
- Ongoing battle for wallet share among various forms of entertainment (video, movies, music etc)
- Music is available for free with use of P2P software

Political

- Current proposal to amend and eliminate some copyright laws
- Suing music consumers
- Court rules in favor of P2P - Grokster, Morpheus etc. Software can be used for legal purposes and sites are not held liable for their users. (Sony v. Universal)
- Policies such as the Induce Act are being drafted by politicians
- FCC is being criticized for allowing vertical media mergers ex.) Clear Channel
- BMG & Sony have been allowed to merge by EU and US officials

Concepts

- Consumer Behavior –previewing music, using Internet, spending more on entertainment, acquiring music for free, purchasing music wherever.
- Technological Advances – increase speed of downloads, portability/wireless options, use of P2P software, convergence
- Changing Business Environment – record labels, retails outlets have consolidated, BMG & Sony merging, Clear Channel vertical integration
- Legislative Impact – Copyright laws, Ruling on P2P, Induce Act, allowing mergers in the marketplace, lawsuits against music consumers

Survey participants were asked to rank factors based on its importance and then on its uncertainty resulting in the following:

Importance To Business

1. CD Price Point
2. Consolidation of broadcast radio stations
3. Limited play lists (at radio)
4. Competition from other forms of entertainment
5. Illegal downloading
6. Digital sales and distribution of music
7. Consolidation of record companies
8. Overhead Costs at record companies
9. Online record stores
10. Age of Buyers
11. US Economics
12. Consumers perception
13. Consumer disposable income
14. Consolidation of retail outlets
15. Copyright laws
16. Development costs of new artists

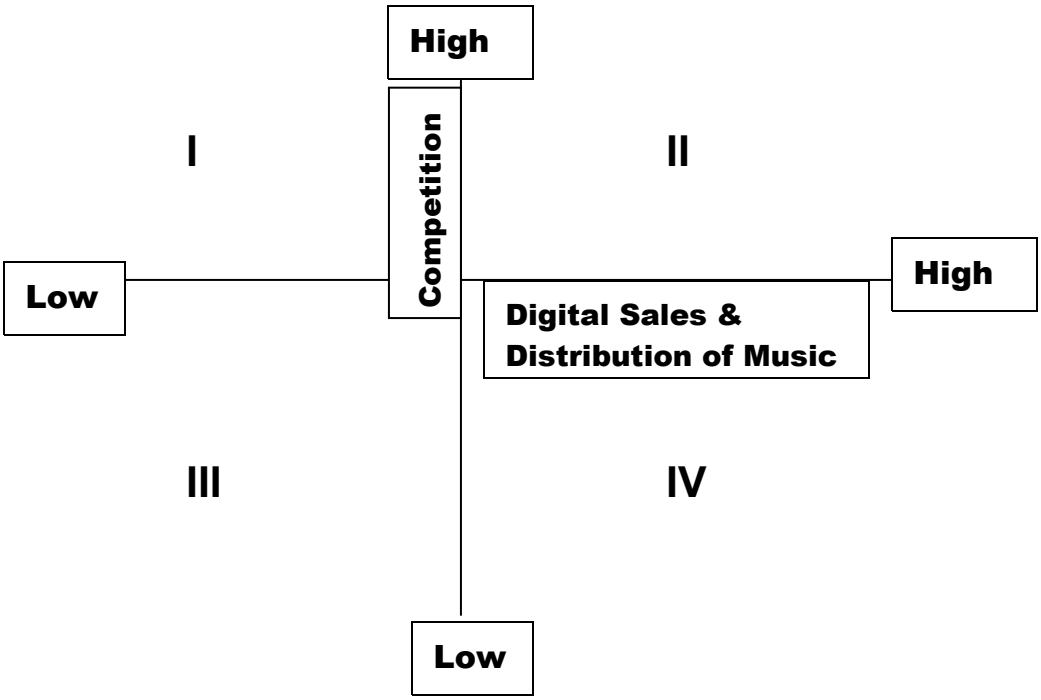
Uncertain Of Impact

1. Copyright laws
2. Age of music buyers
3. Consumers perception
4. On line records stores
5. Digital sales and distribution of music
6. Consolidation of record companies
7. Overhead costs at record companies
8. US Economics
9. Competition from other forms of entertainment
10. Development costs of new artist
11. Consumer disposable income
12. Illegal downloading
13. Consolidation of retail
14. CD Price
15. Limited play lists (at radio)
16. Consolidation of broadcast

Critical Uncertainties

Scenario Drivers chosen for the matrix are digital sales and distribution of music and competition from other forms of entertainment. These drivers were chosen based on importance, uncertainty and viability to developing varied scenarios.

Scenario Matrix
Competition from other forms of entertainment
Digital sales and distribution of music



Scenario I – Stepchild

Music is still a stepchild of the entertainment industry. The consumer still sees no value in music and proceeds to obtain music for free even though the economy is good. The music industry continues to sue customers and forerunners of technology to protect its dwindling assets creating more bad publicity for itself. Music retail for CDs has been absorbed into Costco and Wal-Mart limiting shelf space to children and Christian titles. Speed and technology prevail as more households install broadband or WiFi Internet access - making the downloading and sharing of music faster and easier than ever before. Competition from other entertainment is intense. Destination entertainment (sporting events, live entertainment and movie theatres) invest in major developments and create value and enhancements for the consumer

such as gourmet meals served at sporting events, free premiums (CDs, t-shirts) for concertgoers, stadium style seating at movie theatres with WiFi pre-order/pre-pay for popcorn and drinks from your blackberry. Snazzy new gaming devices (gameboys, n-gage) dazzle the youth who always want the latest version. Consumer wallet share goes to everything but music.

Scenario II – Glory Days

Economy is strong and consumers have a high percentage of disposable dollars. The music industry has spent the past few years building customer relations and creating value for its music products. New, talented artists have been developed for fans to fall in love with. Loyalty to an artist pays off as a fan gets exclusive invitations to meet and greets or last minute live shows and occasionally receives a personal e-mail from the artist. Music retailing has evolved into hot spots like cafes and trendy retailers where you can access song banks at certain locations and download songs on demand in an instant. Portability is all the rage and music fits it like a glove. Due to the small size of music files, consumers choose to load music onto their portables along with other necessary files. Competition is high from other entertainment but their graphics (video & film) result in too heavy a load for portables. Music is in its glory but other entertainment does well and consumers spread the love to all.

Scenario III – Death March

The economy is in a recession and consumers spend money on necessities not entertainment. Getting it for free is the golden rule. Consumers turn to the darknet to get music and buy CDs for $1 at the swap meets. Music retailing is gone and the CD format is dead. The major record labels implode as margins become razor thin

and there's no sales volume to support the business. Shareholders revolt. Music catalogs and other assets are sold off to the highest bidder including McDonalds and Michael Jackson's estate.

Scenario IV – I Tunes Rules

I Tunes and the I Pod reaches its 'tipping point' in the U.S. resulting in 98% of households with the software and ownership of at least one I Pod. New electronic devices that are I Tunes friendly - PDAs, mobile phones, gaming devices - spur the sales of music. The music industry lucks out and gets to sit back as Apple handles distribution, sales and customer relations through its I Tunes music division. A few brick and mortar music retailers survive catering to the new generation of fans that just discovered a band called U2 online and want to learn more. Competition slowly plods along as video, film and sporting entities experience a slump in sales.

STRATEGIC DEVELOPMENT

A true, strategic plan is the assessment of both external and internal environments. The previous analysis focuses on the external environment. There are thousands of record companies established in the U.S. and although most of the major companies are publicly held, the music divisions are only small business units of larger conglomerates (BMG Music/ Bertelsmann, Universal/Vivendi-Universal). Therefore, access to internal information (human capital, organizational resources, physical assets) and other company data (financial statements) is difficult since this information is published in a general and consolidated format or not furnished at all. But the strategy presented will endeavor the reader to begin the development of a genuine strategic plan.

Strategy should focus on creating value – for shareholders, partners, suppliers, employees, and the community - by satisfying the needs and wants of customers better than anyone else.[48] Of course, needs and wants of customers change and this aspect creates the basis of competitive strategy. I recommend that record companies:

- Create value for the customer
- Develop music differently
- Cultivate a new business model

Create Value For The Customer - What Are The Needs And Wants Of The Music Customer?

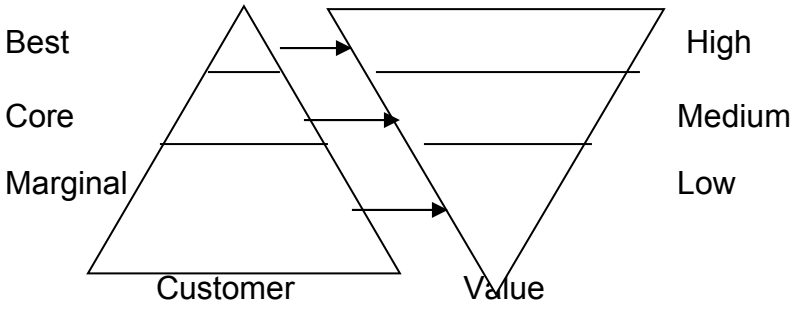
It is time to include the customer in the strategic planning process to find out the answer to this question. Instead of a mass media approach for promoting product, customization becomes fundamental. A recent cover story in Business Week affirms [T]he evolution from mass to micromarketing is a fundamental change driven as much by necessity as opportunity. America today is a far more diverse and commercially self-indulgent society than it was in the hey day of the mass market. The country has atomized into countless market segments defined not only by demography, but by increasingly nuanced and insistent product preferences. “All the research we’re doing tells us that the driver of demand going forward is all about products that are ‘right for me,’” says David Martin, president of Interbrand Corp. “And that’s ultimately about offering a degree of customization for all.”[49] The industry needs to take on the 4 Cs of marketing in order to begin the value process.

<u>4Cs</u>

Customer

Music is emotional and personal so trying to create music that appeals to

everybody lacks focus but creating music and releasing product lines that target your customer is key. Understanding your customer is important to your business. Through the use of the Internet with label, band and other music websites, information and data can be obtained and maintained. Buyer behavior (infrequent, occasional and regular) can also be tracked. Understanding the type of customer you are dealing with can help you allocate resources that aim at your best customers.



Over 45% of music consumers surveyed for this paper reported that they either purchased a CD or downloaded music over the past month. This is regular to high music consumption. Consumers seem to be more song oriented and named FM radio (78%) and word of mouth (73%) as the best sources for finding out about music. But other music sources that influence sales are developing including television (39%), magazines (37%), Internet music sites (34%) and Internet radio (26%).

Cost

The cost of music has run the gamut starting with $0.00 to $18.00 over the past few years. This has created confusion in the marketplace. Investing in research and focus group sessions, in order to understand price elasticity, is imperative especially before launching a new product line or format (ex. dual disc). Music consumers currently have the option to use P2P sites where the cost of music is free. The consumer survey shows the fair price for a CD as $11.00 and the fair price for a full-length download as $9.99.

Convenience

It is important to continually evaluate what is most convenient for the customer. When it comes to music transactions, survey participants cited convenience of time, location and ease of website use as high in the value chain. In addition, security and ownership of music files were also important to the on-line music experience.

Communication

Dialogue is fundamental to creating customer value. Addressing the customer's needs or issues in a quick and professional manner is vital as well as building customer relations through newsletters and e-mail updates.

Develop Music Differently

Most record labels loan money (advances) to artists to record an album (usually delivering 12 – 15 tracks) and then spend resources marketing and promoting the product to the consumer. Some of these extremely high costs are charged to the artist. Taking a look at three potential profit examples (Indie Label, Major Label and Artist) from *A Music Business Primer* [50], you can see the disparity between major label and artist (see next page).

POTENTIAL PROFITS: INDEPENDENT LABELS

Independent labels can profit with substantially fewer sales than major labels by keeping recording and promotional costs down and marketing to niche audiences.

EXAMPLE 1.

An independent label signs a new artist and projects that it will sell 5000 CDs at a distributor wholesale price of $7.19. Of these, 1500 will be purchased by the artist at $7.19 to sell at gigs. Some contracts allow artists to buy at a lower price, with the stipulation that they not be royalty bearing. The label manufactures 25% more CDs (1250) than it anticipates it will sell for promotional giveaways and in anticipation of returns from stores.

The artist receives an advance of $7500 that is used for recording.

Projected gross income from sales	
5000 CDs at a distributor wholesale price of $7.19 (5000 x $7.19)	$35,950.00
Expenses	
Manufacturing ($.75 x 6250)	($4687.50)
Promotion (10% of projected sales of $35,950)	($3595.00)
Record royalties	
10% of $16.95 SLRP less packaging ($1.27 x 5000)	($6350.00)
Publishing royalties at full statutory ($.80)	($4000.00)
Total record company expenses	($18,632.50)
Projected gross profit for the record company:	$17,317.50

The record label makes a gross profit of $17,317.50. The label also recoups $6350 of the $7500 advance it made to the artist. The artist still owes $1150 to the record label, which will be recouped from future royalties when sales exceed 5000 and new recordings are manufactured.

The artist will earn money by selling recordings that they purchased from the record label at their gigs. If the artist writes all the songs and owns their own publishing company he or she will receive the publishing royalties; if not, the publishing royalties will be split between the publisher and the writers.

POTENTIAL PROFITS: MAJOR LABELS

Major labels generally do not make a profit until sales exceed 100,000 units, a goal rarely reached without substantial airplay on commercial radio and television.

Here are two examples of projected income and expense that are applicable to major label deals.

EXAMPLE 1.
The record company estimates it will sell 200,000 recordings. Because the record company will use its parent companies' distribution system to get recordings into major retail record chains, it will receive approximately $10.00 per recording. Because it contracts to manufacture more than a million recordings a year, it pays $.50 per CD. The company anticipates returns on large-volume sales and adds promotional giveaways. It manufactures 25% more CDs (50,000) than it anticipates it will sell. (Stores return unsold product at 100% of their cost.) The artist royalty is 14% of the SLRP less packaging costs. The record company spends $200,000 making a video and another $200,000 on other marketing and promotional costs. It will recoup 50% of these costs from artists' earnings.

The artist receives an all-in advance of $250,000.

Projected gross income from sales ($10.00 x 200,000 units)	$2,000,000
Expenses	
Manufacturing ($.50 x 250,000)	($125,000)
Promotion 50% of $400,000	($200,000)
Record royalties	
14% of SLRP of $16.95 less packaging ($1.78 x 200,000)	($356,000)
Mechanical royalties at 75% of statutory ($.60 x 200,000)	($120,000)
Total record company expense	($801,000)
Gross record company profit	$1,199,000

The record company makes a gross profit of $1,199,000 and recoups its all-in recording fund advance of $250,000 and $200,000 of its promotional costs.

The artist has a total debt of $450,000 (all-in advance plus 50% of promotional costs).

Although the artist earns $356,000 in record royalties, he or she owes the record company $94,000. If the artist wrote all the songs and owns their own publishing company, the record company may recoup the debt from the publishing royalties (cross-collateralization).

POTENTIAL PROFITS: ARTISTS

The profitability of major label contracts with artists is a sore point. Since 90% of major label artists fail to make a profit on their first recording, those artists cannot repay their advances. This means that it is difficult for those artists to get released from their contracts and, at the same time, record companies are reluctant to commit money to promote new recordings. When the companies do promote their new recordings, the artists have already compounded their debt, which makes it harder for them to profit from their new venture.

Some artists make little or no profit even when sales of recordings are substantial. Out of advances and earnings, artists must pay managers, lawyers and producers and bear all the costs of recording and some costs of video production and radio promotion. Some artists feel that the difference between the labels' and artists' gross profits are too heavily weighted in favor of the record companies. Why attorneys and managers allow artists to sign such contracts has begun to be questioned in court by artists that signed them and by numerous artists' advocacy groups.

EXAMPLE: MAJOR LABEL

Units sold	200,000	1,000,000
Gross income from royalties	$356,000	$1,780,000
Expenses		
Manager: 20% of gross	($71,200)	($356,000)
Lawyer: 5% of recording fund advance	($12,500)	($50,000)
Producer: 4% of artists' royalties	($14,240)	($71,200)
Recording	($150,000)	($250,000)
Video production	($100,000)	($250,000)
Radio promotion	($100,000)	($750,000)
Total expenses	$447,940	$1,727,200
Artist gross profit:	$(91,940)	$52,800
Record company gross profit	$1,199,000	$5,995,000

Record companies recoup monies from album sales. Advances as well as some marketing, video and promotion costs are billed back to the artist. Of course, in reality, many records do not reach its projected sales initially set by the record company and the artist ends up owing the record company money. This model perpetuates a cycle of artist debt to the record company and record company losses on its books.

What if a record label develops music differently? If consumers are song driven, how would you deliver songs in a timely and cost effective way? Artists Peter Gabriel and Brian Eno head a musicians' alliance called Magnificent Union of Digitally Downloading Artists or MUDDA. They advocate a direct line between artist and customer providing ideas and options sans record company. Gabriel explains, "I'm an artist who works incredibly slowly. If some of those (songs) could be made available, you don't have to be so trapped into the old way of being confined only by the album cycle." [51]

The music industry needs to break out of its antiquated format and create new ideas for developing product. Beginning with the recording process, record companies could partner with artists in a 60/40 split of recording costs. Artists would retain ownership to their masters and record labels could make sound investments instead of bad loans. This would create a better working relationship between the two parties fostering responsibility and building trust instead of maintaining an old, unbalanced relationship of 'master and servant'. Artists can work with record companies to create new deals such as delivering six songs instead of twelve thus making the artists' initial financing manageable. Record companies could then release a new song every few months keeping on par with consumers' musical needs. CNET's Vince Broady explains. The emergence of digital music players has

made it possible for people to listen to, literally, 10 or 12 hours of music a day, every single day. As a result of that, we think people could run through an entire catalog, in terms of a category of music or several categories, over a period of months or years. Which will give them a hunger for new music that's in a style that they like, but that they haven't already listened to.[52]

Labels could invest capital in recording studios in order to keep these traditionally exorbitant costs in check. Independent labels could work together to create co-operative studio systems and act collectively in order to share costs. While major record companies could consider investing in state of the art recording facilities throughout the country creating a studio "farm" system. Cost savings would be experienced from keeping artists locally based instead of spending money on flights, lodging and other expenses. These studios would be staffed with exceptional production and management teams that would have a vested interest in watching the bottom line.

Advances in technology are beneficial to the recording process. With the use of computers and other digital equipment, musicians are able to create quality recordings in home studios. The ability to deliver basic tracks or even completed songs in this manner speeds up the development of music and ends up saving the artist money.

Borrowing from Ms. Rapaport's model, the numbers can paint a different picture:

Projected Profit: Record Company from One Song Downloaded Retail Price $0.99

10,000 downloads x $0.89 =	$ 8900
Expenses	
Promotional costs (20% of gross)	($ 1780)
Royalties	
Record Royalties to artist 20% x $0.89 x 10,000	($ 1780)
Publishing Royalties to composer/writer 10% x $0.89 x 10,000	($ 890)
Gross Profit	$ 4450

Potential Profit: Artist from One Song Download Retail Price $0.99

10,000 downloads x $0.89 =	$ 1780
Gross Profit	$ 1780

Because record companies and artists are in partnership, a higher record royalty rate as well as a publishing royalty is negotiated. Digital music services take a flat $0.10 from each transaction. Most contracted recording artist couldn't get close to 20,000 units sold but in the digital world, 10,000 downloads are possible with viral and targeted marketing. Artists would still have to pay managers and lawyers but because there are no advances, a flat rate for services could be agreed upon. Of course, all these numbers are fictitious but developing music and the deals that surround it differently could result in profits for all.

Cultivating A New Business Model

The music industry has traditionally operated on a Blockbuster business model. By banking on a few artists, the record company hopes to generate blockbuster sales in order to cover losses generated from the majority of other projects. In order to cultivate a new business model, record companies must re-evaluate internal and external aspects of their business - focusing on strategies that create value and getting rid of processes that drag it down.

Taking stock of internal assets is the first step. Analyzing financial resources provides a strong picture of where the business stands taking into account profitability, liquidity, leverage, activity and risk. In regards to human capital, it is important to treat employees with respect and invest and retain good workers. Who are the people in the company and what can they contribute? The music industry has been plagued with a poor reputation when it comes to human resources. Most record company environments have been known as places that 'churns them up and spits them out'. Egos are known to run high in the business with favoritism blatantly played out. Ruthless behavior has at times been rewarded while playing the company soldier can get you fired. How would you change the culture?

Knowledge and intellectual capital can provide a competitive advantage. In this time of dramatic change, do you have the people and the processes to bring new ideas to market? Are there strong A&R scouts that have the 'ear' and the 'eye' for good music and talented artists?

What are your core competencies? There are some independent labels that are very good at developing new talent and building a sales base. Other labels are strong at creating partnerships with non-music companies that expose their artist to a

bigger market. Core competencies can prove to be very powerful to contributing to success.

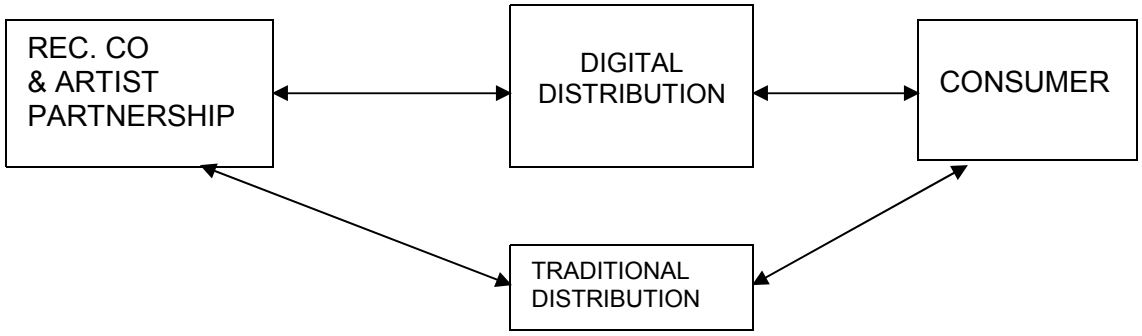
The previous discussion is only the start of a true assessment of internal resources but you are encouraged to continue examining strengths that will help develop a sound strategy.

The external environment also is an intrinsic part of strategy development and aspects of the external forces have been discussed in this paper. As previously mentioned, PricewaterhouseCoopers reports that the U.S. market for recorded music will grow from an $11 billion dollar industry to a $14 billion dollar industry. How are you going to gain your share? The information also shows that album unit sales will grow as its price is decreased. Recently, Universal Music tried to lead the industry towards change by lowering the price of CD s. Its plan to cut CD prices to stimulate sales -- called JumpStart -- alienated music stores and failed to prompt other music companies to follow suite last fall. The idea was to pare prices of new releases to as low as $9 -- and even lower of older music -- while ending lucrative payments to retailers to advertise its CDs, so called co-op money. It figured that retailers could make up for those payments, which often weren't used for ads, with higher sales volume. After retailers squawked, Universal offered in March to restore some co-op payments but stuck with the basic concept. Retailers came around, and now it's working. Universal's sales are up over 18% so far this year.[53]

It is important to develop a unique position that competitors cannot easily copy. In the digital world, record companies have been liberated from the task of distribution allowing for the opportunity to redirect resources and build on strengths such as investing in new talent, developing new types of music product and marketing and promoting this product in cost effective ways.

Cultivating a new business model involves lots of analysis but it also involves lots of guts. The music industry was sent into a tailspin not because file sharing and downloading took place but because it took place at the same time the industry reached the maturity phase of the CD product life cycle. Fixed costs were high and barriers to exit were high. Timing was bad and the industry reacted poorly instead of strategically. The diagram below may seem simple but each box holds its own set of challenges that need to be addressed. A new model requires strategic thinking as well as strategic planning and the time to do it is now.

New Model For The Music Industry



CONCLUSION

It is my hope that this paper has outlined an action plan and provided some ideas for a new music business. Evaluating internal and external environments is an important part of change as well as having the flexibility to adapt to new information. Changes in the legal environment and the market environment will occur and hopefully, some businesses will be able to tap into their organization's resources to make changes. Building core competencies now will result in a unique position for the business in the future securing a competitive position in the marketplace. And investments that improve human capital and corporate culture will benefit the organization. But it is the understanding that the importance of building strategy around consumer value that I would like the reader to retain most in the belief that the future music business can re-connect with customers and strike a harmonious balance between art and commerce.

ENDNOTES

[1] United States Copyright Office. (2004). *Copyright basics, circular 1, what works are protected?* Retrieved July 9, 2004 from http://copyright.gov/circs/circ1.html#wwp

[2] Rapaport, Diane (2003) *A music business primer*. Upper Saddle River, NJ: Prentice Hall

[3] United States Copyright Office. (2004). *Copyright Law of the United States Chapter 5 copyright infringement and remedies § 501 ·infringement of copyright*. Retrieved July 9, 2004 from http://www.copyright.gov/title17/92chap5.html

[4] United States Copyright Office. (2004). *Copyright Law of the United States Chapter 1 subject matter and scope of copyright § 107 limitations of exclusive rights: fair use*. Retrieved July 9, 2004 from http://www.copyright.gov/title17/92chap1.html#107

[5] Id at 2

[6] See Sony Corporation of America et al v. Universal City Studios, Inc., et al, No. 81-1687, (Supreme Court of the United States) 464 U.S. 417 at 428

[7] Id.

[8] Id.

[9] Einhorn, Michael A. (2003). Digitalization. In Towse, Ruth (ed.*) Handbook of Cultural Economics* (1st edition pp 214 - 223). Northampton,MA: Edward Elgar

[10] Healy, Jon (2004, August 19).Legal victory for file sharing. *The Los Angeles Times*.

[11] Id.

[12] Recording Industry Association of America. (August 19,2004) Reaction of RIAA on Appeals Court Decision In Grokster Case. *RIAA Press Room.* Retrieved September 15, 2004 from http://www.riaa.com/news\newsletter\081904.asp

[13] Shell, G. Richard (2004) Suing your customers: A winning strategy? *Electronic Frontier Foundation News.* Retrieved September 16. 2004 from http://www.eff.org/share/suing_customers.php

[14] Recording Industry Association of America. (July 20,2004) RIAA Brings New Round of Illegal File Sharing Lawsuits. *RIAA Press Room*. Retrieved September 8, 2004 from http://www.riaa.com/news/newsletter/072004_2.asp

[15] United States Copyright Office. (2004) *Summary of the Determination of the Librarian of Congress on Rates and Terms for Webcasting and Ephemeral Recordings.* Retrieved July 9, 2004 from http://www.copyright.gov/carp/webcasting_rates_final.html

[16] Abbot, Matthew F. (2004) *Standing at the crossroads: compulsory licensing & the future of online music distribution.* Paper presented to….

[17] United States Copyright Office. (2004, March 11). *Statement of Marybeth Peters The Register of Copyrights before the Subcommittee on Courts,The Internet and Intellectual Property of the House Committee on the Judiciary* Retrieved July 9, 2004 from http://www.copyright.gov/docs/regstat031104.html

[18] *DiMA Joins Retail Trade Organizations to Form CERTA* (n.d.) Retrieved from August 10, 2004 from http://www.digmedia.org/content.cfm?id=7203

[19] Potter, Jonathan (2004, March 11). Section 115 of the Copyright Act: In Need of Update? *Testimony given to the United States House of Representatives*. Retrieved December 21, 2004 from http://www.digmedia.org/searchResults.cfm

[20] Peters, Marybeth (2004, March 11) Statement to the Subcommittee on Courts, The Internet and Intellectual Property of the House Committee on the Judiciary. Retrieved on December 21, 2004 from http://www.copyright.gov/docs/regstat031104.html

[21] Hatch, Orrin (2004, July 22) Judiciary statement: Protecting innovation and art while preventing piracy Retrieved September 8, 2004 from http://hatch.senate.gov/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=1121

[22] Electronic Frontier Foundation (2004) Prelude to a fake complaint. *EFF News* Retrieved September 8, 2004 from http://www.eff.org/IP/Apple_Complaint.php

[23] Id.

[24] Burke, Andrew (2003) Music business In Towse, Ruth(ed.) *Handbook of Cultural Economics* (1st edition pp 321 - 329). Northampton,MA: Edward Elgar

[25] Id.

[26] EMI drops Mariah Carey (2002, January 22) *BBC News.* Retrieved October 20, 2004 from http://news.bbc.co.uk/1/hi/entertainment/music/1777172.stm

[27] Heilbraun, James (2003) Baumol's Cost Disease In Towse, Ruth(ed.) *Handbook of Cultural Economics* (1st edition pp 321 - 329). Northampton,MA: Edward Elgar

[28] Bemis, Alec Hanley (2004, September 24-30). A small new future predictions of the record industry's demise have been greatly exaggerated. *LA Weekly*.

[29] Green, Buford (2004) LaHood encouraged by meeting with EMI *The State Journal Register* . Retrieved September 20, 2004 from http://www.house.gov/lahood/SJR20040422.htm

[30] Id at 21.

[31] Id at 24

[32] Lowry, Tom (2004 September 22) Extended play for Universal's music man. *Business Week Online* http://businessweek.com/print/bwdaily/dnflash/sep2004/nf20040922_2018_db039.htm

[33] Chen, Christine Y. (n.d.) Clear Channel not the bad boys of radio. Fortune. Retrieved December 22, 2004 from http://www.fortune.com/fortune/ceo/articles/0,15114,423802,00.html

[34] Godin, Seth (2002) *Purple Cow transform your business by being remarkable*. New York, New York: Penguin Group.

[35] Id.

[36] Recording Industry Association of America (2003) *2003 Consumer Profile* Washington, D.C. Retrieved August 30, 2004 from http://www.riaa.com

[37] Crupnick, Russ (2004, August) *NPD Music & Movies consumer insights from home front to store front*

Paper presented at the NARM Convention, San Diego, CA.

[38] Id at 34

[39] U.S. Census Bureau (2002). *Communications Industry Forecast* (No. 1102 Media Usage and Consumer Spending: 1996 to 2005). Washington, DC.

[40] Recording Industry Association of America (2003) *2003 Consumer Profile* Washington, D.C. Retrieved August 30, 2004 from http://www.riaa.com

[41] Id at 24

[42] Biddle, Peter, England, Paul, Peinado, Marcus and Willman, Bryan (2002) The darknet and the future of content distribution. Retrieved December 23, 2004 from http://crypto.stanford.edu/DRM2002/darknet5.doc

[43] *Sony BMG begins to cut work force* (2004, August 18) Retrieved August 20, 2004 from http://story.news.yahoo.com/news?tmpl=story&cid=769&e=1&u=/nm/20040818/music_nm/music_sonybmg_dc

[44] U.S. Census Bureau (2002). *Industry Statistics Sampler*. Washington, DC. Retrieved November 15, 2004 from http://www.census.gov/epcd/ec97/industry/E5122.HTM

[45] U.S. Census Bureau (2002). *2003 Service Annual Survey*. Washington, DC. Retrieved November 15, 2004 from http://www.census.gov/svsd/www/sas51.html

[46] International Federation of the Phonograph Industry (2004, September 14) *IFPI publishes definitive statistics yearbook on global recorded music market* http://www.ifpi.org/site-content/press/20040914.html

[47] Jackson, R. Wayne (2004, August 22) *What's Ahead for the Entertainment Industry? PricewaterhouseCoopers Entertainment & Media Practice.* Paper presented at the NARM Convention, San Diego, CA.

[48] de Kluyver, Cornelis A. and Pearce II, John A (2003) *Strategy a view from the top*. Upper Saddle River, NJ: Pearson Education Inc.

[49] Bianco, Anthony (July 12, 2004) The vanishing mass market. *Business Week*.

[50] Id at 2

[51] Doland, Angela (2004) Independent musicians: let tech free you from labels' yoke. *USA Today.* Retrieved December 12, 2004, from http://www.usatoday.com/tech/news/2004-01-26-mudda_x.htm

[52] O'Hara, John (June 16, 2004) CNET's Vince Broady Discusses the Rebirth of a Dot-Com Revolutionary as User-Centric Infoportal. *HITS Daily Double.* http://www.hitsdailydouble.com

[53] Id at 29