Business Models for Music Distribution after the P2P Revolution

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Abstract

The goal of this paper is to sketch the value chain and the business models of the online distribution of music. The perspective of the online digital music market is rather deceiving but the opportunities seem to remain high. Considering the rise of the P2P networks of free music digital files, it seems reasonable to assume this new way to distribute music meets consumer needs. Based on a review of the literature and executive interviews, the paper presents the traditional distribution models; then it addresses how P2P piracy deals with the copyright issues, and describes some emergent business models that could be an answer to illegal digital music distribution.

1. Introduction

Napster's fierce battle in court was a good example of the stakes involved in the new framework of the music industry. Digital downloading through MP3 files and the emergence of the P2P architecture shook the foundations of a very profitable industry. Napster ruling didn't solve the copyright issue and the piracy movement. Who is going to benefit from this? The customer? Would artists have enough incentives to pursue their creative work? What about the retailers who won their first battle against des-intermediation?

This paper aims at getting a better understanding of the economics of the traditional value chain in the music industry and at guessing the possible evolution of the various business models in a world of piracy and des-intermediation. Does the relative success of iTunes mean that consumers have finally agreed to shift to payable model?

The next section shortly presents the traditional value chain of the music industry and gives an overview of the cost and margin repartition among the actors. The section 3 describes the traditional online business models for the time being. The section 4 gives some numbers for the P2P move and presents the copyright issue. The emerging business models are briefly described in the section 5. The section 6 gives a first idea of the integrated offline and online business models.

2. Music industry traditional value chain

The five big companies (AOL Time Warner, BMG, EMI, Sony, Vivendi Universal) control approximately 85% of the market for recorded music in the US, in part because of their marketing muscle [43].

However, according to Ku [29], marketing manipulates what the public hears by paying radio stations to play their music and impedes competition in three ways: (a) it creates barriers-to-entry, (b) it distorts tastes, and (c) it manipulates demand. The Table 1 illustrates the traditional value chain of the music industry and gives a rough idea of the cost repartition. [22] and [34].

Artists	Song writer: \$0.755 per song Recording artist: 14% of the wholesale price but subtracts for breakage
Production	\$100'000 to 200'000 (\$1/CD) studios, sessions musicians, covered by the advance the artists receives from the label
Labels	\$140'000 to 350'000; \$1to \$2/CD of production costs and \$3 to \$10/CD of up-front marketing costs
Wholesaler	Price: \$10.50 to 11.50
Music stores	Mark up \$3 to 5 Vs \$1 to 2 for online retailers
Customers	CD price: \$17 to 19 for a major label and \$13 for an independent label

Table 1 – Music industry traditional value chain

Production costs are \$0.6 in raw materials and \$0.4 in inserts and artwork per CD. Marketing, promotion and tour support costs are \$10'000 to 100'000 per song to lobby the radio stations, and \$50'000 to 75'000 video budget. Distribution costs are \$2 per CD paid to retailers to advertise, display, and offer discounts.

To defend the traditional value chain against the decline of sales, in September 2003, Universal Music

Group reduced CD prices for consumers by nearly a quarter and some discounts stores, such as Best Buy or Wal-Mart, will drive them down more [47].

3. Traditional online business models

For the time being, the perspectives of the online digital music market were rather deceiving. According to an estimate, the legitimate downloads and digital subscription models yielded less than $1 million in global revenue in 2001 [6].

But the opportunities could be huge. According to an estimate, the European online music market represented € 323 millions in 2000 and was estimated to reach € 2 billions in 2006, divided by 63% in sales of CDs and 37% through digital distribution. According to this estimate, it means that by 2006, the digital distribution music market should represent € 463 million in subscription sales and € 321 million in downloads sales [14].

3.1. The subscription model

To fight against the free MP3 files downloading, big labels decided to launch their own services with a fee-based remuneration. For example MusicNet, joint venture from AOL, Bertelsmann, EMI and Real Networks, launched a service offering 100 downloads and 100 streamcasts per month for a subscription of $ 9.95. If you want the same music next month, you have to renew your subscription. Pressplay, started by Sony and Vivendi Universal, offers the same kind of service at the same price, but customers have access to 300 streamcasts and 300 downloads with the permission to copy [11].

Confab offers music downloads, personal play lists and CD burning for a monthly fee of $24.95. It had licenses with EMI and Zomba Music Group [20].

According to Redshift Research, a big disadvantage of these fee-based sites is the fact that they cannot compete on the choice dimension against P2P networks such as Kazaa. In fact, in March 2002, Kazaa claimed more than 180 million available digital files for nearly a billion downloads, when label sites were offering on average only 10% of the top US singles and 9% of the top 100 albums [14].

3.2. The "à la carte" model

The "à la carte" download model offers the possibility to the customer to choose and pay song track by song track. Then, there are two alternatives, either you opt for a play-for-play model where the user pays every time she/he listens, or you offer a pay-for-download service where the user pays just once.

Apples's iTunes users can download songs for 99 cents a track or $9.99 an album, Digital locks embedded in the songs let users store and listen to copies of songs on up to three PCs, and to transfer the songs to unlimited numbers of CDs and portable music players, such as the iPod [48]. Apple's goal was to reach 100 million downloads in its first year [28]. Since its April 2003 launch to March 15, 2004, iTunes users had bought 50 million songs, but according to company's estimates, this figure can be projected into a 130 million downloads annually [4]. Apple's offers more than 500,000 songs but in the US only. Its windows version was launched in October 2003.

3.3. The "à la carte" and subscription bundle model

The subscription and "à la carte" models can be mixed. For a subscription of $ 4.99, Ministry of Sound offers an access to its recording catalogue, including more than 400,000 other tracks from labels like BMG (Figure 1). Moreover, it allows subscribers to download 24 tracks to listen to for a month with an option to pay $ 0.99 to have a permanent access [30].

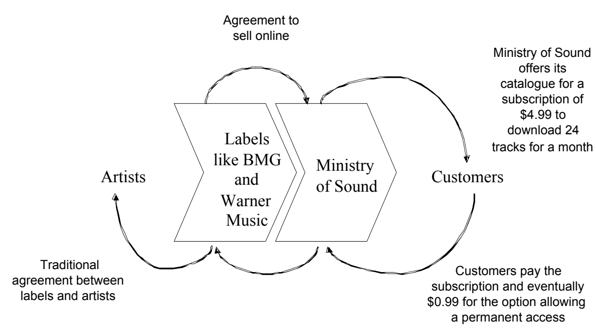

Figure 1. The BMG model.

The new Napster offers subscription access to unlimited downloads and on-demand streams for $9.95 per month or 99 cents grab-and-go downloads. Users can burn individual tracks an unlimited number of times, but the same playlist can only be burned five times [17].

3.4. The online radio model

RealOne, operated by Real Networks, offers radio and music subscription service with MusicNet [11]. Launch Media offers to their subscribers the possibility to design their own radio station that plays their preferred selections [11]. See also Clickradio (Owned by Universal, BMG and Warner) and Radio@AOL.

3.5. The distribution model

OD2's (On Demand Distribution) business strategy is based on the premise that most people investing in online music want to be selling and far fewer are interested in distribution [44]. It is an online music rental service offering to the consumer the opportunity to stream whole catalogs of music before selecting the ones they want to rent for a fixed price as time-limited downloads [15]. OD2 (Figure 2) distributes encrypted licensed copies to e-tailers. The e-tailers sell music to online customers who can play music only if they have the individual digital license required. Each purchase is registered and credited to OD2. OD2 pays royalties to the musicians.

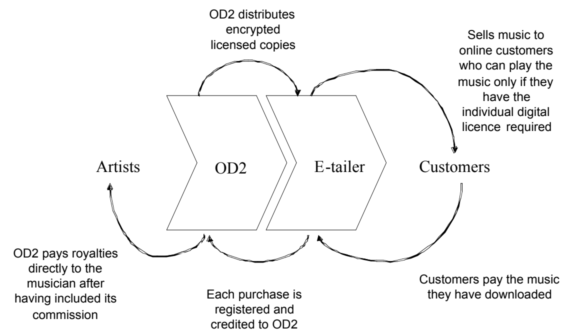

Figure 2. The OD2 model.

3.6. The advertising model

Advertising could be used to generate revenues and pay royalties. According to Garrity, Web's greatest strength is its ability to deliver a targeted message to people who listen or watch online. New research by Arbitron and the Digital Media Assn. reveals that two-thirds of Webcasters have been called by agencies placing Webcast ads [13]. According to this study, 42% of Webcast ad dollars comes from direct advertisers, 33% from interactive agencies and 25% from traditional ad firms. Moreover, 66% of Webcast advertising is bought by brick-and-mortar companies and the rest by dotcoms.

3.7. The integrated model

The first step for big actors, such as major record companies, could be a move toward an integration of all the possibilities offered by online business models. That was the strategy of Bertelsmann which wanted to create a service that was a centralized destination for music content online regardless of format (physical CDs, digital files), of distribution technologies (P2P, streaming, central server), of business models (subscription, *à la carte* downloads, online radio) and of devices (PC, wireless phones, PDAs, digital music players, TV) [14].

4. The P2P move and the copyright issue

According to the Copyright Act of 1976, copyright holders have the exclusive right to control the reproduction, modification, distribution, public performance and public display of their copyright works. According to Ku [29], copyright is monopoly because it makes articles scarce, it makes them dear and it makes them bad.

The issue here related to protecting copyrighted products is how to fight with actors offering unlimited content at a zero cost? The first reaction of recording companies and association of artists was to sue the P2P actors, try to make them disappear and go back to a "normal life".

Then labels decided to hinder copying by protecting and encrypting CDs offered on the market, as the DVDs. During the last quarter of 2001, Universal Music International (UMI) sold 2 million protected CDs. The company received only 200 complaints from consumers [26]. The company considered that it was not a lot. But only a minority of dissatisfied customers complains. Moreover, is it fair from the recording company to prevent the customer from shifting the content and use it on another device? But copy protection scheme can be broken such as CSS, scheme encrypting DVDs that was broken by students who wrote a program with only seven lines [7].

Software companies are also contributing to the protection of copyrighted music such as the Microsoft Media Player that includes a "digital rights management" system allowing content owners to specify such things as how often files can be opened and when they expire [7]. Tracks shared on the new Napster service will play only on the PC of the user who has downloaded them [7].

To prevent P2P piracy, record companies harassed users with technology tools such as *"interdiction"*, swamping a P2P file server with false requests so that downloads are slowed or stopped, *"decoys"* files that are empty or do not work in order to frustrate music downloads, *"redirection"* pointing file swappers at servers that don't contain the files they're looking for, and *file-blocking* [5]. P2P networks were answering to these attempts by elaborating systems such as Morpheus which included a rating system to make it easier to identify fake files in its new version [36]. But some of these labels methods may be illegal.

In his fight against infringement, the RIAA took one big step further in Sept 2003. It started suing 261 John Does identified by their IP address. One of them was, inadvertently, a 12-year-old girl! [27] In January it pursued its massive action against 532 individuals. The average number of illegal uploads by the defendants was 858 files [25]. But they have to have in mind that many file sharers are also major music consumers; therefore a campaign of lawsuits against them would alienate the customers [36]. According to Morris, much of the damage the industry is suffering is at consumer level and recent attempts have achieved little in real term save [31]. The number of US households downloading digital music files from P2P services was up 14% in November 2003 to 12 million after 6 straight months of decline since April 2003 when RIAA began suing individual file sharers [24]. Since June 2003 to August, the public understanding that song-sharing on P2P networks is illegal has risen from 37% to 61% [27]. However, according to Band from Morrison & Foerster, the law [DMCA] "makes a variety of distinctions that do not make sense to people. It is difficult to understand why you can make copies under certain circumstances and not in others." [23]

However, rulings were not all in favor of copyright associations. A first case was won by a P2P network in 2002. In the Netherlands, KaZaa was sued by Buma/Stemra, the Dutch copyright association for infringing copyright rights. KaZaa won the court case and the subsequent appeal by showing that it was not responsible for possible misuse of its software. That responsibility lay with the users [35]. In April 2003, a federal court ruled that Grokster and Morpheus weren't liable for whatever illegal purposes users might put them to [39]. Finally, in December 2003, RIAA could not anymore automatically obtain subpoenas compelling ISP to turn over the names of people suspecting of P2P music downloading activities. It would have to file a lawsuit or send warning letters for settling cases. It would mean ma more burdensome and more expensive process [39].

4.1. The supposed effects of piracy

The death of the first Napster did not stop the free downloading activity that went on increasing: 3.1 million more people were using P2P networks in March 2002 than in February 2001 when Napster was at its peak [3].

The RIAA claimed that the infringement of their copyrights through the widely spread use of P2P networks for illegal downloading activities caused a 5% drop in record sales in 2001 to $33.7 billion (compared with more than $35.3 billion in 2000) [26]. From 1999 to 2003, CD unit sales have plunged 26%, a decline of $2 billion [12]. A report published in September 2003 estimates that the value of lost sales to the industry will raise from $2.4 billion in 2003 to $4.7 billion in 2008 [31]. For the RIAA, it means a loss of more than $1 billion a year, tens of thousands of jobs, lost royalties and a large number of artists not getting contracts [23]. However, according to Nielsen Soundscan, the 3-year slide in music sales began to slow dramatically on almost precisely the same date the suits against individuals were filed, amid massive publicity [39].

But the negative impact of P2P services on record sales is not so clear and demonstrated. In fact, a study from Jupiter Media Metrix reported that 34% of users of unauthorized P2P services spend more money on music compared to 15% who spend less, when only 19% of internet users who didn't access file-sharing programs spent more [32]. 84% of downloaders use the Internet for music beyond just downloading, primarily for sampling, music clips, finding lyrics and tour schedule and to track down information about an artist before buying a CD. According to another study, Internet users who often download illegal files are 75% more likely to boost their music spending than the average Internet user [41].

5. Emerging business models

Considering the rise of the P2P networks and the rise of downloading of free music digital files, it seems reasonable to assume that these new technological tools meet customer needs that were unmet before. At its height, Napster had approximately 75 million registered users downloading 10,000 songs per second [29]. The costs of becoming a global distributor (or pirate) include the prices of a computer, of Internet access and electricity. Putting apart the price, or no price, issue, these concepts brought to the market a new kind of freedom. Consumers can break free from physical CDs and from a particular and unique standard of playing device. Digital files can be played on various devices such as a PC, a wireless phone, a PDA, or a MP3 player. On the contrary, all the attempts to protect copyrights lead to restricting access, and existing rights, such as making copies for personal use [7] Unlicensed music downloads are expected to peak in 2005, with 7.44 billion audio files and then, to decrease due to the arrival on the market of the legitimate music services on the Internet [46]. According to *Europemedia* [46], to be successful, these models should meet the criteria of (a) Availability from the five majors and from the independent labels, (b) Ownership for the customer who can mix it, burn it and copy it, (c) Portability on various devices, (d) Exclusivity with unique content and services that differentiate from unlicensed downloads, and (e) Digital rights management allowing share of music. We will describe hereunder some business models less well-known than the traditional ones that could represent innovative ways of earning money with digital music distribution.

5.1. The ransom model

This model was drawn from what Stephen King did with his last story. People who downloaded his story paid him $1, making a profit of more than $ 400,000. He announced that if he did not receive payments for at least 75%, he would not finish the story. According to Ku, by the same way, musicians could tease the public with free samples but withhold releasing a full album, or refuse to release any new works, or refuse to go on tour until sufficient compensation has been received [29].

5.2. The tipping model

With internet sites such as Espra and Snarfizilla, when users download a song they are given the opportunity to tip the artist. According to Ku [29], if only 1% of Napster users tipped each download, it would amount to half a million dollars in revenue per song.

5.3. The promotion model

In 2002, the rock band Smashing Pumpkins used Napster to distribute music on the Internet without traditional marketing [29].

Ticket sales, t-shirts sales and commercial endorsements are function of an artist's popularity. Internet could be considered as a valuable tool for increasing popularity by offering its music for free and thereby increasing its revenue as a result of fame [29]. For example, the artist Janis Jan offered free music downloads at her own site resulting in a 300% rise in merchandise sales [10] (see Figure 3).

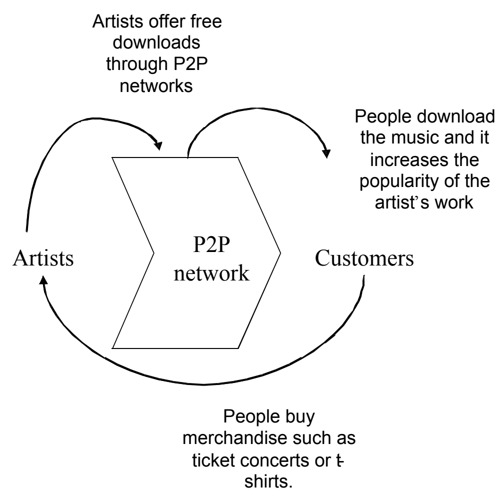

Figure 3. The promotion model.

Another version of promotion model could the one of PromOH3 which delivers tracks to a mailing list of members. Each e-mail is forwarded twice. The service is free to DJs and tastemakers but it seems that it would evolve into a membership-with-password model [33].

5.4. The customer data model

Files can be programmed to "phone home" every time they are used [29]. These data could be used by labels to direct investments and by artists to evaluation consumer preferences. This is even more crucial if you consider that 30% of American downloaders have had their musical tastes broadened by downloading and have indicated that their preferred genre of music has changed [32].

DJintheMix.com also charges for giving feedback to labels. It is a promotion and feedback tool for labels and the DJ community. Labels are charged between $250 and $600 per track for receiving feedback within 48 hours instead of two months. [33]

5.5. The preferred placement model

For less than one dollar per track in average, Altnet offers a secured content plus a sponsorship-driven search engine system. Companies pay for preferred placement in P2P, i.e., KaZaa, search results. They are gambling on the fact that customers will pay for higher quality content even if all tracks will still be available for downloads as free MP3s. This system can be used as a pre-radio promotion in order to build awareness [2].

MusicCity, operated by StreamCast Networks, offers also encrypted files via the Gnutella network. It wanted to focus on independent artists allowing musicians to set the price and content and receive 70% of the profits [16].

Considering this business model, recording companies as marketing machines and traditional physical retailer, either brick-and-mortar or online retailer, can be bypassed (Figure 4).

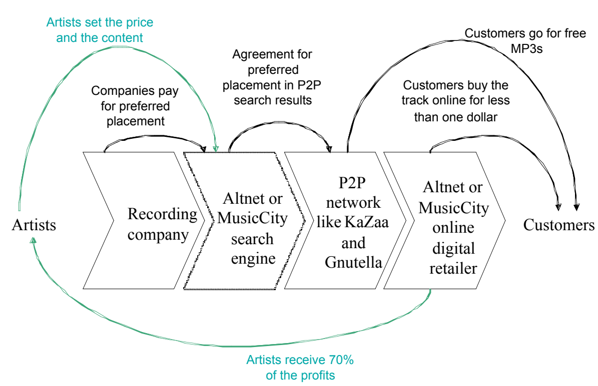

Figure 4. The preferred placement model.

5.6. The statutory levy model

An alternative to maintain a financial incentive for creation could be the imposition of a statutory levy, e.g., "a tax on the sales of the various goodies and services related to the duplication and distribution of digital works that would be used to fund creation." [29]. According to Ku, in 2000, computer and software stores in the US made about $ 23 billion in sales and radio, TV and electronic stores earned $ 42 billion. If a 2% statutory levy had been imposed, it would have yield about $1.3 billion to be distributed to the artists or $48,000 per new release. This amount refers to the projected revenues for the entire downloading market under copyright in 2002. In Germany, 182 million blank CDs used to burn music were sold in 2001 for 185 million CD albums [3].

Studies on the volume of downloaded audio files differ. Reliable estimates say that P2P services have 80 million users. Imposing them at the price of $1.99 per month would result in increased revenue of nearly $2 billion according to *Music Week* [19].

5.7. The space/time-shifting model

MP3.com operated the My.MP3 instant-listening service, in which copyright material is offered as on-demand stream [20]. MP3.com copied thousands of CDs to its Web site requiring each user to first prove that he or she had already purchased the desired CD. Once verified, the user was allowed to access the version stored on MP3.com's Web site from any Internet access point, without repeating the verification process [8].

In August 2001, Copyright.net and a consortium of 50 independent music publishers have filed a $25 million copyright-infringement suit against MP3.com [20]. MP3.com also held that it was a "fair use" helping users listen to CDs they had already purchased at a different location. MP3.com argued that its "space shifting" was entitled to the same "fair use" defence as the "time shifting" in the Sony case, i.e., recording a television program on a VCR for viewing at a later time. The court rejected this defence and ordered MP3.com to pay $25,000 for each copied CD. MP3.com settled with four of labels by agreeing to payments totalling $110 million [8]. MP3.com was then acquired by Vivendi Universal [45]

6. Integrated business models

What would be the possible future for music retailers? The Jupiter's European study (cited in [14]) showed that consumers were most interested in a pay service that also bundles discounts towards concert tickets, events and merchandise. "Consumers are looking for the most cost-effective experience online."

More and more companies are investigating the possible uses of a multimedia purchasing environment, especially the launch of digital kiosks allowing customers to hear samples and/or download digital tracks for a fee. Liquidaudio.com tempted to convince retail stores to place downloading kiosks. But the problem was that retailers made a very slim margin and the kiosk cost over $ 100,000 each [38].

6.1. The partnership model

According to S. Bazalgette, CEO of Music Choice Europe, "music will likely have to be bundled with other subscription based content [15]. For example, through a partnership with OD2, Times readers were able to download eight of Peter Gabriel's tracks before the official release of the new album. The reader had to use a PIN number included in the newspaper and register via a website [44].

Partnerships can be established between online players. For example, SpinArt staffers sent instant-message random users who downloaded the tracks and gave them gift certificates to the e-tailer Insound.com [13].

In order to build its brand online, Music.com has launched a magazine offline with publisher Milor Entertainment Group [13]. The magazine would be sold at $4.99 for a locked-content CD, Disc Space tied back to the Music.com site, offering 40 music tracks that can be purchased as downloads [13].

More recently Apple built partnerships with AOL and Pepsi. Consumers can link directly to iTunes from AOL's music site and would be able to win free downloads by buying specially marked Pepsi bottles [28].

6.2. The merchandise model

The merchandise business model aims at offering music for free and earning revenues by selling related music merchandise. Songspy is offering free downloads to its customers. Through the sale of merchandise, it will pay royalties to artists for tracks which songs are downloaded [40].

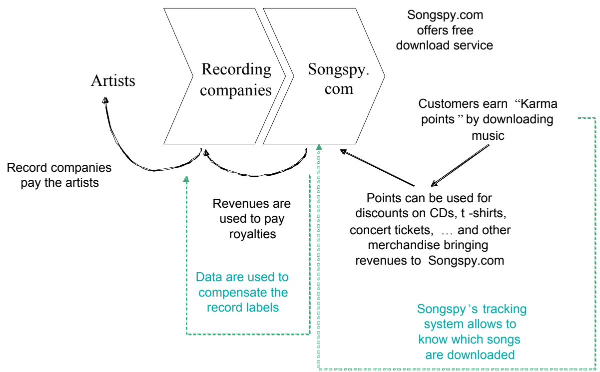

Figure 5. The Songspy model.

Songspy customers can earn "Karma points" based on their downloading activity. These points can be used for discounts on merchandise and promotional items like concert tickets. [40]. This business model as it uses a tracking system can also be considered as a customer data business model which offers the possibility to the record companies to monitor the downloading activity of the users and therefore to analyze customers' preferences (Figure 5).

7. Conclusion

One of the main problems as confirmed by Ted Cohen, EMI VP of New Media, is that "nobody feels wrong about doing what [downloading free MP3s on the Internet] they're doing" [20]. Another problem is the population concerned. Namely, people most fond of downloading free MP3s are the young customers, which should also be the future customers for CDs market. [1].

Even if some people are enthusiastic about online projects such as iTunes or Rhapsody, numbers are still far in favor of P2P alternatives. According to Electronic Frontier Fondations, 60 million of Americans were downloading music from P2P in October 2003, and 9.5 million in Europe used KaZaa compared to the 140'000 subscribers for MusicNet or the 350,000 of Rhapsody. Even if the KaZaa P2P activity slowed down after the massive suing of individuals by the RIAA, the risk of being sued is comparable to the weekly risk of dying to an auto accident, according to the *Network Magazine* [9]. Moreover, new alternatives appeared such as the darknets, i.e. private networks working like underground secret societies where you need to know the name of the group and a password to gain access [21].

According to Ku [29], there will still be a market for physical CDs given the ubiquity of compact disc players, the convenience of purchasing, the reliability of the data stored and the selection of music. The music industry may benefit from the example of the DVD. For the same price as a CD, the customer gets much more, e.g., a movie that costs millions of dollars to make (not a CD recorded in a garage) and all the extras, the interviews, the documentaries [29].

Kolosine, Astralwerks GM, thinks the opposite way: "We have a computer-savvy and youthful audience. The physical manifestation of product doesn't matter to them. Today's kids have been raised in a virtual world. […] They want music unconditionally." [cited in 33].

The business model seems to be shifting from a more physical product to a service concept; the power, from labels to artists and to consumers. Who is going to own the customer relationship? For instance, in the P2P world, customers seemed to be more loyal to the software than to the network [37]. Who is going to earn money from downloading music on the Internet? Would consumers accept more constraints and pay for some perceived added value? What would be the forms of added value?

According to the musician Moby, "the record industry will have to throw out its current business model. […] Once the record companies have less marketing clout, and with internet distribution, artists will be in powerful position. Why is a record company any more qualified to send an MP3 to iTunes than I am?" [cited in 47]

More research has to be conducted for confirming the assumption made by Sweeting [42] "The future of recorded music almost certainly lies in shorter more flexible, lower-profit-margin configuration than today's hugely overpriced CDs" .

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