

Business as usual or a real paradigm shift?

The music industry's response to e-commerce technology and ideology

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Abstract. Digital production and distribution technology, in theory, provide powerful opportunities for creators and performers of musical works to reach a potential global audience without dependence on the series of intermediaries that are so typical of the established music industry. Such a development, however, does not appear to have occurred in practice. This paper looks at the resilient nature of the established music industry value chain. Current data suggests, that the power structure in the music industry serves to retain a status quo where powerful players in the value chain can maintain their influence and revenue share, although their contribution in terms of value added had changed beyond recognition. The age-old tensions between concentration and diversification have not been markedly altered by the introduction of digital networks and production technology.

1. Background

The potential of e-commerce, particularly in the business to consumer arena (B2C), was widely promoted via a number of well-publicised predictions in the latter half of the 1990s. Value chains linking producers and consumers could be shortened, unnecessary intermediaries would be “disintermediated”. The consumer’s range of choice would expand by leaps and bounds. Prices would fall as consumer access to perfect information was reflected in competition. Suppliers’ profits would rise, since the need for middlemen and their commission would decrease radically. Issues of trust and security in commercial relationships were seen purely as technological challenges to be solved by technological means – related cultural issues were largely ignored.

The rise and fall of the dot.coms dramatically illustrated that many early e-commerce predictions and promises were neither easy to deliver nor, in some cases, at all correct. In many cases, the difficulties experienced or even failures could be traced to an ignorance of the relationship between the tangible and the non-tangible world. Few forms of e-commerce over digital networks can be totally independent of factors such as physical logistics and fulfilment costs, or even some form of physical presence related to trust [1], [2].

2. The music industry and e-commerce

Even a very modest interpretation of the early e-commerce promises suggested that the Music Industry could be a prime candidate for a restructuring of business processes in the digital, networked environment. Consider the following characteristics:

Production process: Input to the manufacturing process of the dominant physical products (recordings on CDs, printed materials) is already, as a rule, in a digital form. Digital distribution, in other words, should allow for the elimination of traditional manufacturing costs.

Production technology: High quality digital recording equipment is widely available at affordable prices. Digital sampling and simulation techniques have decreased producers' dependence on hiring the services of live musicians.

Distribution technology: Networks and associated software allowing the creator, in theory, to meet a world-wide audience are becoming more sophisticated as well as user-friendly. Peer-to-Peer file-sharing techniques such as those used in Napster allow interested potential consumers to exchange samples of music at will. The physical process of creating groups of fans (sub-cultures) in the physical world can, to a certain extent, be replicated in the virtual environment. Even if bandwidth constraints still constitute limitations of delivery speed and quality, the potential is there.

Music industry revenue sources: There has been a shift from tangible to intangible sources of revenue. In Sweden, for instance, over 50% of the music industry's net revenue came from other sources than the sale of pieces of plastic as early as 1992 [3], i.e. primarily from publishing and performance rights. More recent figures from one of the five major players in the industry, EMI, show publishing activities (generating revenue via exploiting or trading in Intellectual Property Rights assigned to EMI by composers) accounting for 17% of the EMI groups turnover, but no less than 47% of net revenue in the year 2000 [4].

Music industry roles: The traditional music industry value chain involves a number of intermediaries. It assumes that a writer creates a work of music, and assigns the right to exploit the work to a publisher. The publisher was originally part of the production process, investing in and distributing sheet music. A 50/50 revenue split with the composer was (and still is) regarded as reasonable because of the publisher's earlier investment requirements for producing sheet music. The publisher would also seek to find artists and record companies willing to record and distribute the composer's works. Once a combination of work and artists had been decided, the record company would produce the recording, manufacture phonograms, promote the product and distribute. The division of roles has hardly changed at all despite a) the shift to intangible sources of income, and b) the de facto integration of publishing and recording activities in gigantic vertically integrated corporations.

3. Trends in the music industry value chain

Various trends involving the amalgamation of roles in the music industry value chain can be observed [5], [6], [7], [8]:

- 1) The combined *singer-songwriter* (an artist singing his or her own songs) is now the rule rather than the exception in many pop genres.
- 2) Sheet music production is no longer the core activity of most major music publishers – new software programmes for writing music have been adopted by most composers thus eliminating the need for a publisher who invests in a manual operation.
- 3) Many creative talents have achieved a high degree of IT literacy, leading to the emergence of the combined studio producer/ writer role. Max Martin from Sweden, writer and producer of the majority of songs recorded by artists such as Britney Spears, is such an example.
- 4) Some publishers have moved gradually into traditional areas of record company operations, particularly that of A&R, i.e. the matching of repertoire with choice of artists. By building their own studios and contracting singer-songwriters to both write and record demonstration recordings, (which then may or may not be released and distributed by a record company) they have moved further up the value chain in the direction of the consumer.

4. So what should have/has happened?

The observations above suggest that a radical restructuring of the music industry is under way, one which should automatically enhance a shift in favour of the e-commerce visions noted at the start of this paper. Singer-songwriters and their studio producers should be able to bypass the established industry and find their own audience via the Internet (as long as they can make themselves known and heard in all the noise in this distribution channel).

In 1998, the market research organisation, Jupiter Communications was predicting the collapse of the 5 major music corporations' oligopoly control over music production and distribution. "Although a viable distribution model is still far from being established, development continues and online music industry players are slowly wresting the rights away from the traditional distribution dominance of the major record labels" [9].

What actually happened hardly supported the predictions of analysts. The five leading music corporations (AOL-Time Warner, Universal-Vivendi, Sony, EMI and BMG, known as the "Majors") were very slow to adopt the Internet as a distribution channel. Their fear was that they would lose control over their copyrights once music was let loose in this "un-managed" network. While they were slowly deciding how to possibly embrace the on-line environment, others were doing it in very different ways. MP3.com and related companies quite simply made music available, in a fashion which was clearly incompatible with intellectual property legislation. Napster followed with what turned out to be a "killer application", a remarkably simple application allowing users to have access to music stored on their own hard discs.

The so-called Secure Digital Music Initiative (SDMI) was the music industry's most highly publicised attempt to provide a secure digital environment for music distribution. The SDMI consortium, a mixture of music companies, companies specialising in digital security technology, telephone companies, consumer electronic firms, banks etc., was formed in early 1999. The aim was to produce watermarking standards which could be observed by both the hardware and the software industries [10], [11]. SDMI did not materialise probably because of the wide range of personal agendas characterising the members of the consortium. A challenge to hackers in late 2000 led to the codes being cracked within hours by researchers at Princeton University [12].

On-line sales have not taken off in a spectacular fashion. The on-line share of the music US sound carrier market in 2000 was 3.2%, up 0.8% from 1999. In reporting these figures from the Record Industry association of America (RIAA), the London-based "Music and Copyright" newsletter noted that the figures "supported the view that delays by the major international record companies in developing their online strategies have slowed down the expansion of the US online market" [13].

A second type of reaction can be observed in the case of smaller independent recording companies (the "Indies"), that have been keen to test the new technology. They saw the Internet as an amazing opportunity for music creators to discover the shortest distance to a potential audience anywhere in the world. Often working with lesser-known artists or less popular musical genres, these companies naturally saw such opportunities to bypass the mainstream industry as particularly attractive. Even here, however, success was limited. Consumers showed little willingness to pay for digital downloads of recorded music. Their propensity to pay was decreased even further by the emergence of companies such as MP3.com and file-sharing applications such as Napster which made recorded music available "for free". That said, there is evidence that the increased availability of music in virtual form as MP3 files leads to an increased consumption of physical products such as CDs. For example, in an address to the annual PopCom music trade fair in Germany, the forecasting company Jupiter presented findings suggesting that 26% of those who used Napster while

searching for music on-line actually increased their purchases of CDs whereas the corresponding figure for non-Napster users was only 16% [14].

5. The potential for disintermediation in the music industry (revisited)

Let us now return to the potential of e-commerce in the music industry. Digitisation in the music industry suggests a very simple business model, where composers/artists can produce their own recorded products without involving intermediaries or external suppliers. The Internet offers a means to present such material to both businesses and consumers, with the only problem being the efficiency of search engines and noise in the system. If a consumer is not aware of the existence of a new artist, composer, group or style of music, then how can the supplier attract a potential audience?

It would be naive to assume that no intermediaries are required between creator and customer. Commercial users of music such as radio stations can hardly have an interest in dealing individually with every creator or rights holder. This is why a system of “blanket licences” exists between broadcasters and intermediaries representing the rights of numerous creators. The music Copyright Collection Societies fulfil this role when giving broadcasters access to all the repertoire that has been assigned to them by rights holders (composers and publishers). The PRS in the UK and STIM in Sweden are examples. Similar organisations exist in several countries for collecting and distributing performance dues for performers (e.g. PAMRA in the UK and SAMI in Sweden).

Such intermediaries need efficient databases which hold correct details of all the works /rights holders they represent. They must also be able to identify usage of works in different contexts, and be able to distribute income accordingly. They must be fair, transparent and efficient (essential prerequisites for functioning intermediaries in an e-commerce business model).

6. Vertical integration in the music industry and its effects

From the outside of the music industry, it would appear that collecting societies play a pivotal role in the operations of the industry, controlling tariffs and regulating the flows of money between exploiters (record companies, broadcasters, etc.) and rights owners (authors, publishers). This, however, is a gross simplification of the actual workings of the industry. The reasons can be found in the move towards vertical integration, with the same corporation controlling both publishing, recording activities and, in some cases, even broadcasting. For example, the amalgamation of AOL and Time Warner in 2000 added considerable Internet and cable access to the areas under AOL Time Warner control.

Vertical integration, involving the control over different stages in the production and distribution process, has allowed the major players to hinder disintermediation in the traditional music industry value chain. It has allowed them, for instance, to control value chain entities on both sides of the significant intermediaries (collecting societies), by exerting overall control over rights ownership (via publishers) and rights exploitation (e.g. record companies).

Major publishers, by virtue of their size, can choose to play one of three different roles in their relationships to collection societies:

- They can act as loyal members, using the society as a powerful negotiator when negotiating prices with music users.
- They can demand preferential treatment because of the large number of copyrights they control.

- They can even compete, by endeavouring to bypass societies. An example of this would be a large publisher doing a one-to-one deal with a mobile phone manufacturer for its works to be made available as ring tone signals, as opposed to the local society offering a deal which covers all repertoire.

Rivalry between Copyright Societies has also been encouraged by competition authorities concerned with the copyright societies monopoly status. It is clear that the value chain needs efficient intermediaries to remain efficient. Our analysis above questions whether there is still the need for both publishers and record companies in their traditional roles.

7. The traditional music industry's e-commerce track record

This paper will now attempt to summarise the sequence of events which lead to the “business as usual” postulate.

7.1 Production and distribution technologies

New digital distribution technologies are introduced which offer the potential for creators-/producers of music products to reach a global audience. The need for some traditional intermediaries should diminish.

Music products can easily be digitised, and digital technology has decentralised the production process. This suggests that the music industry could easily and speedily reap the benefits of electronic commerce.

7.2 Consumers' use of technology, new entrepreneurs and threats to copyright control

Since digital networks allow consumers more power over what happens to copyrighted material, the reaction of the major players was one of suspicion and fear. Only projects where music files could be encrypted or watermarked were encouraged.

Interaction between users and the new technologies led to a variety of initiatives outside the control of the established music industry:

- MP3.com offered copyrighted materials over its distribution network – it also offered individual creators the ability to post material on the MPP3 site and share part of any incomes from advertising (thus disintermediating much of the established industry). MP3's policy of making copyrighted materials available to its subscribers was clearly illegal – maybe this was a conscious decision as part of a strategy to achieve critical mass by any means.
- Napster allowed users to share files on their respective hard discs. This put Napster in a grey zone of legality – by involving a central server which could log activity, it could be claimed that Napster was supporting the uncontrolled spread of copyrighted materials, thus causing copyright owners considerable losses. The music and film industries claim that this is the same as stealing since it would seem to discourage users from buying physical products or even paying for digital variants. File-swapping adherents claim that it is merely a digital equivalent of lending a personal CD to a friend.

7.3 Industry reactions (technological, legal and financial)

The established industry countered such digital initiatives in three ways:

- a variety of initiatives and limited trials aimed at implementing a completely “secure” distribution system (where technological solutions and not user friendliness were the driving force),

- a series of legal cases brought against companies such as MP3.com and Napster,
- indirect involvement in new e-music initiatives by buying a stake in them without necessarily making copyrighted materials available for distribution. On the 18th of April 2000, the Wall Street Journal reported that one of AOL's first actions when planning its merger with Time Warner was to block development of the Gnutella application (a simpler form of Napster which does not require central servers and is thus harder to police). After a complaint from Time Warner "AOL removed the software from its site and denounced the project as 'an unauthorised freelance project'".

There are several examples illustrating how these two strategies have been combined. One of the lesser publicised but most instructive is that of the US company Scour.com, which offered a file sharing system somewhat similar to Napster, for both audio and video materials.

Scour was sued by both the US recording industry and the film industry in July of 2000. To alleviate its problems, Scour filed for bankruptcy and offered to sell its assets to another e-commerce firm, listen.com. All five major record companies have a financial interest in listen.com. A spokesperson for the Recording Industry Association of America (RIAA) said that cancellation of the suit against Scour would be dependent on its new owner, listen.com, shutting down its "file exchange service and search engine" [15].

BMG, via its parent company Bertelsmann, applied an even more direct strategy to come to terms with file swapping companies. In 2000, Bertelsmann did a deal directly with Napster while a legal case for damages driven by the RIAA was still in progress. The majors' actions against MP3 were settled out of court, with one exception. Universal (Now Universal-Vivendi) won a court action but used some of the proceeds to purchase share options in MP3.com, and then moved to take total control of MP3.com.

The industry policy in other words was one of "get rid of them or control them".

By introducing a number of filters in the Napster system, as a result of court actions by the RIAA, it could be assumed that file sharing of copyrighted materials would be drastically reduced. From a creator's point of view, of course, this assumes that every file shared by a peer-to-peer system is equivalent to a lost commercial sale (a dubious postulate which is not universally supported by available research).

8. Conclusions – business as usual?

Is it back to business as usual, with the same 5 major music/entertainment corporations controlling the rules of play? Or has the drama and rhetoric of Napster court cases and MP3 settlements masked significant irreversible developments?

Some of the most interesting survivors amongst the e-commerce music initiatives are those linked to the music collecting societies.

This paper has stressed the importance of these intermediaries which collect and distribute "intangible" revenues to artists, publishers, composers and producers. They have extensive databases about artists, composers and works. They can, in theory, offer new platforms through which creators can find a shortcut to users, both business users and individual consumers. The Spanish collecting society has invested heavily in an Internet site known as Portalatino, offering composers the ability to create their own home pages and make recordings available to consumers who visit the site, without the involvement of intermediaries such as record companies and publishers. The society was taken to court by the major publishers who claimed that this was a misuse of members' funds, since they too are members of collecting societies such as SGAE. Another interesting initiative is the Phonofile digital base in Norway, which allows commercial users to browse and purchase from over 25,000 digitised recordings, mainly from independent Norwegian record companies.

Such initiatives might not be highly appreciated by sectors of the existing music industry value-chain, but they would seem to be the only way to shorten the route between creators and listeners in the digital environment. They also represent interesting e-commerce developments which have been masked by the drama of Napster and MP3.com.

9. Final thought

The concentration of power in the music and entertainment industry via vertical and horizontal integration witnessed in the latter half of the 1990s is unprecedented. The role of regulators towards those who wish to control, on a global level, rights' ownership and means of production and distribution will be critical, as will be the interaction between people and new technology. Fortunately, the interaction of people and technology in the media field always seems to result in applications that have never been foreseen either by the inventors or the financial forces that seek to exploit or block the same technologies.

As for Napster and the other software applications which have emerged from the interaction between technology, users and developers, one thing is very clear. Millions of Internet users have learnt the art and experienced the rewards of peer-to-peer file sharing techniques. This represents a move along a societal learning curve which could never have been achieved so speedily by either government policies or the most imaginative of IT industry-led marketing campaigns. If the established music industry had had its way, it would not have happened at all.

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