RIAA Ex. O-146-DP

"The Future of Music *is now and the authors have clearly seen it. This comprehensive and controversial commentary is a must-read for every serious music industry professional."*

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"The Future of Music *could only be told by visionaries such as Kusek and Leonhard, who live and play both the high and low notes in the business of music. What a sweet sound would be played if music and business would blend consumer needs, technology, and business models, and the authors certainly know all pieces to this puzzle."*

—Jeanne M. Sullivan, StarVest Partners, L.P.

"A must-read for musicians planning to survive the next five years."

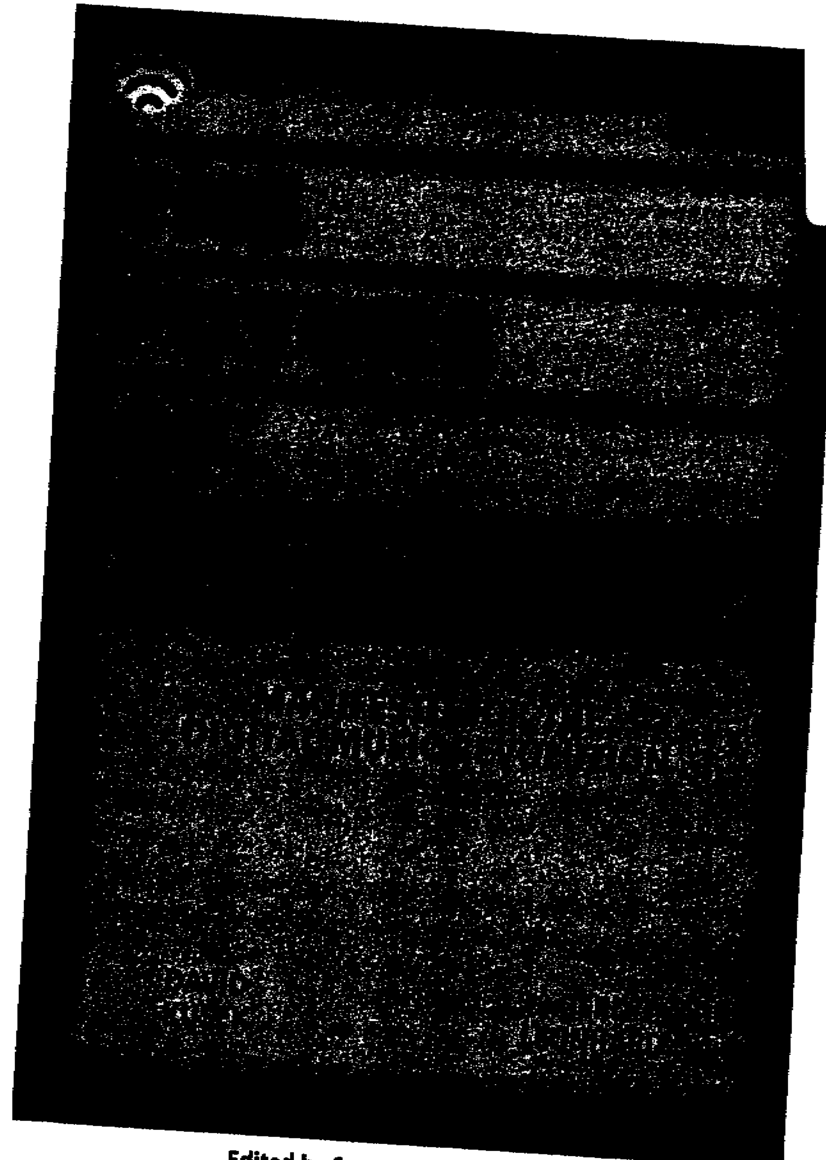
—Mark Featherstone-Witty, CEO, The Liverpool Institute for Performing Arts

"The Future of Music *is an essential primer for professionals, creators, educators, and music aficionados, and those who need to understand just how the unbounded public appetite for digital music is changing the very core of the music experience. This well-articulated book provides a much-needed path through the thicket of confusion that has characterized the modern music industry. It is a most useful resource to help understand the profound changes that are reshaping the way music is bought, sold, digested, eaten, stored, and swapped."*

—Ralph Simon, Chairman, Mobile Entertainment Forum-Americas

"I know of no other text that as beautifully and concisely presents the fundamental challenge that music now faces. This book is essential for anyone who wants to understand what is at stake in this debate."

—Lawrence Lessig, Professor of Law, Stanford University and founder of Creative Commons



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Printed in the United States of America by Vicks Lithographic & Printing
12 11 10 09 08 07 06 05 6 5 4 3 2

Library of Congress Cataloging-in-Publication Data
Kusek, David, 1955-
The future of music / David Kusek, Leonhard Gerd.
p. cm.
Includes index.
ISBN 0-87639-059-9
1. Music trade. 2. Sound recording industry. I. Leonhard, Gerd, 1961- II. Title.
ML3790.K86 2005
381'.4578'0266–dc22

2004025942

1140 Boylston Street
Boston, MA 02215-3693 USA
(617) 747-2146
Visit Berklee Press Online at
www.berkleepress.com

DISTRIBUTED BY
HAL•LEONARD®
CORPORATION
7777 W. BLUEMOUND RD. P.O. BOX 13819
MILWAUKEE, WISCONSIN 53213

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www.halleonard.com

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In the future, the opportunity to influence, and thus market to, large groups will lie squarely with the ability to reach them quickly, inexpensively, and of course *virally*, via peer groups and via the smart leveraging of social networks. Radio play, advertising, street teams, events, and many other traditional forms of marketing are going to fit right next to new forms of peer-to-peer digital marketing. Creating a buzz has always been essential in the promotion of music. Exposure begets discovery, which begets income. Smart marketers will try to compete with free music and enable the kids to transact easily, much as Apple is doing with its iTunes "allowance" and as Napster 2 is doing with its prepaid download cards distributed at major retailers. Smart Web sites, cell phones, and network savvy applications are where it is at in the future of music marketing to the digital kids.

7

A New Music Econo

Long Time Gone: A Perfectly Broken System

The music business has been based on a star model since its inception. The RIAA confirms that less than 10 percent of recording artists ever recoup their royalty advances, and even that number is wishful thinking, really. Of the approximately thirty-two thousand new CDs released each year, only 250 sell more than ten thousand copies, and fewer than thirty go platinum (one million units sold, in the U.S.). That's 1/10 of 1 percent of the new releases (0.001). Sort of like playing the lottery, except if you're the artist, you're betting with your life—and the odds may indeed be better with the lottery.

Only 15 percent of the musicians who are members of the American Federation of Musicians union have steady gigs in music, and the 273,000 working musicians in America make an average of $30,000 a year—compare that to a cab driver's income. Of course, the real steady money in the music business is in publishing, where songwriters, due to the compulsory mechanical royalty on all records sold and the revenues that flow from public performance, can often make a decent living over a reasonable period of time—nickels and dimes from a multitude of sources.

Most record companies today market artists based on a "see if it sticks" approach. They put a hundred different artists on the market, knowing that less than five of them will ever break even. They hope for that one act that will hit the big-time so that they recoup the entire investment across their whole roster of acts—not much different than a venture capitalist who invests in thirty companies with the hope that one of them will grow to be the next Netscape. Looking back, one could convincingly argue that artist development declined long before the Internet assault on the music business began. The CD replacement cycle that saw many of the fans buying the same music on CD, again, caused an unexpected ten-year boom for the record companies, and this boom was largely based on reissuing existing catalog in the high-quality CD format.

Artist development and the idea of nurturing a career gave way to a herd mentality, in which label executives scrambled to chase and repeat the success of someone else's combination of talent, timing, and good luck. Remember the disco explosion that followed Donna

Summer's early hits, or the rush to sign Grunge bands from Seattle after Nirvana broke big, or the boy bands of the 1990s, or the *American Idol* and revived *Star Search* television shows of today.

In addition, the consolidation and concentration of record labels into the hands of a few large conglomerates, and the deterioration of radio playlist diversity brought on by that industry's deregulation, has made the industry even more risk-averse than ever. With the exception of EMI, and more recently Warner, the major music labels are but small subsidiaries of huge corporations, and it often seems that the actual *music* no longer really matters in their day-to-day decision making. According to Joni Mitchell, in a *Rolling Stone* interview, "I hope it all goes down the crapper. I would never take another deal in the record business . . . I'll be damned if I'll line their pockets."

Still, the Internet and other digital content networks have taken the lid off the record business. The veil of secrecy and nepotism has been removed, exposing the uniquely bizarre behavior that is still prevalent in this business, plain for all to see. Once pioneering artists such as Todd Rundgren, Prince, Aimee Mann, and Peter Gabriel realized that they no longer needed to be the chips in the record industry's poker game, things began to change. Digital content networks now provide the opportunity and exposure for artists to drive their own careers, as musicians and artists, without being under the de-facto control of an international cartel.

During the first decade of online music, the incumbent music companies were not sure how to handle the many issues associated with selling music online, and most major players simply held out, and stayed put, in order to eke out the best possible deal. Most notable were the major labels that, for a long time, basically refused to license their catalogs to the early entrants into the digital space. A lot of song and dance went on, but few deals were closed, and even fewer actually allowed for any real business to happen. The result: music fans flocked to unlicensed services.

The labels wanted to keep the control of *all* pieces of this puzzle, at all times, simply because they felt that it was, after all, "their" recordings that were being downloaded and used as the prime force in this business. Then again, this view has now been proven wrong: content *in and of itself* is *not* king, and is no longer the sole reason that people will give the music said earlier, content is king, the customer is King Kong, and service is Godzilla—that could well be the mantra of the days to come. The next few pages will describe some of the bright spots in the future of music and will help us think about new ways of reconfiguring the music business and the artist/fan relationship.

Pennies from Heaven

Publishing and all kinds of licensing will likely be digital cash-cows for artists and writers, in the future even more so than today. New contract constructs and agency-type deals are likely to approach the digital transaction from a licensing point of view rather than from a "work for hire" standpoint. Artists may stop doing business with record labels that have become outmoded dinosaurs. Ultimately, within the next five to eight years, the legitimate music downloading services such as iTunes and Rhapsody have enormous potential to generate substantial revenue, and very likely, the pie will only be larger, with more pieces for everyone. But the real question is: *who will get the money?* When credit card and payment companies make a larger share than the artist, something clearly is wrong.

The prevailing business model of publishing, in which royalties are collected and administered on behalf of the songwriter, still has a firm place in the future, as long as people will spend money (or its equivalent) for music—and it's safe to assume that they will, under the right circumstances. Although the actual methods of distribution may vary, it remains the mission and duty of the publisher to ensure that a writer's work is heard and seen, and that they are paid for it, one way or another. While mechanical reproduction income from CD sales will likely drop further, there is significant potential for this revenue stream to be bolstered with the legitimate download model.

The digital network itself will benefit writers and artists because sales and/or uses are much easier to accurately track and report. Currently, most performing rights organizations still rely on human estimates, averaging, and sampling. For example, the royalties paid on music played in restaurants is based on the same sample data as radio airplay, and surely that data is skewed because no consideration is given for the more likely ethnic diversity of music played in restaurants.

Independent Labels

Independent and smaller artist-owned labels are usually structured so that they can survive with much lower sales and turn a profit by employing niche-marketing methods. Thus they are less threatened than the large record labels. In the past, the independent labels were agreeable to licensing their catalogs to legitimate music download services when major labels stalled. Smaller labels are also better able to focus on developing the careers of their artists. Their smaller size also will help them to remain flexible, as they will be able to adapt and re-tool their business models when necessary. More than ten thousand independent labels exist today, with many more on the way. This is extremely good news for the music business.

Most of the innovation in music has always come from the independent labels that were willing to take risks. When rock 'n' roll exploded on the scene in the mid-1950s, major labels scorned it. However, basement concerns like Chess and Sun made fortunes. Likewise, no one initially saw a buck in disco except Casablanca Records; again, millions were made. More recently, rap, hip-hop, country, and to a lesser extent, reggae, illustrate the same story. Major record labels are often too large and ponderous to be in a position to discover and nurture great musicians during the early phases of their careers. Independents worldwide have been and will continue to be the lifeblood of the music industry, and most significant musical trends have had their origins in small independent music labels.

The Billboard charts of the last few years show an interesting and somewhat surprising trend. Thanks to the installation of point-of-sale systems at major music chain retailers, SoundScan's computers can poll music stores and get the exact number of each title sold. Prior to SoundScan, sales were tracked by a questionable method of manually polling music chains, wholesalers, and independent record stores—a process that highly favored the major record labels.

By 1991, three indie labels had entered the list of top-twenty labels, placing nineteen titles on the Billboard 200 for 5.1 percent of the label chart share. By 1992, the indie labels represented thirty-four titles on the chart. The trend is even more dramatic if we look at Billboard's Top R&B Albums chart, where the indies' share doubled between 1990 and 1992, to a total of 22.2 percent. During one week in 1996, indie-label bands occupied all top five spots on the chart!

Majors today seem to act more like film distributors than production houses. They have the organization, the capital, and the clout to take new music to the broad public, but little ability to develop the next hot artists, themselves. Indies are the highly valued testing grounds for the superstars of tomorrow.

"While the majors want to sell music like McDonald's sells hamburgers, we'd rather be a small chain of gourmet restaurants with a line going around the block," says Bruce Iglauer, founder of indie label Alligator Records. "It's the menu that counts—not how many are served." Independent labels are artistically and creatively on the cutting-edge of the new music, and new music is not a fad; it is the fastest-growing segment of the music market. It includes everything from rap, urban, and alternative to country, world, and folk.

Growing market segmentation by musical style is another significant factor for independent labels. Rock's share of music sales, so long the mainstay of pop music, has plunged 27 percent since 1987 to about 32 percent of the total. This new musical diversity is reflected in the Grammy awards, which started in 1959 with a mere twenty-eight categories. That number has grown to nearly one hundred.

A rapidly segmenting music market means more opportunity for independents whose releases detail the richness of particular niche musical forms: the blues of Black Top and Alligator, the rap of Priority and Ruffhouse, the industrial dance meshes of Nettwerk and Wax Trax, the world folk of Green Linnet, the rock 'n' roll of Touch 'n' Go—the list goes on and on.

Many of these companies didn't just find a niche and fill it, as so many lesser New Age and "fuzak" labels do, nor did they just concoct one and market it, like so many major-label-forged "alternative" indies. They usually developed their label along with the music they presented, often as a hobby, bringing bands and artists to an ardent audience and then riding the crest of their influence. For a number of the smarter and luckier indies, yesterday's hobby has become today's gold mine.

Record retail is only part of the story. Independents have long known that the most effective way to reach their niche audiences is to go direct via mail and now, of course, via the Internet. Direct marketing of music recordings accounts for about 10 percent of overall sales in the U.S. for major labels, but up to 50 percent of sales

for independents! Other record retail alternatives include bookstores, record clubs, specialty gift stores, and television home shopping.

Going forward, music will increasingly be direct marketed and distributed on digital networks. It is now possible to reach an audience directly and use the Internet to deliver the music, or leverage the almost daily-appearing digital music distribution services that are exploding online. Here, it is more important than ever to develop a loyal fan base and meaningful customer relationships. "The accelerating trend," says Davitt Sigerson, former president of Island Records, "is putting much more control in the hands of the public, and much less control in the hands of the tastemakers and gatekeepers."

Sanctuary Group

Sanctuary Group, *PLC* is terrific example of a well-run musician business providing a network of connected companies that address all aspects and opportunities in the music industry. It is perhaps the model for the music company of the future, with 360-degree participation of all the related revenue streams meaningful to artists. Sanctuary businesses include recorded music, visual entertainment, artist and producer management, tour support, live booking, music publishing and licensing, new media, marketing services, recording studios, book and DVD publishing, and merchandising.

Sanctuary has achieved impressive growth by focusing on established artists with a substantial fan base and providing them with all the services and support they could possibly need. While most of the major record labels were dumping acts by the dozens, with some artists running screaming from them, Sanctuary has been steadily picking up the established acts with staying power and loyal fans. Sanctuary has focused mightily on developing their artist services businesses—management, live booking, and merchandising—across a wide spectrum of artists. This strategy is paying off and positions them as a potential long-term survivor. They are filling the vacuum left by the major labels with a more enlightened business model, based on a philosophy of artist management.

Sanctuary is the U.K.'s largest independent record company focused on producing music and DVDs for their artists. Their catalog includes Morrissey, the Libertines, Kiss, Lynyrd Skynyrd, Spiritualized, the Strokes, Widespread Panic, Ween, Nash, Alison Moyet, the Delays, Small Faces, and Fun Lovin' Criminals, across over twenty labels. DVD titles include the Who, Iron Maiden, and Rush. But far more than just a record label, Sanctuary provides a host of services to artists seeking success in the music business.

Their artist management teams represent Beyoncé, Destiny's Child, Mary J Blige, Judas Priest, the Who, Groove Armada, Guns N' Roses, Iron Maiden, Fleetwood Mac, the Von Bondies, Jane's Addiction, Slayer, Slipknot, and others. They also manage music producers, including John Alagia, Bob Ezrin, Ethan Johns, and Chris Neil. Sanctuary now owns the largest live booking agency outside the U.S., booking some seven thousand shows last year and reporting a very healthy marketplace for live music. The booking agency handles tours for lots of bands, including Robbie Williams, the Darkness, Dido, Eminem, Red Hot Chili Peppers, Metallica, Coldplay, Marilyn Manson, and 50 Cent. Sanctuary also runs an in-house travel agency and tour production company, which provide tour logistics for their managed acts.

The Bravado company sells merchandise on live tours, at retail outlets, and on the Web. Bravado claims to be the fastest growing entertainment merchandiser in the world today, representing Christina Aguilera, Robbie Williams, Eminem, 50 Cent, Iron Maiden, Led Zeppelin, N.E.R.D., Elton John, Hilary Duff, Beyoncé, Jane's Addiction, and Oasis. Bravado can provide artists with lots of opportunities to sell things, including ring tones, branded games and wallpapers for mobile phones, as well as the usual T-shirts and posters.

Founded in 1979 as a management company for Iron Maiden, the Sanctuary Group has been on a financial tear for the past years, expanding revenues from £23 million in 1999 to £152 million in 2003, all the while being very profitable. And we thought the music business was in trouble?

www.sanctuarygroup.com

Live Performance and Touring

While CD sales were falling over the last four to five years, the popularity of live shows, festivals, and concerts has been increasing every year, and revenues from big-ticket concerts have grown steadily. For musicians in the pop and rock genres, the chance of making a living in the traditional CD-sales based "record business" is rapidly dwindling—but maybe that's a good thing. After all, that elusive major-

label record deal all too often proved to be a pyrrhic victory, anyhow, since only 4 percent of records ever sold enough copies to break even.

Perpetual obscurity would thus seem to be the default destiny for many of today's musicians, if it were not for the "music like water" paradigm changes described in this book. This new paradigm—in which music changes from product to service, and musicians derive greater exposure and income from live performance, digital performances, and other revenue streams than they do from CD sales—will not be as daunting for jazz and classical musicians, for example, who are accustomed to earning most of their money from live performance anyway.

Is this where the music industry is heading, in a digital future? Back to earning a living "with your feet" and hitting the road to make a buck, in order to find and reach your audience? Yes and no. We think that many aspects of digital music (and "digital music marketing") and live entertainment will be converging down the road, and that the two sectors will be much more intertwined than music/CD retail and touring could ever have been. Why? Because *digital music is mobile*, and as intangible and experience-based as the concert experience. In fact, because of digital technologies, we may well see the manager and agents of the future take on some distribution and product marketing tasks, as well, and thus further decimate the importance of the traditional record company.

Historically, the music retail business seems to have developed on a separate tangent from the live music industry, with a different view on how money is made and shared, a different breed of people working in it, and with its own conventions, events, and trade shows. As a result, we have two rather different segments within one industry, but this will rapidly be amalgamated in the digital environment. Digital music companies will have to take a much more inclusive view of the music industry landscape, and will quickly seek to harvest a lot of synergistic revenues. Live music promoters and agents have always been much closer to the artists and to their audiences (i.e., the ticket-buyers and concert-goers), so it is only natural that they would recognize the shifts in the marketplace and act accordingly.

Technology has long been embraced wholeheartedly in the concert and touring business, whether it is in the production sectors (lights, sound, multimedia), logistics (booking and accounting communications), or the marketing of the shows (e-mail, online tickets, market research, etc.), and many cutting-edge applications of technology have emerged. New services like Boston's SonicBids (www.sonicbids.com) allow concert promoters to gauge their target audience in various markets, and thus avoid booking shows in locations that are less likely to work with any specific act.

Most importantly, since the concert business has always been an experience business, its executives and managers have always been required to stay very much in touch with their customers to avoid costly disconnects and productions that did not succeed in getting the attention of the marketplace. Customer empowerment is already a default setting in the concert business: the customer calls the shots, and always gets what he wants. We saw this clearly in the summer of 2004 in the U.S., where customers actually turned away from popular shows because of the sky-high ticket prices promoters had set. This has caused the concert business to reassess the advances and guarantees paid to artists and realign their pricing strategy to the clear signal from the buying public. Compare that to the traditional record business, which is essentially internally oriented. In the record business, a few companies and their moguls have dictated the terms that the "user" must adhere to, or else forget about the music.

Sadly, but not surprisingly, customer empowerment is not what the record business has been all about, and if the record business can take a few pages from the concert business, it would be much better off. But it may be a case of "too little, too late." The record business of tomorrow may have left itself wide open to a takeover by the agents and managers. Imagine the strategy-room whiteboards in those big music agencies!

The record industry, in its obsession with mass marketing, huge profit margins, and top-down domination, has gradually but steadily grown detached from its artists and, even worse, from its fans and consumers. There is very little direct communication between the people who run record companies and the people who buy their records, and it shows. The disconnect runs so deep that record companies actually thought they could get away with suing their own customers without consequence for looking elsewhere to get their needs met. The real "music guys" in the record business have come and gone—with notable exceptions such as Clive Davis and Quincy

Jones—and the ships are now captained by corporate functionaries who could just as well be running Novartis, Toys "R" Us, or Starbucks.

While the record industry has grown isolated and out-of-touch in its New York high-rises, Hollywood Jacuzzis, or the golf courses surrounding Guetersloh, Germany (home of Bertelsmann, of BMG), the concert industry has had to face the tough reality of what people will *actually* buy, and for how much, day in and day out. While many joke that music publishers practically "make money in their sleep," collecting royalties from the performance and use of their songs in far-away places without having to actually be there themselves, the concert business works every single show, right there, in person, in real time.

The concert promoters and venue owners like Clear Channel are already distributing live recordings of the shows directly to the audience as they leave the venue. Artists including Phish, the Allman Brothers Band, Peter Gabriel, the Who, String Cheese Incident, Primus, Dave Matthews, Duran Duran, Moe, and Incubus have all experimented with delivering live shows via the Internet, and many are finding it quite lucrative. You can get the show on CD, directly download it to a portable USB key drive, or download it off the venue or band Web site when you get home. In the near future, you will be able to collect a real-time stream of a live performance you are listening to directly to your WiFi-enabled device, and take it home with you.

This live interaction and integrated music experience, combined with the Web and the power of direct marketing and community building, is about to blow the doors off all previous forms of music marketing and distribution. The record companies are getting broadsided by their buddies in the concert business, who appear to be set on increasing revenues at the expense of those asleep at the wheel.

Merchandising

Artist merchandising stands to benefit nicely from the digital transformation of the music business. Direct marketing is the Web's way of selling, and it's certainly easier than having fans wait in line at a show—it also helps to form a richer and more direct consumer relationship. For many years, music merchandising was simply the days, the very nature of music merchandising is undergoing a very positive transformation, and it is now more about the marriage of music, culture, creative marketing, and fashion. Jimmy Buffet built an empire of restaurants on the "Margueritaville" theme, and got into tequila distribution and frozen foods alongside his sold-out concerts and CDs. Applying entrepreneurial thinking to the development of "musician businesses" often includes a redefinition of merchandising—and it is creating a new industry that transcends the notion that the only way to make money in music is to record and perform. One only has to look at the success of Def Jam and Bad Boy Entertainment to see the power that music marketing and merchandising have in driving all kinds of new forms of revenue for artists.

The Hip-Hop Phenomenon and the Rise of the New Moguls

Hip-hop culture has become a de-facto part of mainstream culture through the combined power of music, merchandise, and marketing. Brands such as Baby Phat, Roc-A-Wear, Sean Jean, Phat Farm, Shady, and Snoop Dogg are among the leading brands of hip-hop-inspired clothing and merchandising businesses, and are making many of hip-hop's smartest artists very wealthy. According to Simmons Lathan Media Group, 45.3 million consumers worldwide spend $12.6 billion annually on hip-hop media and merchandise. The hip-hop success formula has a lot more to do with creating far-reaching musician businesses than just selling CDs.

Entrepreneur Russell Simmons spearheaded hip-hop culture's move to the mainstream with Def Jam Records in the '80s, and has since expanded into marketing, fashion, theater, and jewelry. Sean "Puffy" Combs began developing recording artists as a teen. Within two decades, he had parlayed his skills into a multifaceted, multimillion-dollar empire that includes his own record label, clothing line, and restaurant chain. Jay-Z has clothing company Roc-A-Wear, a Vodka distribution business, and another joint venture with Reebok to market his S. Carter Collection sneakers. Hip-hop artists Simmons, L.L. Cool J, Missy Elliott, Eminem, Ludacris, Nelly, Sean Combs, and Jay-Z have shown corporate America that hip-hop can generate substantial dollars outside the recorded music industry. They have parlayed their early success in the record business into powerful empires that they control.

Hot Topic

Founded in 1989, Hot Topic, Inc. seized the potential of fusing music videos, alternative artists, and teenage fashions. Over the past fifteen years, the company has built a powerful merchandising empire around this concept. At Hot Topic stores, you can find a huge assortment of street wear, retro-influenced lounge, punk, club, and Gothic clothing and merchandise, including lingerie, hosiery, cosmetics, belts, handbags, shoes, body jewelry, make-up, rings, shoes, gifts, furniture, candles, magazines, vinyl and CDs, action figures, and more.

Hot Topic features clothing and merchandise for a wide array of bands: AC/DC, Black Sabbath, Deftones, Disturbed, Godsmack, Green Day, Incubus, Insane Clown Posse, Iron Maiden, Judas Priest, Kid Rock, Korn, Linkin Park, Machine Head, Marilyn Manson, Megadeth, Metallica, Mötley Crüe, Motorhead, Ozzy, Pantera, Papa Roach, Rage Against the Machine, Slayer, Slipknot, Staind, Stone Temple Pilots, System of a Down, Taproot, and many others. While they don't sell much in the way of actual music at the moment, they have taken merchandising to a new level of sophistication.

Proving the power of using music to sell merchandise, the company had 2004 revenues of $572 million and earnings of $48 million. It operates more than 550 mall-based stores throughout the United States and Puerto Rico, as well as the Hot Topic and Torrid Web sites (www.hottopic.com and www.torrid.com). Hot Topic is well positioned to become a retail platform that takes advantage of the evolution of the music business.

Mixtapes, MP3 Blogs, and File-Sharing

While major label representatives officially decry the evil of file-sharing, one can see that the inherent behavior involved has been going on for some time, often with the endorsement of the major labels themselves, even if unofficially. Music compilations originally on cassette and now on CDs are widely used in the hip-hop and other music communities to help create a "buzz . . . before a single goes to radio," says Courtney Powell, Elektra's director of rap promotions and street marketing. To achieve that buzz, Powell will pass a song along

Globe. The proliferation of this free music has propelled the careers of many artists including 50 Cent, Eminem, Beyoncé, and Ludacris.

The label people in the promotion and marketing departments actually enable and encourage this infringement of copyright in order to grease the skids and help break the songs. The DJs that make the mixtapes and help lubricate the wheels of commerce are integral to the marketing and credibility of a new song or artist in the hip-hop community. Mixtapes made by DJs including Kay Slay, Envy, Green Lantern, Whoo Kid, Clue, and other "streets" set the pace for what is hip and what is not. MTV even features the medium in their "Mixtape Mondays" segments. You can buy the bootleg CDs from friends, DJs, local retailers, or online at mixtapesusa.com, buymixtapes.com, and mixtapeskings.com. Illegal, yes, but powerful and important to breaking a song in the hip-hop genre.

While the RIAA rattles its swords at illegitimate file-sharing and free music in general, the labels nevertheless find both to be extremely effective promotional vehicles. On one side, it is clearly a demonstration of the power of free music as a promotion; the fact that the labels themselves feed the mixtape machine is indicative of its effectiveness. There are also many anecdotes of tracks "leaked" to the Internet by people inside the record companies, days or weeks before the street date of the CD. Warner Records actually asked several MP3 blogs to post tracks from rock band Secret Machines in August 2004.

On the other hand, the music industry relies on a shaky defense that puts the copying and distribution responsibility on the shoulders of the DJs that produce the mixtapes. There have been raids on small stores that sell mixtapes, and some DJs have been arrested. However, soon after, the beat goes on and the genre is once again alive with the proliferation of illegally leaked, duplicated, and distributed mixtapes that fuel the buzz and subsequent acceptance of new tracks into the marketplace.

> Long before the Internet, people used to pass tapes of bands that I've never gotten to see live and fall in love with them. And I think the Internet is an easy way to do that, to really turn people on.
>
> —Jason Mraz, musician, in ***Teen Music***

CD Pricing

For a long time, people have been complaining about the high price of CDs, and they have voted with their feet by choosing to purchase music at the huge discounts offered by mass merchants such as Best Buy. These big-box retailers made it very difficult for stand-alone CD stores to compete. In an effort to prop up the independent music stores, Universal, the largest of the major record labels, announced price cuts in the summer of 2003. The cuts, which took effect in October 2003, slashed CD pricing from \$17–\$19 list to \$12.95. While this is a long overdue move on the part of the major labels, most people believe that it is too little, too late. Jim Urie, president of Universal music and video distribution, said at the time, "Music sales needed a jump-start. We needed to get people back in stores and into the habit of paying for music." This statement fits neatly with the party line that, basically, online file-sharing is responsible for killing the industry. Jim appears to forget the proven fact that people have always liked that \$10–\$12 price point, and have been paying that much for music at the mass merchandisers for some time.

This price cut has been carried out in typical major-label fashion. Along with the introduction of the new pricing model, Universal also slashed the co-op marketing money and positioning fees they had paid to the retailers to promote their records. Universal claims that they will instead direct the money toward their own radio, television, and print advertising campaigns. However, many retailers around the country relied on these marketing funds to promote their stores, with many of them netting more money from these fees than they did from selling CDs. While consumers could be the biggest beneficiaries of the price cuts in the short run, the retailers could end up being the biggest losers. And if brick-and-mortar retail channels continue to shrink, there will be even fewer places for people to purchase CDs, leading to even fewer choices on the shelves and an even greater migration to the digital networks.

The voices of the industry clearly tell the story. Anne Garbus, owner of a chain of music stores in Michigan that will close because of declining sales, told the *Chicago Tribune*:

> We've been telling the major labels for years that they're priced too high, and we were told to stop whining. I applaud them for finally listening to consumers. But it's too late for the 600 record stores that closed last year, it's too late for places like Tower Records, and it's too late for me.

In the same paper, Mike Dreese, CEO of Newbury Comics, said:

> As technologies emerge that allow consumers to run their lives better, faster, smarter, there is no doubt that the utter digitization of it all will lead to a place where in seven, eight years we will still have a huge music industry, but not too much of a CD industry. Cutting prices like Universal did will slow the decline, but it won't stop it.

And from attorney and artist manager Ken Hertz:

> Record stores don't carry nearly the inventory, in relative terms, that they once did—there aren't that many record stores, they're closing, because record companies have driven the margin out of the business. Who is going to suffer the most from the recent drop in wholesale prices by Universal? The record retailers! Because Best Buy is going to sell a $9 record for $10, but the record company is going to go from $12 down to $9, and the traditional retailers are going to go from $18 down to $10. And the artist is going to lose, and is going to bear most of the drop in price, because of the difference between an $18 retail price and a $12 retail price, in terms of a royalty . . .

Ron Stone, President of Gold Mountain Entertainment, the artist management company with Neil Young, Joni Mitchell, the Eagles, Crosby, Stills & Nash, Beck, the Foo Fighters, Sonic Youth, and the Beastie Boys as clients, comments:

> I think it's the most incredibly disingenuous decision they have ever made. It reminds me of the Bush administration—it's a big lie. What they're doing is making that 25 percent cut on the back of the retailer and on the artists. That's it—they're going to make the same amount of money. Somebody figured out that they're spending more money for point and position, buying shelf space in the stores. By the way, the retailers probably make more money from the fees that they collect from the record companies than from record sales. So what Universal, being the 800 lb. gorilla that represents 38 percent of the market, they said, "Look, give us 25 percent of the shelf space, and we'll give you the price, so you could sell it at $9.99 . . . and the retailers being retailers, that's the magic bullet number—$10 a CD, that's a winner. Okay, so then they're going to make that deal—they're going to give them 25 percent of the shelf space. Then they're going to turn around to the artists, which they already are, and say, "Look, we're taking a 25–30 percent reduction in our wholesale price, and we're passing that along to you, dudes." So now they're going to make the same exact money that they started out making, and the retailer and the artists are going to take the reduction.

Singles Pricing

The sale of a "digital single" is a business model in which a music service provider such as Napster or iTunes charges the user a one-off fee of 99¢ per downloaded song. This idea has some history: the 45 RPM record was once an influential and essential promotion tool used heavily during what most would say were the heydays of rock 'n' roll. Bands like the Beatles, the Beach Boys, and the Rolling Stones all released singles on 45s as ways of distributing their tracks and kindling interest in the complete work—the LPs. Indeed the labels used to give massive quantities of singles to retailers to be sold for $.99 or $1.29 to prop up the Soundscan numbers, attract the attention of the radio program directors, and drive the songs up the charts. These days, the single has been largely phased out of the market, due to its lackluster profitability (or, shall we say, its confirmed loss-leader status), and the CD-album is pretty much the only product available to law-abiding consumers.

By essentially phasing out the single, the labels forced customers to buy CDs containing twelve or more songs in order to obtain access terms, this would be okay if there was no other way of getting that single track. Along with an album, however, comes the considerable price tag that today's connected fans no longer seem to want to pay. This has certainly been one of the instrumental factors in the massive popularity of file-sharing and P2P networks—not the refusal to pay but rather the reluctance to pay the price that is being asked, for a product that is rapidly looking less attractive compared to other entertainment offerings. As a consequence, when people feel duped by the record companies, rightly so or not, they may feel equally free to "steal" from them. One could argue that record companies' refusal to adapt to technological advances and comparative pricing pressures created this "digital monster" in the first place.

The problem with track-based pricing for digital music is that it is not a good deal for anyone. It is simply a vestige of the way that music has been sold in the past: twelve songs for $12. Individual digital track pricing would have to be substantially reduced to be a good deal, and a much more "liquid" pricing system would need to be created. Sony Connect's Senior Vice President Jay Samit puts this into perspective: "The only way to make money with a 99¢ download is with corporate support," like McDonald's. "The highest-paid artist for a 99¢ download is Visa or another credit card company."

Executives at the "new" Napster and Rhapsody have a different point of view. They appear to be banking on subscription services while still providing individual track downloads on an a-la-carte basis. Sean Ryan, Real Network's Vice President of Music Services, says, "The only way to make money with a 99-cent download service is in a mix of services, including subscriptions, downloads, and radio streams. I would not want to only be an online download store at this point." Rhapsody claims to have over four hundred-fifty thousand subscribers at the time of this writing, and is offering the service directly and via ISPs Comcast and RCN. Under the terms of their subscription deal, the music is only available while the customer is online, which seems a tedious provision for most customers, and a bit early in terms of the prevailing technical infrastructure. Perhaps some form of a subscription model will really catch on in the future.

Singles, of course, have never been profitable for the recording artists, and the new pay-per-track online model being used by iTunes, Napster, Sony Connect, BuyMusic, and others are not likely

to fare better. One would think that the labels could find a way to use the free tracks being distributed on the P2P networks to help promote CD sales, but no one presently seems to be thinking along those lines.

The 99-cent digital download does appear to be helping Apple to sell hardware, though, which is the primary business that Apple is in. At the time of this writing, around ten million iPods have been sold, selling in greater unit volumes than Apple's Macintosh computers, at more than 12 percent of Apple's overall revenue. Here, music is a Trojan horse for hardware, much as it has always been for the consumer electronics manufacturers. This model in which the sales of recorded music drives the sale of something else like turntables, stereos, CD players, and Walkman devices, has worked quite well for large multinational corporations such as Sony and many others. Expect to see a flood of MP3 and other digital music format players in the marketplace with more features and increasingly lower prices as hardware manufacturers take advantage of the widespread availability of digital music in the years ahead.

Compensation

The models for artist compensation need to change—and are changing. We think that the traditional approach to the label/artist business model is destined for failure, because it is not sustainable. A more equitable system might be one in which artists and their musician businesses contract directly with distributors—in most future scenarios, digital distribution services—and would take care of their marketing and production costs themselves, likely via third-party service agencies. The music service providers, in turn, could fulfill an additional marketing function by leveraging collaborative filtering and recommendation technologies, and a whole lot more.

In 2002, veteran manager Irving Azoff stated in a Reuters newswire story, "If this thing really connects, they're going to have to go back to artists and pay more of the 50/50 model than the 80/20 model they're trying to do right now." We couldn't agree more!

One of the fortunate byproducts of the current music downloading wars is the fact that the record labels are slowly but surely being forced are computed and distributed. Royalty accounting has long been the bane of artists, managers, and producers. Digital distribution is forcing the labels to move to a more transparent royalty accounting model, and this will lead to overall better compensation for artists.

Music companies and labels are also going to be looking at the overall return on investment calculations that have traditionally driven their financials. Because it is increasingly difficult to control the retail channel and drive huge hit-record successes, the labels can no longer sustain a scenario in which the one in five hundred records that sell tens of millions of units supports the records that do not sell at all. They'll also need to lower break-even points so that records do not need to sell one million copies to pay for themselves. All of this favors the small independent musician business.

Using technology to its fullest extent, the industry can achieve lower overall risk ratios. Technology can help make music more readily available to the customer and on a business-to-business level such as for films or games, and more importantly, it can also drastically lower marketing costs and other operational and administrative overhead. All of this is entirely feasible today, but requires drastic restructuring and a complete retooling of the music industry infrastructure and operating paradigms.

It remains to be seen how adept record companies will be at navigating the turbulent waters ahead; some will make it and some will not. EMI, for one, is clearly thinking about the future in fresh and creative ways. Says CFO Roger Faxon on CFO.com (February 2002):

> The record business has been focusing on the product and the product alone. But the reality is that it isn't just about the music. It's about how you get the music to consumers, how you get consumers excited about a product. It might not seem like a big leap, but the conceptual shifts are massive for our business. My view is that we must be consumer-facing. It doesn't mean that we have to be any less creative, but we have to understand how [our business] fits into the consumer context. It no longer works to say, "If we make great music, they will come."

EMI has been pioneering new business models for some time, and was one of the major labels that proactively licensed its music

to the new digital distributors. EMI entered into a very creative deal with singer Robbie Williams—a deal that encompassed far more than the traditional recording contract. It also included participation in William's touring, publishing, and merchandising activities. EMI has become a partner in Robbie Williams' musician business, and is signing an increasing number of similar deals with artists in Asia and other territories. In so doing, it is helping to shape the path of profitability in the future.

Why Can't File-Sharing Be a Winner for Everybody?

Nearly seventy-five years ago, radio was threatening to destroy the existing music business. Sheet music was the "product" of the time, and people had to go to concerts to hear and see their favorite artists. Radio changed all that. According to *Music Trades* magazine, a representative of the Association of Sheet Music Dealers, Williams Arms Fisher, said at the time:

> Radio at one blow undermines the concert tours of artists who perform to potential buyers of sheet music and diverts music into the ear of those who follow the line of least resistance—by that I mean those who might desire to sing or play or perform—but with radio, content themselves by bathing in music as a pleasant sensation, and with half-hearted attention.

Amazing how shortsighted people can be when their basic interest is to preserve the status quo, rather than to embrace change. Think about what would have happened if the original large telephone companies, such as ATT and the other "Baby Bells," had insisted on a strategy of litigating the emerging cell phone players like Nextel and Cingular out of existence. What if the telephone companies had claimed the exclusive right to distribute telephone conversations? If that had happened, we might not have today's flourishing cell phone industry.

The smart move today would be for the major record labels—while they are still viable players in this business—to find a way to either appropriate or somehow license the P2P file-sharing services, in order to extract revenue from their astounding popularity. Having said that, it seems likely that they will encounter significant legal and structural hurdles that will prevent them from pulling this off without committing economic or political hara-kiri. When Cary Sherman, President of the RIAA, says, "We simply cannot allow online piracy to continue destroying the livelihoods of artists, musicians, songwriters, retailers, and everyone in the music industry," you just want to say to him: "Hey Cary, if you can't beat 'em, join 'em—or *buy 'em*!"

Just as ASCAP or BMI collect blanket licensing fees from radio stations, so could similar organizations collect blanket licensing fees from the P2P companies or ISPs, who could in turn charge the customers for access via their systems. That super-distribution model has been around since the invention of the 'Net. If 50 percent of the world's active Internet users would pay only $2 per month, the industry would collect $500 million per month—$6 billion per year—a whopping 20 percent of the current revenues from CD sales. Other calculations based on a sliding scale might work equally well, where people in developed nations paid $3–4 per month, and other emerging economies paying $1 or $0.50 or $0.25 per month to create a pool of money. And that would be just the beginning.

The record companies need to adapt to the realities of the marketplace and cast off their antiquated business models, just like they have cast off the thousands of artists whose records did not sell enough copies of their first album. Legitimate music distribution businesses can outdo the existing "rogue" P2P networks by developing their own delivery and customer interaction systems that employ superior technologies, recommendation engines, and customer service—watch for this to happen eventually.

In fact, Napster's founder Shawn Fanning is quietly working with the record companies on a project called "Snocap" to create a way of filtering and tracking P2P file-sharing. By identifying files via a "fingerprint" and comparing the file to its database, the Snocap software could, in theory, provide a payment mechanism for files traded via peer-to-peer networks. Such a concept should be very appealing to current content "owners" who wish to maintain control over their property, but not likely very appealing to the P2P companies who may wish to develop more enlightened business models. It remains

to be seen whether the record labels will or will not agree to do business with their former nemeses. For now, many of these companies (and people) are simply blacklisted, and anyone who wants to do business with the labels has to stay away from them.

New Operating Mantras

Without sounding too "California," we believe that more relevant and more mindful music business models of the future must be based on the following paradigms:

Respect. There must be respect for the underlying intent of the original copyright principles, a healthy balance of the creator's rights versus the user's rights, and dedication to upholding fair-use and first-sale doctrines.

Sharing. Music should be shareable among its audiences. Whether the process includes the sharing of the actual media files or not is less relevant than the sustainability of communities that share their music.

Portability. People are increasingly mobile, thus digital music needs to be mobile and "un-wired."

Transparency. All parties involved (i.e., the consumer, the provider, and the creator) must strive to create and maintain a mutual understanding in regards to how the proceeds are to be split up and distributed. Transparency is the key.

Fair Pricing. Music products and services need to be market driven and priced according to their actual market value at any given time, in relation to location, timing, level of access, user rights, and comparative value with other media.

Easy Access to Music. Everything should always be available, at any location, and playable on any device.

Without true, no-frills, no-parachute cooperation, and serious compromises on the part of the current music business players, a fair, equitable, and *timely* solution to the current music industry crisis will be difficult to achieve. Therefore, we may still have to go through something like a systematic marketplace failure that may be difficult to recover from without outside (i.e., non-government) intervention.

New Licensing Approaches

One solution may be the introduction of some kind of a license that all record labels either would or must grant, by default, to any legitimate online music retailers. Another option is to institute a small fee in the form of a "utility license" or—dare we say it—tax that would allow people to download any and all music online. This fee could be included in the price of blank media, MP3 players, ISPs, DSL, wireless, and cable.

If the involved industries cannot voluntarily agree on and create such a legal structure themselves—and do so soon—then maybe the governments should do it, as happened several times before, such as with radio in the 1920s and cable television in the 1970s. Community antenna television, now called cable television, was started by John and Margaret Watson in 1948, in Pennsylvania. They set up an antenna on a local mountaintop, and received clear broadcast signals from the three Pennsylvania stations. The antenna was then connected to Watson's store via a cable and modified signal boosters. Watson later connected the mountain antenna to both his store and several of his clients' homes that were located along the cable path—the first CATV system in history.

When cable television operators first re-used the freely available "on-air" television feeds and plugged them into their cable systems, the large television networks sued them over the use of their programs, and the ensuing litigation went on to the U.S. Supreme Court. The U.S. Congress finally decreed a compulsory license. In 1976, U.S. Congress passed the Copyright Revision Act, which established a "compulsory license," allowing cable systems to retransmit broadcast stations. It also set fee schedules for carrying distant signals for the first time, making the cable operator also responsible for copyright payments (17 U.S.C. 101-118). In 1970, about 7 percent of homes had cable television (Donnerstein, 1994), but today everyone has it—more revenues for all involved parties, but years of struggle to make it happen. Technology prevailed but it took the legal system a few decades to catch up.

Government involvement may actually be necessary to address and solve the anti-trust implications of any widespread, cross-industry collaboration among the major players, without whom

significant momentum would be unattainable. As they have done before, perhaps the U.S. Congress, or indeed the European Commission, can chisel out a fair and equitable solution that supports the needs and desires of all parties: writers, musicians, labels, publishers, and consumers alike. This would make more sense than trying to preserve and support a monopoly that is quickly becoming outmoded.

Terry Fischer, Harvard professor and author of *Promises to Keep* (Stanford University Press, 2004), has proposed an Alternative Compensation System for the music and media business. He suggests either a compulsory system funded through user fees or taxes and managed by government agencies, or a voluntary system funded by subscription fees and based around an entertainment co-op model. In either case, authors are compensated from a large pool of money based on the relative popularity of the author's work across the system. Artists would have to register their work with the copyright office or another agency, which would track usage and collect the fees. Professor Fischer said that he is working with the Brazilian Minister of Culture, musician Gilberto Gil, to explore this idea. A very descriptive chapter from his book is available at cyber.law.harvard.edu/people/tfisher/PTKChapter6.pdf.

Fisher is one of a handful of pioneers, including Lawrence Lessig and his Creative Commons venture, who are exploring the potential of fair use, copyright, and media in the twenty-first century. You can read more about some of these initiatives at the Berkman Center for Internet and Society at Harvard University and their Digital Media Project at cyber.law.harvard.edu/media/overview.

The 'Net has already become the leading "information utility" for a good many people; licensing content as part of this utility is just the next step. The Electronic Frontier Foundation (www.eff.org), one of the leading think tanks in this area and advocates of civil liberty, describes two licensing alternatives: voluntary collective licensing and compulsory licensing. Here are their models, explained.

Voluntary Collective Licensing: Copyright holders could join together and voluntarily offer blanket licenses. This solution does not require any changes to the current copyright law and leaves the price-setting to the copyright owners. This approach has been used in radio and broadcast licensing for the past seventy years, and performing rights organizations were formed to administer it. In the U.S., ASCAP, BMI, and SESAC have been collecting fees from the radio and television stations ever since, passing the monies on to the publishers and writers. Their European equivalents also work hand-in-hand with yet other societies such as the PPL (U.K.) and the GVL (Germany), which collect money on behalf of the performing artists and the owner of the recording, an idea that is making only slow progress in the U.S.

The record companies and music publishers could proceed to implement such a system, without having to change any applicable laws. Back in 2001, the "old," ill-fated Napster offered $1 billion to agree to this idea, and was turned down. Sharman Networks, owner of the popular Kazaa P2P network, and the newly founded P2P United Foundation in Washington, D.C., have undertaken similar efforts and are now lobbying both in Washington and Brussels to get the attention of lawmakers. The seemingly insurmountable problem is that virtually all rights owners and their stakeholders would need to agree to this licensing procedure, and therefore enjoin and forego the usual barrage of lawsuits, in exchange for a reasonable piece of the pie—an unprecedented assumption. Not surprisingly, so far, the big entertainment companies have shown no interest in pursuing a voluntary collective licensing plan.

A voluntary collective license for music on digital networks, if drafted with great care, may solve these problems by simply creating a large "pool of money" generated by online file trading, and then determining a fair way to split it up. While the record companies and the publishers have had ample opportunity to voluntarily put such a licensing system in place, making it easy for consumers to get the music that they want digitally, it is quite unlikely that they will ever do so of their own accord, for what is now a familiar reason: they lose control. But as Jim Griffin puts it quite succinctly, "Every time we exercise control, we lose. Every time we let go, the thing we fought becomes the thing that feeds us. We need a way to monetize the anarchy."

Historically, voluntary licensing has rarely been the solution to adapting to massive discontinuities in the way business is done, because it severely threatens the existing status quo, the distribution of cash, and the incumbent power structures.

Compulsory Licensing: Compulsory licensing has been proven necessary in the case of player pianos, cable television, satellite television, digital recording media, and Internet radio, and it appears to have served the respective constituents well. Compulsory licenses are used to legally allow music to be played on the radio, in restaurants, stores, elevators, and in shopping malls as background music. When copyright holders can't reach consensus on licensing terms, Congress has properly stepped forward and required them to adhere to the rules it stipulated. The very first compulsory license in the U.S. (1909) targeted player pianos, allowing the so-called "mechanical" reproduction of other people's songs. Today, this license forms the underpinnings of the most stable and reliable form of payment to songwriters, the "mechanical royalty."

One way to collect a pool of money would be to get the ISPs to add a small monthly fee to their current charges in order to include digital music services. This is being looked into in Europe, e.g., with a company called Play Louder ISP. This fee would be passed on to the rights holders (artists/writers, publishers, and labels), therefore essentially taxing the bandwidth used to deliver the music. Another part of the solution would be an additional levy or sales tax on digital media and media players such as CDRs, iPods, and CD burners. Some combination of these methods could be used to establish that ominous "pool of money." Then, a fair and transparent way to split it up and distribute it would need to be devised—perhaps a good task for today's performing rights organizations (PRO) and mechanical rights organizations (MROs).

This "content tax" seems like a reasonable solution to the current, rather ridiculous environment in which each piece of music must be individually licensed, from each rights owner, on a track-by-track basis. This new tax could be a form of insurance against online piracy, and rather than trying to sue everyone to force an overall change in consumer attitudes and behavior, the industry would simply "tax" them.

This would let consumers make unlimited copies of the songs in whatever forms they wished, and would allow them to legally share and discover music together, without the need for secret and private "darknets" that allow member-only access, or the fear of lawsuits by the recording industry. The users would pay only slightly more for their Internet services, blank media, and consumer electronics, but the music would feel like free.

It would seem plausible that two pools could be created: one to compensate the publishers and writers, and another to compensate the labels and the recording artists. These pools would be split 50/50 between the label and artist, and the publisher and writer. Such an approach may cut through the legal issues involved in artist and publishing contracts, and would seem like a fair way to compensate everyone.

We believe that charging for music at the primary point of access, rather than in every single instance, is a powerful concept—similar to the utility model used by water and power companies. This certainly makes the transaction easier for the customer, and creates transparency and liquidity. Most consumers already get their monthly bills from their ISPs, phone companies, or other utility companies, and anyone using the account could access the music, thus solving the many issues related to who has a credit card and who does not. It seems that an unprecedented opportunity exists for the music industry to solve the online piracy problem, by working with the government and digital network providers.

On a per-person basis, the fee that would need to be charged is actually quite small. The International Federation of the Phonographic Industry reports U.S. gross revenue for 2002 to be $12.3 billion. With current estimates at approximately 167 million people online in the U.S., that would amount to about $6 per month, per person, using gross dollars—but as outlined above, that would assume a total displacement of the revenues derived from the sale of CDs. That is highly unlikely in the next ten to fifteen years, if indeed it will ever occur. And if we were to look at the numbers another way and consider the "street value," i.e. what people actually pay for CDs, and divide it by the total number of people who purchase music, the figure would more like $2–$3 per person online, per month. Again, if one allows for the many up-selling and cross-selling opportunities that could additionally be exploited, even $1 per month may work, and would certainly represent a fantastic value to the music fan. Imagine total ubiquity for the price of a bus token!

If the record companies and publishers were to be compelled to license at least a large majority of their catalogs (and archives!) in this manner, we believe it could nearly double their profits, because

they would still profit from the CD sales that are likely to continue for some time, albeit of course with a downward trend. And let's keep in mind that this "new" money would be extremely profitable because it is pure licensing income for everyone, and few additional costs would need to be incurred.

This argument should not be lost on today's artists and writers: licensing fees can be split more or less evenly, resulting in a much better deal for artists and writers alike, way beyond what they are currently getting from the sales of recorded music, if they are getting anything at all. A scheme like this would make online music legitimate, create a huge and growing pool of cash to compensate everyone involved, and give the music industry enough time to retool its business models.

A Digital Utility License for Media Companies

The future of music will be most significantly influenced by those who can give their customers a completely integrated and cross-marketed mix of recorded music, live shows, merchandising, tickets, artist access, mobile music, video games, television, radio, film, software, and other publishing and information products. Integrating music purchasing and enjoyment into an overall entertainment or lifestyle experience is a model that may work very well. Similar to cable television, in which you pay for a package of services, music can be buried into a larger package. Who can do this? In the U.S., AOL, MSN, Yahoo, MTV (Viacom), Sony, cable television networks, and others like them. But will they?

When cable television reared its head, the broadcast and television networks fought it tooth and nail. In the absence of any clear regulations in this field, CATV operators started to rebroadcast copyrighted programming to a willing public of what would nowadays be called "pirates," until the unresolved complaints and actions of the copyright owners forced Congress to step in and solve the problem, to the ultimate benefit of all. There clearly was a desire and need on the part of the consumer, demonstrated by a willingness to pirate the signals. There was also a need for an improved and efficient system for distributing the shows at higher quality levels and to a more could address. The combination of market demand and technological superiority appeared unstoppable. Sound familiar?

Well, let's see what happened subsequently, and find the lesson here. A vastly expanded broadcast and production industry was allowed to develop, creating cash, jobs, and opportunities for people, companies, and cities around the world. Entirely new concepts, such as "superstations" and PPV channels, were developed along with a thousand niche channels programmed to address the needs of sports fans, movie buffs, news addicts, and many other interest areas.

Production companies flourished, as did the distributors. Advertising revenues grew alongside entirely new revenue streams based on subscriptions and pay-per-view events. More actors, musicians, set designers, producers, makeup artists, camera operators, technicians, booking agents, and hundreds of related professionals could find jobs than ever before. Radical transformation gave way to unprecedented growth and opportunity, once the incumbent media moguls were forced to play the new game that their customers demanded.

A New Type of Music Company

Here is a framework for a new music business model for a "next-generation" music company—one that is fully aligned and synchronized with the interests of the artist and fan. We see some of this already emerging, most notably with the Sanctuary Group, management companies like The Firm, and organizations such as the IMMF already heading down this path. We believe that the music company of the future will be active in a number of things, including artist management, publishing, touring, merchandising, and recording. The *artists'* brands will drive the business, and the win-win-win economics between artist, company, and fan will make the risk more tolerable and the return on investment more predictable. Instead of betting on a traditional 10-to-1 recording model that relies on huge CD sales from just a few artists, the now-evolving business model can test-market artists more efficiently, and work on much lower volumes by spreading the risk across multiple revenue streams and different forms of "product."

For example, building artists as brands requires a constant

distribute the music, bundles of two to three songs can be released to test the waters, not unlike the old "singles" business or, more recently, the "EP" business. Rather than investing in the production of a complete album at first, the company can continuously release music into the marketplace, and the songs can be used to support the tours and keep the music fresh and the company nimble. A more rational, slower-growth approach can be used to support multiple artists with less financial risk—versus the "bet the farm" mentality of the old record business.

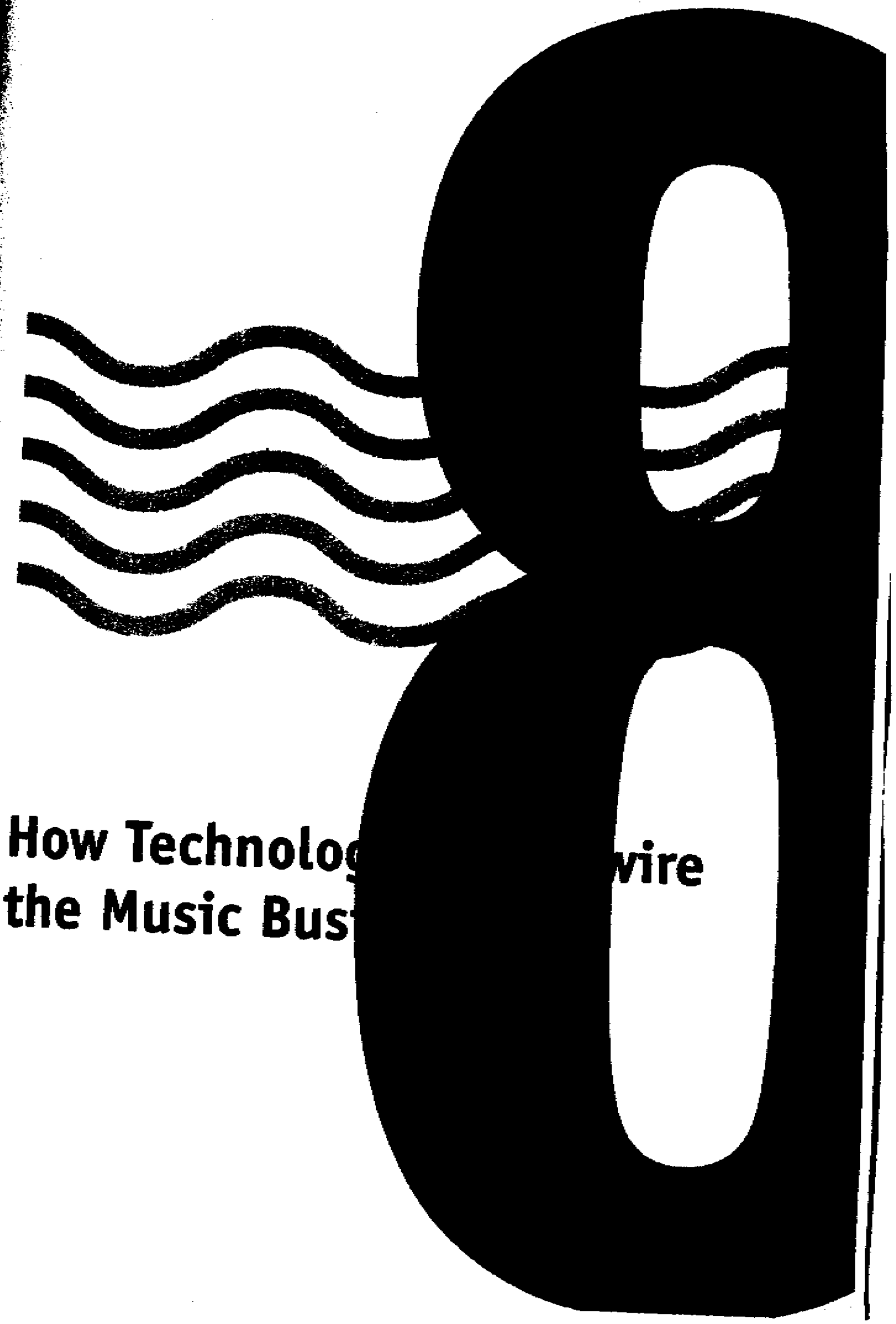
This new musician-business model combines the functions of a record label, management company, publisher, and merchandiser into a single entity or related set of entities, such as the Sanctuary Group. The company signs artists to deals in which the artists retain ownership of the masters, and only license (lease) them to the company for a limited time. Artists create their own recordings, and the company takes this music to market in digital and hard formats, creates merchandise to sell, and provides management and touring logistics for live performances. The company also acts as the publisher for all songs written while under contract. This increases the potential return on investment for each artist signed, by aligning the interests of the artist, manager, label, and publisher into a single entity that splits all of the revenue streams. This model is based on lowering the cost of production, distribution, and promotion for all parties to minimize the risk of financing a new act—and maximizing potential return.

The skills that are essential to recognizing talent, helping to develop that talent, and matching artists with potentially receptive audiences are at the heart of the game—both in the record business of the past and in the musician business of the future. But by marrying this effort with all the revenue streams available to an artist, a broadly defined musician business can reduce its risks and lower the break-even point of the overall investment. The potential conflicts of interest that can arise from having artist management inside of the overall revenue generating engine can be minimized to a degree by keeping the term of the artist's contract reasonably short and the financial accounting transparent.

This model is not unlike what EMI has done with Robbie Williams or the model that bands like Phish and already using within their own companies, and similar to the model of an independent record label with a publishing arm. The major change is the integration of management and touring into the business mix. This way, the company can take an integrated and synchronized marketing approach across all the revenue possibilities and try to maximize income and opportunity.

We think this model is particularly interesting in light of the negative effects of unlicensed music distribution via P2P networks on recording and mechanical income. By maximizing the revenue potential by including touring, publishing, and merchandising in the mix, the company can try new creative marketing approaches that leverage freely (and cheaply) distributed music to drive other income streams.

As Seth Rosen wrote in *U.S. News & World Report,* "Ultimately the creative industries may have to adapt to a new role in which they act more as publicists and less as distributors, perhaps earning a percentage of the artist's revenues."



How Technolog wire the Music Bus