MUSIC, MANTRAS, AND MARKETS:
FACTS AND MYTHS IN THE BRAVE NEW WORLD

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"This will prove a brave kingdom to me, where I shall have my music for nothing"
Stephano, drunkard, *Tempe `st*

1. Introduction

A way cool alliance of artists, technologists, file-sharers, and law professors now contends that record prices are unfair and the recording industry is non-competitive. Yes, the folk wisdom is certain -- labels are just making too much damn money for anyone's good. America is a semiotic oligarchy. Present prices do not pass the smell taste for fairness. Cash-deprived college students are forced to huddle in the cold and share files. Perhaps the threat of a compulsory license can restore record labels and other evil-doers to their senses.

2. The Music Services

We are all entitled to our own opinions, but not to our own facts. And in this regard, a factual analysis of the true state of market competition can deconstruct these myths.

First, let's consider the music services. Present competition is vigorous. At least Apple, Sony, Napster, RealNetworks, Walmart, Microsoft, Virgin, and MusicMatch have attracted brand name recognition as music providers. The present state of the market is a far cry from 2001 when MusicNet and Pressplay initially offered kludgy services that did not permit permanent burning.

Second, none of the major service retailers is owned or controlled by any label. The major labels now provide catalog to each of the major services which may license independent content as well. For example, market leader iTunes has composed a catalog of over 1 million songs from 300 labels, including songs from each of the Big 4 recording companies. The Antitrust Division of the Department of Justice in 2003 dropped a two-year investigation of anti-competitive restrictions in label licensing practices.[1]

Third, the new capabilities of online services may present new techniques that facilitate music shopping and listening. The leading subscription service with 550,000 accounts, Real Network's Rhapsody now enables sampling with an "all you can eat" streaming service for $9.99 per month; Virgin recently launched a competing service for $7.99 that featured a one million track catalog. Soon to be integrated with Yahoo and its radio service Launch, MusicMatch provides a premier music jukebox and allows friends to

sample favored tunes up to three times for free. Weedshare actually pays a portion of its sales revenues to customers who "superdistribute" new songs to other users. Music Rebellion aims to offer prices that may vary by track and/or in line with coincident consumer demand. .

Fourth, service prices are now at competitive levels. The market price of 99 cents per download on iTunes, Sony Connect, MusicMatch, and Napster is roughly equal to the related cost of content, bandwidth, credit card services, and administration that these services pay. Price-cost parity is consistent with what would be expected in a competitive market.

Fifth, the business models are instructive experiments. Apple and Sony operate their music services at losses in order to sell their iPods and Walkman devices at considerable profit. Yahoo and MusicMatch will merge two major platforms so to promote advertising and music to a wide base of customers. Starbucks will forego bandwidth to allow customer to burn tracks from in-store locations. Circuit City recently bought up the digital music platform MusicNow (f.k.a. FullAudio), Target has a distribution deal with Napster, and Best Buy distributes music services from Rhapsody and Napster.

This rivalry in the stratum for music services is competition at its healthiest -- new players, processes, and ideas vying for a market share in a newly developing sector. This enables what economist Joseph Schumpeter called "creative destruction". Market innovation is a hallmark of dynamic capitalism.

What stands in the way of faster takeoff of the new music services? The illegal use of p2p. While market leader iTunes has sold over 125 million songs since its inception in April, 2003, p2p may have enabled up to 5 billion downloads per day at the end of 2003.[2] File sharers now take for free many of the same files that a competitive music service would sell for a reasonable profit. This bypasses the competitive and innovative structure for digital distribution that is now evolving. The power of the potent and reactive forces unleashed in the market crucible will be weakened considerably if pirate services are able to preempt the outcome.

3. Label Prices and Profits

Are label prices unfair and improper? If so, what price levels and rate parities would be satisfactory? And if free market exchange is not appropriate to determining prices, what means or rules are?

As a matter of economic theory, there is no scientific basis to determine whether a price is fair. Professional economists can only consider whether price increases exceed increases in related costs, and whether producer profits are supra-competitive. These would seem reasonable proxies for a more philosophic notion of fairness.

Since most of the costs of a record involve the service labor of staffers and creators, a reasonable cost measure would be the consumer price index, which tracks the costs of

goods and services that urban workers purchase. Comparing the average price of a CD sold in the U.S. and the corresponding annual consumer price index over the past ten years:[3].

Year	Price	% Inc.	CPI	% Inc.
1994	12.78	NA	148.2	NA
1995	12.97	1.5%	152.4	2.8%
1996	12.75	-1.7%	156.9	3.0%
1997	13.17	3.2%	160.5	2.3%
1998	13.48	2.4%	163	1.6%
1999	13.65	1.3%	166.6	2.2%
2000	14.02	2.7%	172.2	3.4%
2001	14.64	4.4%	177.1	2.8%
2002	14.99	2.4%	179.9	1.6%
2003	15.06	0.4%	184	2.3%

In 1994-2003, the average CD price increased 17.8%, while the corresponding CPI increased 24.2%. In the five years of file-sharing (1999-2003), the CD price increased 10.3% and the CPI increased 10.4%.

Regarding producer profits, the RIAA reported in 2003 an average store CD price of $15.05 (dividing annual revenues by sales, on yearend statistics available on their website).[4] Based on available numbers in the year 2001, 53 percent of collected retail revenue went to the recording label; the remainder to the store and intermediate distributor.[5] Multiplying $15 by 53 percent, a label then receives $8.00 wholesale. Deducting $1 to $1.50 for manufacturing and packaging of the disk and box gives $6.50-7.00.

Of the remaining $6.50-$7.00, some 12-15 percent (8.5 cents per song) are generally assigned to cover the mechanical royalties paid to music publishers for reproduction rights in their compositions.[6] Each recording act is assigned an additional artist royalty that may generally amount to about ten percent of suggested retail price that probably exceeds $15,[7] which may be closer to 20 percent of the wholesale amount that a label actually receives. Once established, royalties in any account may be used to retire unrecovered advances or owed promotion costs laid out beforehand in order to produce and market the album. When the account is cleared, artists receive all additional royalties directly.

So how does it all work out? Using publicly available information regarding costs at EMI is instructive.[8] For the fiscal years 2000-2002 (2003 would be less favorable), EMI data show:

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	2002	2001	2000
Revenue[9]	3,486.7	3,785.3	3,798.8

Cost - Goods Sold[10]	2,461.3	2,463.2	2,467.0
Gross Profit[11]	1,025.4	1,322.1	1,331.9
SG&A Expense[12]	1,169.4	861.8	846.8
Net Receivables[13]	1,088.7	1,230.6	1,319.9
Inventories[14]	61.3	65.3	63.5

The chart illustrates a few points. First, as a percentage of revenue, cost of goods sold (which include manufacturing, packaging, artwork, and artist and publisher royalties) ranged from 65 to 70 percent of company revenues. Second, revenues that exceed direct costs (i.e., gross profits) were used to cover apportioned overhead expenses of artist and repertoire, record promotion, and other business development needed to acquire talent and break acts through radio, retailing, video production, and promotional touring. Third, gross profits at EMI in 2002 were insufficient to cover its SG&A expenses. Even holding SG&A at its lower 2001 level, a dollar of revenue yields 4.6 cents of operating income once all expenses were deducted. No apparent great excess, the accrued amount is used to compensate shareholders for use of their equity.

Finally, net receivables at EMI amounted to about one third of its incoming revenues in 2002. These amounts generally result from unsecured advances and artist support laid out in hope of eventual full recovery, which may actually result fully in perhaps 10 percent of a label's acts. However, a label's capacity to monetize costs from any of its acts depends crucially upon its ability to deter piracy. This is a particularly relevant point for the most popular venues; a casual inspection of playlists on the Big Champagne tracking service reveals that p2p users download new tracks from major artists more than anything else.[15]

4. The Labels and the Services

As another bit of folk wisdom, labels apparently should learn to lower prices to the music services. For example, after Real Networks slashed download prices to 49 cents a song and $4.99 per album, Steven Levy of Newsweek suggested that labels learn the lesson and lower their online royalties as well. After all, he suggests, the distribution costs of content online are zero (sic), so why not slash label prices accordingly?

A major label receives 65 cents from online downloads that sell for 99 cents.[16] The remaining 34 cents pays for publisher interests, bandwidth, credit card use, and distributor service and overhead. Accordingly, if an online album costs $9.99, we can presume that the label receives no more than $6.50. Counting for differences in distribution expenses, a label then makes a similar margin in store and digital retail sectors.

It is consistent with hard-nosed management and competition that a producer should recover the same profit margin from the new distribution channel as it does from its

incumbent alternatives. As digital sales continue to increase, former buyers of store CDs will purchase the album online instead. If labels fail to recover the requisite margin, profitability in the emerging market evidently declines. So too does the incentive to record and promote new acts.

5. Alternative Compensation Systems

A trendy academic proposal that would allow music and movie fans to make unlimited takings of copyrighted content is "alternative compensations systems", which is Newspeak for either compulsory licensing or the strong implicit threat thereof. . Despite its impracticality, the present dialog nonetheless serves as a keen example of what happens when Richard Posner's "public intellectuals" run amok without factual immersion or disciplined attention to economic reasoning..

Under a number of enabling proposals, users may freely download some subset of music, movies, etc. through P2P networks of various natures.[17] Neil Netanel of UCLA would allow noncommercial takers to "share" (i.e., take) everything they want.[18] Terry Fisher confines his wish list to movies and music that can be monitored in real time, but extends his generosity to include commercial takings as well.[19] Anxious not to be abusive, Jessica Litman suggests that content owners be permitted to "opt out", but disqualifies record labels entirely from receiving compensation (unwittingly guaranteeing that they will indeed opt out).[20]

Proper levy amounts under compulsory licensing would be instituted by Congress and administered by the Copyright Office. Revenues would be collected on internet subscriptions, computers, storage media, and other services and hardware that have the potential to be used for an infringing activity. Collections in the U.S. would be distributed to copyright owners per values assigned by a royalty tribunal or arbitration panel convened by the Copyright Office.

Practical problems? Just a tad. First, the levies would be assessed upon individual equipment purchasers and Internet subscribers regardless of their actual use of P2P technology and level of copyright infringement. In order to finance the entertainment industry and the "catch as catch can" proclivities of some of its younger listeners, the majority of computer users would be harmed by a system of taxation that will reduce their wealth and possibly stifle their purchases and upgrade of equipment.

Second, the panel would face the daunting task of parsing out a fixed pot of revenues to contending uses and determining the relative worth of each. How to do? If Netanel's idea were seriously considered, the panel would need to consider the relative worth of a one hundred page novel, a two hour movie, a three minute song, a 4 x 7 photograph, and a five frame comic strip.

How about Fisher? The panel must decide the value of different lengths of the same product; i.e., how much more a symphony than a song, how much more a full length

movie vs. a documentary short, how much more a two hour recording vs a two hour film. Are any distinctions made for new releases now in video stores vs. classics from 1932? Can I upload movies that I rent from Blockbuster? How about TV shows before they go into the syndication market? How does one begin to measure the displacement, loss of licensing value, and commensurate market harm?

Third, the long-run administration costs for setting and revising the license terms will be considerable. As consumers download increasing amounts of content, copyright administrators and legislators will need to reconvene hearings annually just to adjust the tax instrument in order to keep up with revenue requirements. A souvenir of an earlier day, this kind of "pancaking" in rate regulation was famous for devastating the electric utility sector whose investments in generation plant (much like investment in artistic production) required a revenue recovery that could be reasonably anticipated.

Furthermore, in the foreseeable event that content downloading outgrows anticipated levy dollars, compensation per individual work would necessary diminish. Content owners then fight for a revenue pot that bears no direct relation to the value of underlying content. The uncertain nexus between individual effort and anticipated reward evidently harms the incentive of a content provider to invest resources needed to produce and bring its commercial wares to market.

Fourth, what do we do about foreign takings of U.S. product. Congress evidently can't levy a fee on their computers or ISP subscriptions, and the Copyright Office has no ratemaking authority over them.

So how about this? We show up in foreign capitals and demand they too institute a levy on equipment and subscriptions. The garnered amounts should be passed back predominantly to the U.S. parties that own most content. To ensure that our artists and labels are justly compensated, the Copyright Office will review the foreign rates to determine that they are consistent with our valuations of displaced revenues. And if their analysts come up with different numbers than ours, we'll sit down and reason it through before WIPO. Sounds good? You bet! Who said it can't be done?

ABOUT THE AUTHOR

Michael A. Einhorn (mae@mediatechcopy.com, http://www.mediatechcopy.com) is an economic consultant and expert witness active in the areas of intellectual property, media, entertainment, damage valuation, licensing, antitrust, personal injury, and commercial losses. He received a Ph. D. in economics from Yale University. He is the author of the book *Media, Technology, and Copyright: Integrating Law and Economics* (Edward Elgar Publishers), a Senior Research Fellow at the Columbia Institute for Tele-Information, and a former professor of economics and law at Rutgers University. He has published over seventy professional and academic articles and lectured in Great Britain, France, Holland, Germany, Italy, Sri Lanka, China, and Japan.

In the technology sector, Dr. Einhorn worked at Bell Laboratories and the U.S. Department of Justice (Antitrust Division) and consulted to General Electric, AT&T, Argonne Labs, Telcordia, Pacific Gas and Electric, and the Federal Energy Regulatory Commission. He has advised parties and supported litigation in matters involving patent damages and related valuations in semiconductors, medical technologies, search engines, e-commerce, wireless systems, and proprietary and open source software.

Litigation support involving media economics and copyright damages has involved music, movies, television, advertising, branding, apparel, architecture, fine arts, video games, and photography. Matters have involved Universal Music, BMG, Sony Music Holdings, Disney Music, NBCUniversal, Paramount Pictures, DreamWorks, Burnett Productions, Rascal Flatts, P. Diddy, Nelly Furtado, Usher, 50 Cent, Madonna, and U2.

Matters involving trademark damages have included the Kardashians/BOLDFACE Licensing, Oprah Winfrey/Harpo Productions, Madonna/Material Girl, CompUSA, Steve Madden Shoes, Kohl's Department Stores, *The New York Observer*, and Avon Cosmetics. Matters in publicity right damages have involved Zooey Deschanel, Arnold Schwarzenegger, Rosa Parks, Diane Keaton, Michelle Pfeiffer, Yogi Berra, Melina Kanakaredes, Woody Allen, and Sandra Bullock.

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[1] Statement by Assistant Attorney General R. Hewitt Pate Regarding the Closing of the Digital Music Investigation, at
http://www.usdoj.gov/atr/public/press_releases/2003/201946.htm (retrieved October 5, 2004)

[2]At http://news.com.com/Online+musics+winners+and+losers/2030-1027_3-5133561.htm (retrieved October 5, 2004)

[3]Recording Industry Association of America, Yearend Statistics: 2003, at http://www.riaa.com/news/newsletter/pdf/2003yearEnd.pdf (retrieved October 5, 2004)

[4]Id.

[5] W. Fisher, Promises to Keep: Technology, Law, and the Future of Entertainment (Stanford University Press), Chapter 6, 11, available at http://cyber.law.harvard.edu/people/tfisher/PTKChapter6.pdf (retrieved October 5, 2004)

[6]Labels benefit to the degree that they recover these fees through their publishing division, or if they can negotiate payments down to controlled compositions owned by the particular recording artist

[7]This number incorporates some informal downward adjustments from gross to incorporate packaging, return, "new technology" costs, and other ideosyncratic deductions that are now a part of a recording contract. .

[8] G. Ziemann, EMI – The World's Last Record Company, at http://www.azoz.com/news/truth12.html (retrieved October 5, 2004).

[9] Revenue equals totals sales from operations.

[10] Cost of Goods Sold includes all expenses directly associated with the production of goods or services the company sells (such as material, labor, overhead) as well as artist and publisher royalties. It does not include SG&A or depreciation.

[11] Gross Profit equals Revenue minus Cost of Goods Sold.

[12] SG&A Expenses (Selling, General, and Administrative Expenses) include all salaries, indirect production, marketing, and general corporate expenses.

[13] Net Receivables are amounts owed to the company by retailers, distributors, and artists, net of any provisions for bad debts

[14] Inventories are merchandise bought for resale or supplies and raw materials purchased for use in revenue producing operations. get

[15]Most popular tracks on p2p systems are posted at http://www.bigchampagne.com. (retrieved October 5, 2004)

[16]See, for example, http://www.narip.com/index.php?page=article/Shrinking (retrieved October 5, 2004)

[17]For a kind review, see J. Gratz, "Reform in the 'Brave Kingdom'; Alternative Compensation Systems for Peer-to-Peer File Sharing", at http://www.joegratz.net/files/JosephGratz-ReformInTheBraveKingdom-Dec19.pdf (retrieved October 5, 2004)

[18]N. W. Netanel, "Impose a Noncommercial Use Levy to Allow Free Peer-to-Peer File Sharing", 17 HARV. J. LW & TECH., December, 2003.

[19]Supra note 5.

[20]J. D. Litman, "Sharing and Stealing", at http://ssrn.com/abstract=472141 (retrieved October 5, 2004)