Digital Music Business Models

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Introduction

With the advent of the MP3 format compression technology and the debut of Internet file sharing services like Napster, Gnutella, and Scour, the music industry changed almost overnight. For much of this year we had the major labels hauling almost anyone having to do with digital music into court – Scour, Napster, MP3.com, MP3Board – the list goes on. Basically digital music distribution was seen as an evil that had to be stopped (or at least tightly controlled) at all costs. The fear – how can we possibly make any money if music becomes available in digital format for free? Once music is available for free, why would anyone pay for it? But is Napster really the first technology development to provide access to content for free? Cartoonist Rueben Bolling doesn’t think so (see Exhibit 1). While his analogy does not translate perfectly to digital music (for one thing you have to return a library book eventually while you can keep MP3s forever), it does provide an alternative (albeit somewhat sarcastic) view to the “the sky is falling” mantra of the major record labels.

But with surveys like the one compiled by digital commerce services company Magex predicting that online piracy will cost the music industry $10 billion a year by 2003, some may find it hard not to be concerned. (1) Among consumers, digital music is being adopted at an extremely fast rate. Forrester Research predicts that by 2005, digital audio distribution will have penetrated 41% of the U.S. population (See Table 1) (4). And with services like Napster allowing free peer-to-peer file swapping, 41% represents a significant amount of potential cannibalization of record label profits.

“We have to make buying music easier than stealing music,” says EMI senior vice president of new media Jay Samit. (1) He’s right about that – but the majors are going to have to work out a number of other issues as well if they are going to compete head-to-head with Napster through their own digital music offerings.

![Table 1](image)

**Projected Adoption of Digital Music Technology**

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected U.S. Population</td>
<td>273</td>
<td>276</td>
<td>278</td>
<td>281</td>
<td>284</td>
<td>287</td>
</tr>
<tr>
<td>Penetration of Digital Audio</td>
<td>20%</td>
<td>21%</td>
<td>23%</td>
<td>26%</td>
<td>32%</td>
<td>41%</td>
</tr>
<tr>
<td>People Using Digital Audio&lt;sup&gt;1&lt;/sup&gt;</td>
<td>54.6</td>
<td>57.9</td>
<td>64.1</td>
<td>73.1</td>
<td>90.9</td>
<td>117.6</td>
</tr>
<tr>
<td>Number Using Streaming&lt;sup&gt;2&lt;/sup&gt;</td>
<td>46.2</td>
<td>49.0</td>
<td>58.0</td>
<td>67.0</td>
<td>76.0</td>
<td>99.0</td>
</tr>
<tr>
<td>Number Downloading&lt;sup&gt;2&lt;/sup&gt;</td>
<td>17.9</td>
<td>19.0</td>
<td>22.0</td>
<td>25.0</td>
<td>28.0</td>
<td>34.0</td>
</tr>
</tbody>
</table>

*Source: Forrester Research (4)*

1 Numbers for 2001, 2004, and 2005 obtained from Forrester Research - intervening years estimated on straight-line basis

2 Numbers for streaming and downloading do not sum to total since some people may use both methods

The Peer-to-Peer Revolution (a.k.a – Why is Napster So Popular?)

Clearly, part of the appeal of Napster is the idea of getting something for nothing – who doesn’t like that? However, I would argue that much of the popularity of Napster lies not so much the price point, but rather the other freedoms and conveniences that the peer-to-peer technology and file sharing allows consumers to enjoy, such as:
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- **Content In One Easy-to-Use Format:** The MP3 format provides a standard that is sharable across platforms (Mac and Windows) and gives access to a number of on-line (Real Jukebox, MusicMatch Jukebox, etc.) and physical (Diamond Rio MP3 player) playback devices.

- **Easy Access To a Wide Range of Content:** On Napster, all you have to do is type in an artist or the name of a song, and the content is downloaded to your hard drive – easy.

- **Ability to Try Before You Buy:** According to a Forrester Research Survey, 55% of Napster users say that use of the system has not impacted the amount of music they buy and 25% say they actually buy more CDs since they started using Napster. The argument is that Napster allows them to try more music at no risk and then find the ones they really want to buy – and so far it appears they are still buying.(3)

- **New Ways to Enjoy Music:** A lot of the value created by owning digital music files lies in the consumer’s ability to easily access numerous different songs in whatever order they choose without having to have a 100 CD changer or make numerous mix tapes or CDs. All songs are at your fingertips ready to be mixed and matched. And with the emergence of easy to use portable MP3 players, people can now transport their music more easily than ever before. (2) Since the major labels have been reluctant to provide their music in this format to allow consumers to experience this type of convenience, they are willing to go steal the content on Napster and create the convenience for themselves.

These advantages only become more compelling as broad band and wireless internet technology advance to become more ubiquitous, and people begin to envision access to their music collection on their cell phone, PDA, in their car – basically anywhere.

So if these are the features and conveniences consumers have shown they want, what does this mean for the current industry in terms of what their strategy and business model should be going forward? How will the economics of the music industry likely change in the future? The remainder of this paper offers a qualitative assessment of some of the possible future business models for digital music distribution that have been suggested recently. In addition, for some of the more promising models, I have tried to put a rough frame around the economics of these models to get a sense of what kind of revenue these models may be able to generate and for whom. Finally, I provide my thoughts on the course I believe the music industry should eventually take and discuss in some detail what it all means for the major stakeholders in the industry. But before diving into internet business models, it is instructive to take a quick looks at the structure of the traditional music industry.

**The Traditional Music Business Model (a.k.a. Fat & Happy Record Labels)**

The traditional music industry supply chain is depicted below in Figure 1. Basically, the artist or content originator goes through a record label which coordinates the recording, manufacturing, distribution, and marketing of the CD. The figure also shows the traditional distribution of the cost of a $15.98 CD among the various participants in the value chain. One of the historically popular complaints about the big record labels is brought to light by this example – the artist only receives about $2.13 for each CD sold which must be split between the members of the band and the composer/song writer (if different). In general, artists make a much larger percentage of their overall income from concert appearances and merchandise sales than they do from actual sales of their work. The labels, however, keep a full 32% in exchange for their marketing and promotional efforts. Many have said that the emergence of digital music distribution may, in the future, allow artists to completely bypass these labels or at least tip the scales of power more in their favor, allowing them to capture a larger piece of this pie. These possibilities are explored in more detail later.
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Internet Business Models for Digital Music Distribution

On the surface, digital distribution looks like a huge windfall for the record labels. We just cut out manufacturing, distribution, and most (if not all) retail costs, and for the same $15.98 CD the labels pick up $13.69 – sounds great. But of course life is not that simple, much to the label's chagrin. Consumers can do the same math and with many consumers and most artists complaining about fat record label profits, it seems highly unlikely that the price point for a digitally delivered CD will remain anywhere near $15.98. And when you throw in the Napster effect you can see that a price point of $15.98 looks pretty unattractive when put up against a free option.

Of course CDs will be around for quite a number of years to come, being sold through traditional channels such as Tower Records or Amazon.com for likely a similar price point to what they cost now. But digital distribution is the future and will slowly start to erode physical CD sales in the future. The question is what new models will evolve and at what price points, and what does it mean to the major players in the value chain?

Early Attempts (a.k.a. The Ones That Won’t Work)

Prevention Model

The “prevention model” is the model that, to date, has received the most attention from the major music labels. This model is put forth by various Digital Rights Management (DRM) companies that are working on technological solutions to prevent the pirating of copyrighted digital content. The idea behind this model is to use encryption and other forms of access control to prevent file swapping. In theory, if this could be done, the labels could basically move their current business model onto the web (which is probably why the labels are clinging so tightly to it). Basically this “pay-to-own” model would allow labels to continue to sell songs, albums, and compilations in digital format (much as they do with physical CDs) and be ensured that those digital files are not being illegally shared because they have been encrypted against copying.

The economics of this model seem to work out very well for the labels. They get to cut out much of the cost in the supply chain (manufacturing, packaging, distribution, retail markup) thus allowing them to bring down the overall cost of the album to the consumer, while perhaps maintaining much of their current profit...
per CD (and who knows, they could even cut the artist in on a piece of the action too). Essentially, digital distribution becomes simply another format like tape or CD, only with much cheaper distribution.

So what kind of price points can we expect from this model? A survey by Forrester Research shows that the majority of people surveyed would rather not pay anything for their music (surprise, surprise) and that, in general, for those who would pay something, paying more that $1 per song or $5 for a full-length album starts to become unpalatable (see Table 2). (4)

If we take the average price of a CD to be the $15.98 in Figure 1 above and assume an average of 11 songs per CD, the recording industry is currently charging about $1.45 per song which according to the Forrester survey, only 10% of people are now willing to pay in the digital world. In addition, that $15.98 for the CD looks like it will have to drop to about $5 or less in the digital world. If we make the broad assumption that all other supply chain costs can be eliminated and the artists will be allowed to keep their $2.00 per CD\textsuperscript{1}, this means the record label’s share must drop from about $5 per CD (Figure 1) to $3 per CD, or a loss of 40% of their total revenue per CD. If the labels are doing similar back-of-the-envelope calculations, its easy to see why they are so tentative when it comes to embracing digital distribution – if I thought I was going to take a 40% revenue cut on every CD I sold digitally, I’d be afraid too. This loss could be even worse if they can not fully eliminate the other supply chain costs (e.g., they do not sell directly to consumers but go through aggregators that combine content from many labels for sale, and thus charge a markup for their services).

In this scenario, artists gain over the status quo, consumers gain over the traditional model, but still pay more than they do on Napster or Gnutella, and the labels clearly lose as their over-inflated CD prices can no longer be supported. Besides the sub-par economic outlook for the record labels, there are numerous other reasons why I do not believe this should (or will) be the winning economic model. This is a model built on clinging to control of content by the record labels and about putting limitations on consumers and how they experience their music by employing encryption and technology. The following is a list of just some of the reasons this model is destined to fail: (2)

- **No technology is fool-proof** – Even if technology is developed that is secure enough to prevent 99.99% of all people from copying the music, it just takes one person to crack the code and then make the content freely available to all over peer-to-peer networks like Napster and Gnutella – and you can be sure there are plenty of people out there just dying to try to crack the latest impediment to

\textsuperscript{1} This may be a big assumption, but one argument might say that with technology making digital production and distribution easier, artists would now have more leverage over the labels to negotiate a better share of the sale proceeds by threatening to market their music independently and cutting the labels out altogether. Faced with a reduced stake or no stake, the labels might concede a larger share to the artist in the future – but only because they will be forced to.

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**Table 2**

"What Would You Pay For the Following Types of Content"

<table>
<thead>
<tr>
<th></th>
<th>Nothing</th>
<th>Less Than $1</th>
<th>Between $1 and $5</th>
<th>More Than $5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single Song</td>
<td>76%</td>
<td>15%</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>Full-length Album</td>
<td>60%</td>
<td>5%</td>
<td>22%</td>
<td>13%</td>
</tr>
<tr>
<td>Multiple Artist Compilation</td>
<td>67%</td>
<td>6%</td>
<td>17%</td>
<td>10%</td>
</tr>
</tbody>
</table>

*Source: Forrester Research (4)*

Totals may not sum to 100% due to rounding
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free music. In fact, in response to a contest held by the Secure Digital Music Initiative (SDMI)\(^2\) where hackers from all over the world were invited to try to crack several new music encryption options, SDMI recently announced it was awarding $5,000 each to two different hackers who were able to crack their codes.\(^1\)\(^5\)

- **P2P Technology is here to stay** – Even if the record industry is successful in shutting down Napster and Scour which have corporate facilities and employees to be the subject of lawsuits, more community based services like Gnutella and FreeNet are P2P options with no one in particular to sue. Like a virtual game of Whack-a-Mole – if you knock one down, two more are sure to spring up in its place.

- **Content Must Turn Analog at Sometime** – and when it does, that’s when it is copyable. Music has to come out of speakers, movies onto a TV screen, and books onto a page or screen. This analog version can always be recorded, scanned, or otherwise captured. The fact that these copies may have degraded quality does not appear to be an issue to the consumer – MP3s do not sound as good as CDs, but they are still extremely popular.

- **Compatibility and ease of use is an issue** – the more complex the encryption technology, the harder it will be to smoothly integrate it on all platforms. Earlier this year BMG abandoned its secure CD trial (CDs that could not be copied) because they found about 3% of them would not play in consumers’ existing CD players. Stephen King, a Mac user, could not even read his own e-book *Riding the Bullet* because it was distributed in PC format only. Consumers will not put up with these kind of hassles and will continue to use P2P to “steal” music if paying for it is not painfully simple and hassle free.

- **Increased Legal Action Will Backfire** – Over 80% of Napster users freely admit they know it is illegal to download copyrighted music without payment or permission, but at the same time this does not deter them. (3) Consumers clearly want the kind of flexibility with their music that Napster offers (see section above on why Napster is so popular) and are willing to steal to get it. The solution is to find ways to let them have the flexibility and convenience they want, not strengthen existing copyright laws and start rounding up college students and sending them to jail.

The Ad-Supported Model

The next step in the evolution of on-line business models is the advertising-supported model. There has been little detail disclosed about how such a model might work, but it might work something like this: technology would be developed to wrap advertisements around copyrighted content that the user would have to see or hear in the process of accessing the content. For example, in a streaming music service one could imagine inserting a commercial once every five songs or so. The problem with this model is it too closely approximates radio (albeit a radio station where you control the music programming), which is currently available for free. People may be unlikely to pay for a service that is similar to their favorite radio station. Another variant that has been mentioned in some Forrester research is to have advertising wrapped into the actual music files that are shared on Napster. (2) It is unclear exactly how this would be accomplished, but when in competition with the commercial-free version of the same song, I don’t see the commercial version lasting too long on the Napster trading floor. If the consumer’s goal in moving to digital music is to gain more freedom in how they experience their music, commercials are likely to be seen as quite intrusive by consumers who are already used to the commercial free Napster model. No

\(^2\) The SDMI is an association of over 180 companies including the five major record labels, the RIAA, and a list of technology and internet companies that reads like a who’s who of e-commerce. Selected members include Microsoft, AT&T, IBM, AOL, Compaq, Intel, Ericsson, Nokia, Motorola, Real Networks, and yes – even Napster! For more, check out http://www.sdmi.org/.

\(^3\) One winner was from the U.S. and the other from Finland. In order to win, they had to demonstrate that they were able to disable the security options in a way that was easily replicable by others and did not significantly harm the sound quality of the music. This “Hack SDMI Challenge” was largely boycotted by the hacker community which saw this as doing the “dirty work” of the major labels. Who knows how many successes there would be if all hackers were in on the contest……
matter how much potential there may be in theory to make money on these ads, that potential quickly drops to zero as annoyed consumers shun these commercial laden services in favor of the commercial-free Napster model they enjoy now. This ad-supported model is a step backwards for consumers in terms of freedom and therefore is destined to fail.

An Interim Model (a.k.a. Napster for a Monthly Fee)

The model of the week right now is the “new Napster” subscription model. Since the announcement that Napster and big-five record giant Bertelsmann, owner of BMG Music, were setting up a partnership, there have been vague references to the development of a $4.95 per month subscription model for Napster. (6) Of course these vague references are just that – no one has really explained how the model might work or how much money it may make.

The “new Napster” model has a number of challenges before it. First, to really have this subscription be worth anything, it must include licensing music from all the major labels, not just BMG, and right now all the other labels have copyright infringement litigation pending against Napster. People need to have access to basically all music ever recorded for this to truly be a universally attractive option. The more people look for songs and can’t find what they want, the faster they will cancel their subscription. In addition, they need to ensure that independent artists have access and that Napster does not just become a way for the labels to push their same narrow view of what popular music is.

But for now, for the sake of argument, let’s assume Napster can overcome the stigma of now working with the record labels and its band of loyal users continue using the service. Let’s assume also that Napster is successful in dismissing all of their litigation and signs licensing agreements with all the major labels, thus establishing a viable music library for the service.

The latest count puts registered Napster users at approximately 40 million. (7) At $4.95 per month, this would yield nearly $2.4 billion in revenues. The question arises then, how much traditional revenue is this replacing? If you believe the Forrester survey cited earlier, 55% of Napster users buy the same number of CDs, 25% say they buy more since they started using Napster, and only 20% say they buy less. If this is true, then overall Napster seems to have little impact on traditional CD sales and may actually cause a slight incremental increase – that is if you believe all Napster users are equal. This argument would say that CD sales would be unaffected or increased, and the additional revenue generated by the Napster subscription is incremental revenue to the industry.

However, there are some flawed assumptions in this model. First, all 40 million Napster users will not sign on to the service. Daniel Beldy, a partner at Hummer Winblad Venture Partners, which has a stake in Napster, thinks that only half the subscribers, or 20 million users will actually pay a modest fee for the service. (8) We should really be looking at scenarios in this range. Second, all Napster users are not created equal. It is my belief that there are both high demand and low demand users among Napster’s base of 40 million. Most low demand users who are just in it for a few songs here and there will not participate in the new subscription model, leaving Napster stuck with the high-demand users which will cost them more than they are paying in subscription fees. Third, an perhaps most importantly, even if you believe that Napster currently does not adversely impact CD sales, it almost certainly will in the future. Reasons why Napster may not be hurting (or may be helping) CD sales now include:

- MP3s still have lower sound quality than CDs, so some users may opt for CD quality (but advances in technology and bandwidth will soon remove this discrepancy).
- Portable MP3 players are still very expensive, so most MP3 files are still confined to people’s computers. A survey by Spin Magazine found that of people who listen to digital music files, 90% do so at their PCs and only 10% currently use portable devices. (11) Therefore, in order to take their music mobile to the gym or in the car, they need a CD to fit their existing playback hardware (but prices of MP3 players will soon drop and car radios that are MP3 equipped are on the horizon)
Once these obstacles are overcome in the near future, I think we will see significant substitution of MP3 files for CD purchases.

Exhibit 2 shows four possible scenarios taking into account the assumption revisions discussed above. In this example, 56% of Napster users are categorized as “heavy” users while 44% are “light” users. This was based on a Forrester survey that noted that 56% of Napster users are in the 16 to 22 age group, the group that is most active in purchasing music. (3) I have assumed that the remainder are light users, which may be conservative. Once we move to a subscription model, most of the casual light users will leave and Napster will only retain 15% of them. The die hard users of Napster will be more likely to stay and we have assumed an 80% capture rate for these heavy users. The result is a little over half of the users stay, which is in line with a recent survey by Webnoize this summer that cites that over half of Napster users would be willing to pay for the service. (9) At $4.95 per month or $60 per year, this translates into about $1.2 billion in revenue for the service at 2000 user levels. In terms of the likely distribution levels for revenues, Napster at one point offered a revenue sharing deal with the major labels that reportedly would start a subscription service and pay labels 70% off the top, leaving 30% for Napster. (10) Assuming the same distribution of revenue sharing between the labels and the artist implied in Figure 1 above, of that 70% given up by Napster, the labels would likely keep 70% and the artist 30%. This makes the total distribution among the three players 30%, 50%, 20% for Napster, the labels, and artists, respectively.

Next we must factor in the cannibalization effect mentioned earlier, as surely over time MP3’s will begin cannibalizing CD sales, even if they currently do not. In the future, CDs will be bulky and inconvenient and people will abandon them as soon as technology allows them to do so. So if we factor in an estimated cannibalization rate based on an assumed number of CDs that would have been purchased in the absence of Napster, but now are not, and assume a revenue loss per CD to the labels and the artists in line with the numbers in Figure 1 ($5.04 and $2.13, respectively), we arrive at the revenue loss due to cannibalization. The net effect on revenue to the three main industry players shown is the net of their share of the Napster subscription revenues and the effect of cannibalized CD sales revenue.

As shown in Scenarios 1 and 2 in Exhibit 2, at a price point of $5, whether cannibalization is assumed to be light or heavy, the rate of cannibalization overpowers the subscription revenue for both the labels and the artists. They have a net gain overall to start with, but as people become more comfortable with digital music and begin replacing a lot more of their CD purchases with digital music, the cannibalization effect causes a net loss over time for these players. The only one who wins and shows increasing revenues over time is Napster (this may be an indication as to why the labels rejected Napster’s offer of the 70-30 split).

However, if we assume a light cannibalization rate scenario and move to a $20 per month price point as in Scenario 3, we see that not only do all players show a net gain, but that net gain is growing larger as time goes on for everyone involved. The $20 price point might seem steep, but a survey of college-aged Napster users by Webnoize showed 59% were willing to pay $15 per month, so perhaps $20 per month is not too much of a stretch. (9) However, what we can see is that the viability of this type of subscription option is dependent upon setting a subscription price that more than covers the cannibalization rate. We see in Scenario 4 that even the $20 price point cannot overcome the heavy cannibalization scenario. In fact, a price point of $50 per month or $600 per year is necessary to make the heavy cannibalization scenario look good for all involved.

Of course there are a lot of assumptions built into this model and many things have been simplified. But what it does show is that key to setting the price for this subscription model is knowing who your users are and what their traditional music purchasing habits are. If all your users are light CD buyers, you may be able to actually make money at $5 a month because the cannibalization will be low. But if your users are all heavy CD buyers, their substitution of Napster for CDs over time means the subscription cost will have to be a lot higher to offset lost CD sales. This presents a great challenge for those trying to set a single price for everyone, since too high a price will price low-volume users out of the market, but too low a price will cause massive revenue loss from heavy users who see the service as the bargain of a lifetime. Therefore it seems that a flat rate may not be the best option, and Napster may want to consider
some level of price discrimination based on usage, somewhat like your phone bill. But as we have seen with ISPs and telephone companies, consumers don’t really like the pay-by-the minute or pay-by-the-song billing format, which is why AOL has a flat rate for unlimited use. Those tasked with developing the right price point for these types of services have their work cut out for them.

Next Generation Models (a.k.a The Ones That Have A Chance)

There are two slight variations on the Napster model that I think, in the long-run, have a much better chance of success than the Napster model. Both are subscription-based models as well, however the key difference is that they involve streaming audio rather than sharing actual MP3 music files. Separate financial projections are not provided for these options as they share many of the same characteristics as the Napster model previously discussed. Their success too is predicated on setting the appropriate price that balances subscription revenue with lost CD sales revenue. However, each of the models below has other characteristics that I believe give it a better long-run chance of success. Each of these variations is discussed below.

Streaming Subscription

The streaming subscription model involves consumers paying a flat monthly rate for unlimited access to a certain library of music, very much like people pay a monthly fee for cable television now. Right now I pay $35 per month for cable and have no movie channels and can get only a small percentage of the programming content available (e.g., through a satellite dish). The question for music is, how much are people willing to pay for access to music? And what kind of access will they get? This model could involve a subscription to a specific music genre or genres or an unlimited subscription to all music genres, each at a different price point depending on what the consumer wants. You would pay one monthly fee and have access to whatever old music is out there and whatever new music is released that month. You never really buy music anymore, you simply subscribe to an ever growing database of music that is continually updated with the latest music.

While this model shares many of the same pricing issues with the Napster model, there are certain benefits to the streaming model that make it more attractive than the Napster file sharing model.

• The first is security. We have already discussed at length that no security will ever be fool proof. However, while sending audio in streaming form rather than file form does not completely prevent the content from being copied and illegally distributed, it does require much more work on the part of the user to do so. Right now anyone can take a physical CD and rip it into MP3s using any one of a number of freely available software applications. But if physical CDs are replaced by streaming content, there is no physical CD to copy. People have to develop devices or programs to capture and encode the streaming content and turn it into a file. This will be difficult for the average person to do, at least for the foreseeable future.

• Next is convenience, which we have already cited as the consumer’s primary objective. As long as we are dealing with owning actual music files, people will have to contend with storage space issues. I for one have currently maxed out my available hard drive space on my computer. Two years ago when I purchased my computer I requested a 10 Gig hard drive and was told by the Darden technology manager, “6 gigs is more than enough memory – I’d be surprised if you ever needed more than that.” Clearly this person did not foresee the looming popularity of MP3 music files. In a subscription service, the music is housed by the host on a central server and streamed to the user upon request, thus freeing the user from the memory constraints of their computer or handheld device. The fact that I do not have to buy my own storage in itself saves me money and is worth paying for. In addition, as long as we have physical files, we still have to deal with transferring them from the computer to the portable MP3 player or from the MP3 player to the car radio. This can be time consuming and annoying. With a subscription model (and the promise of broadband and increased wireless access) I can soon graduate from streaming to my computer to streaming to my car or my cell phone. Using the streaming model now primes consumers for these future times when
audio will be on-demand everywhere. This central storage and access from anywhere feature is also a value-added service worth paying for that the simple Napster file swapping option does not provide.

While the major labels are beginning to toy with streaming services themselves, the real added value is in aggregator sites that have licenses from all the majors and can store all the music I want in one place. No one wants to go to the Sony site to get Sony artists and the Universal site to get Universal artists – most people wouldn’t even know which label to go to in order to find most artists. That is another reason why Napster and BMG partnering may be a negative factor. If they are seen as too closely linked (or if BMG even buys Napster) this will possibly preclude them from being able to license music from the other labels, thus dooming them to failure. The true winners are going to be the independent aggregators who have licensed content from all the major labels.

“Music Locker” Model

Which leads us to another slight variant of the subscription model dubbed the “music locker” model. This model allows the consumer to have access to a specific library of music that is determined by what music the consumer already owns and subsequently purchases. Companies like MP3.com and MusicBank.com are offering services where you would place your current CDs in your CD-ROM and their site would read the CD and confirm you own a physical copy. Once it is confirmed that you own the CD, you are given access to that music on their site and can stream it to your computer. In addition, from now on, whenever you buy new music from a partner site, that music is transferred to your music locker immediately so you can now listen to music instantly upon purchasing it, instead of waiting for your purchase to arrive through the mail. Until recently, MP3.com’s on-line buying partners for this program were somewhat obscure. However, MP3.com recently reported that they have signed a partnering deal with Tower Records, which finally makes their on-line instant buying program seem legitimate.

This model seems to be the most promising right now and offers a number of benefits to both the consumer and the company operating the service that neither the Napster model or the straight streaming subscription models offer:

• Under a straight subscription model (and the Napster model as well) you have to sort through a vast music library containing thousands of songs you don’t like in order to find the ones you do. With a music locker, all the music is music you have chosen.

• The music locker companies provide additional services like custom playlists you can create and store and then access from anywhere – basically your virtual mix-tape. Playlists are another value-added service worth paying for.

• This model creates stickiness for the site because once you have loaded your entire music library and have created multiple custom play lists, there is a huge switching cost to setting that all up again with another company.

• As opposed to a subscription service which can only start tracking your listening habits from the time you begin using the service, a music locker has the benefit of having your entire music purchasing history available for use in their collaborative filtering models. Imagine how much better Amazon’s suggestion feature could be if they knew not only what books I have bought from them, but also the books I bought from other bookstores. In addition, what if they knew all the books I have ever purchased in my life, as opposed to just the ones I purchased since I started using Amazon a couple years back? That kind of powerful preference history is available to those who run a service that stores a person’s lifetime music locker. It seems this could be the engine behind a very powerful suggestion feature that could lead to additional purchases of music people otherwise would never have known about. This has the potential to actually increase the total amount of music sold, rather than decrease it. A good suggestion feature is yet another value-added service that people may be willing to pay for.
This model (along with the streaming subscription model) also has the added benefit over Napster of quality control, which people may also pay for. On Napster you may occasionally get a song that cuts out in the middle or skips (if it was “ripped” at too high a speed). In addition, some people encode MP3s at CD quality levels (which take up much more file space) and some encode at much lower quality levels, and it is somewhat random as to what level of quality you will be able to find for a particular song at a particular time because it depends on who else is on-line at the time you are looking. With a music locker or subscription, the provider can guarantee the quality of the recording and guarantee its availability at all times from a central server.

There will always be free file sharing options out there like Gnutella and FreeNet for swapping files. Where the real money is in providing value-added services that give the customer more freedom regarding how and where they access their music. Moving away from file downloads and the Napster model to centrally stored streaming audio like the MP3.com model seems to give the consumer more options, and therefore more reason to subscribe long-term to the service.

So if Music Lockers Are Where We Are Going, What Should the Labels Be Doing?

Basically, the labels are going to have to focus on what they really are – service companies. The majors currently think of themselves as manufacturers and distributors of music content. However technology is making the manufacturing and distribution of music both inexpensive and easy. Where labels can still really add value is with marketing, promotion, artist development services, and navigation services.

First, as independent Internet artists begin asking why they need a big record label anymore, the majors must be ready with a good answer. They have to convince artists that they are still the best marketers of music in the world and no one knows how to create a national or global superstar like they do. With their connections to media, concerts, TV, radio, and, yes, even the internet, these labels must sell the idea that their marketing skill is still needed to really develop a new artist. It’s true that their music contracts may have to be revised to be a little more generous to the artist in order to be convincing, but with the savings in other parts of the supply chain by using the internet, these better deals may become possible.

The labels can also add value by discovering new talent and helping to bring it to market. Despite all the bad press the industry receives for supposedly foisting on consumers a very narrow selection of the music that exists out there, the labels do provide a type of service in cutting through all the clutter and bringing us music that a large percentage of us are likely to enjoy. Faced with a seemingly endless list of content to be sifted through on Napster, some people may gladly pay for the services of labels who will help them navigate this sea of new content and provide suggestions and recommendations about what they might like. If you don’t think so, think about how you might react after listening to 20 or 30 independent artist releases in a row you found on Napster and finding you hate all of them – you may be begging for someone to take a first cut at filtering content for you. Those who were clamoring for more choice than the labels were providing and heralding the internet as the answer, may soon find this to be a case of “be careful what you wish for, because you just might get it”.

Another key for labels as they move to focus on being service companies is to let go of their tight grip on distribution. In fact, they should partner with as many different distribution sites as possible. I’ve been advocating this for over a year now ever since MP3.com began marketing My.MP3.com, their version of the music locker model. This seemed like a win-win proposition for the labels, who would gain from incremental sales due to the “super collaborative filtering” models that it could generate, MP3.com who would gain from charging subscription or access fees, and the consumer who would receive easy access to music from all labels any time and any where they wanted. Yet the labels were not ready for this scenario. They clung tightly to their control over their content and distribution by suing everyone under the sun. A year later we see in just the past month or so, the labels may finally be coming around. MP3.com has settled all its lawsuits and now has license agreements with all the majors, as does MusicBank.com, a competing service to MP3.com. By allowing many of these types of sites to license their content and try all kinds of different business models (as described above) they can, in a sense, place lots of bets in case some of these models do not work out. With their main revenue model shifting to the provision of
services, reasonable licensing fees charged to multiple sites trying to develop working business models could be a nice secondary source of revenues for the labels. As long as they get their licensing fees, it is then up to the independent site to figure out how to make money by using the licensed content.

In this context, the labels must stop fighting the inevitability of services like Napster, Gnutella, and FreeNet and treat them as a source of viral marketing. These services facilitate sharing of music among people, but once you find music you like, you can only download so much before your hard drive gets full. I for one am either going to have to get a larger hard drive or start deleting unnecessary applications like Excel and Word in order to make room for more MP3s. The storage capacity, access from anywhere (not just a PC), custom playlists, and other value added services will drive people to the MP3s and MusicBanks of the world, with whom the labels have licensing agreements. People may share and discover new music on Napster, but to really integrate it into their "available anywhere" collection, they will have to pay to add it to their My.MP3 or MusicBank music locker. (Or for the less technologically savvy, those who want to listen to their new MP3 in the car, at least for now, will have to go out and buy the CD – either way, the labels capture revenue).

This is quite a departure from the major labels' traditional business model and the change has happened extremely quickly. It's really no wonder the labels have been stunned and slow to respond. But their lawsuits against MP3, Napster, and others have given them the last year or so to gather their thoughts and it seems they are starting to come around. In this new economy where change is constant, these major old economy players are going to have to be willing to blow up their old model and take on a new, more service-based model, if they hope to survive the digital revolution.
References

Exhibit 1: Still looking for a business plan after 149 years.

Was Napster the first technology innovation to provide free access to content? Not by a long shot -- check out cartoonist Ruben Bolling’s take on lending libraries at http://www.salon.com/comics/boll/2000/08/24/boll/index.html