# Record companies face an uphill struggle to protect digital revenues

IT IS A COMMON GRIPE IN THE MUSIC INDUSTRY that record companies include seemingly unfair provisions in their recording agreements, apparently to inflate their own profits. The most common of these provisions is the application of a 'packaging' or 'format' deduction. Whether an artist's royalty should be subject to a packaging/format deduction, the level of that deduction and the circumstances in which it should be applied has always been a contentious issue when negotiating a record deal. However, with the cost of music now being artificially forced down by market forces outside of the record labels' control, the application of these deductions is becoming even more necessary as a tool for the record companies to make a profit from their artists' digital sales.

The manufacture and distribution of records has always been subject to a certain number of direct and indirect costs. It was the direct costs that initially led to the application of packaging/format deductions.

### DIRECT COSTS

These are fixed costs per unit of a format that is produced, such as mechanical royalty payments (songwriters' royalties), taxes, distributor fees and packaging costs.

Traditionally, when vinyl was the primary format, royalty rates were set at a certain level to take these direct costs into consideration, although in addition to this most record labels would either:

1) apply a 25% deduction to the artists' royalties; or

2) agree that they would only pay royalties on 75% of their net sales of records because it was widely understood that approximately 25% of the total number of records shipped would be broken in transit en route to the record stores.

Cassettes, and later CDs, replaced vinyl as the principal formats for music. Although these formats were more robust than vinyl and therefore less likely to break in transit, they were also comparatively much more expensive to produce. The existing royalty rates were preserved for the new formats, but while the 'breakage' deduction was phased out, a different deduction was still applied to compensate for the higher manufacturing costs. This was between 10-35%, depending on the format in question, and usually settled at approximately 25%. It became known as the 'packaging' or 'format' deduction.

### INDIRECT COSTS

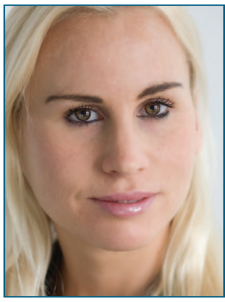
These costs have to be incurred in order to create the music, but do not directly relate to the number of units of any particular format produced. The indirect costs include recording the music, producing artwork and associated advertising, promotion and marketing costs.

This means that an artist signed to a record deal with a 20% royalty (a right to receive 20% of the record label's turnover from the sale of recordings of that artist's music), normally only receives a net royalty of approximately 15%. This means that the record label retains approximately 85% of the turnover from record sales and it has to use this balance to cover all the indirect costs relating to the music. The record company therefore has to sell sufficient units to recover these indirect costs, not to mention funding its general operating costs as well.

### A MORE TRANSPARENT APPROACH

A few years ago some record labels, notably Sony BMG and XL Recordings, realised that as artists' royalties were being 'netted down' and the ultimate effect was the same, it would be better to offer artists what they termed 'more transparent' recording agreements. These agreements specified a lower 'headline royalty rate' to be paid to artists, but without deductions. This did make the royalty calculation provisions more transparent, but obviously did not alter what the artist would actually receive per record sold.

These types of 'transparent' deal were generally seen as a welcome development from the royalty calculation perspective, but were greeted with



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mixed reviews overall. This was generally because the opportunity to bring their precedents up to date did, understandably, lead to a number of other, non-royalty-related overhauls that artist representatives were somewhat less enthusiastic about.

When other record labels were asked why they didn't follow suit, one of the most common reasons was actually that artists, used to seeing a higher royalty rate in their agreement (despite knowing that deductions would be applied to it), didn't like the principle of a lower headline royalty rate.

### CURRENT LEVEL OF MISUNDERSTANDING

When a number of high-profile artists recently left or chose not to enter into new deals with EMI, there was some grumbling that the record label (like so many others) was not being forward-thinking. These criticisms stemmed from its application of packaging/format deductions to royalty payments for digital downloads, which seemingly require no packaging. However, this argument oversimplifies the issue, as it assumes that these types of deduction solely relate to 'packaging' in the colloquial sense, when in fact they relate to a number of direct costs, but are also an accounting tool to preserve the labels' margins so they can cover all the indirect costs associated with the sale of records.

There are a number of direct costs associated with the production of digital downloads, many of which are the same as for physical sales (mechanical royalty payments, taxes and distributor fees). In addition, the indirect costs are the same as for physical formats, because the music still needs to be recorded, the associated artwork still needs to be created and the music needs to be promoted to encourage consumers to download it.

There are also some specific costs that relate only to digital delivery, such as the cost of creating the 'metadata' relating to each recording – embedded data containing the album name and song titles, as well as the label copy information and reporting data required by the service provider from whom the recording is downloaded. There are also digital rights management (DRM) costs, for technology that helps to keep the digital files secure and goes some way towards preventing them being shared through illegal file-sharing or peer-to-peer (P2P) networks.

### FEELING THE DIGITAL SQUEEZE

When digital music stores such as iTunes were originally launched and consumers saw the price of music plummet to just 79p per track (compared to between £1.99 and £3.99 for CD singles) they were understandably aggrieved, complaining that the record companies must have been inflating the price of music for years prior to this. However, the record labels were in fact forced into accepting much lower rates for digital downloads then they had ever anticipated.

Apple is one of the most recognised brands in the world today, boasting almost 70% of the worldwide music download market, with an 85% share of the US market (according to *The Guardian*). In fact Apple's iTunes store has recently been hailed as the second-largest overall music retailer in the US (behind Wal-Mart). However, Apple has freely admitted that its primary business is selling the digital music players on which these music downloads are played, so it can afford to push down the cost of downloads for consumers without too much impact on its own bottom line, thus enabling it to sell single-track downloads for 79p.

These reduced rates mean that the record labels' turnover is much less overall and therefore they have to sell significantly more digital units to recover their costs. This reduced turnover, coupled with the fact that illegal file-sharing or P2P networks divert a considerable number of sales away from the record labels, has meant that they are under considerable financial pressure to make digital sales profitable.

### APPLE APPLIES PRESSURE

This situation may not improve, as on 9 January 2008 Apple publicly announced that, in response to complaints by the European Commission and UK consumer body Which?, it would be reducing the cost of digital downloads from its UK iTunes store by almost 10%. The reduction, from 79p to 74p per track, brings the UK price into line with the 'pan-European rate', which equates to the current cost in euros of downloads from Apple's European iTunes store. Apple has also stated that it will have to 'reconsider its continuing relationship' in the UK with any record label that does not lower its wholesale prices to reflect the pan-European level within six months of its announcement.

The argument to unify the rates is interesting, because as long as the UK does not adopt the euro the actual price comparison between the 99 euro cents/79p per track will fluctuate, it is only in the current climate that 99 euro cents is more akin to 74p than 79p. We cannot help wondering, if the price comparison had been in reverse would Apple have been as keen to increase the cost of UK downloads? The trend has seemingly always been to keep the price down. No doubt, however, any reticence by the record labels to accept these lower rates will be seen as anti-consumerism on their part. ›

Apple may claim that it is championing the consumer by reducing the price of music downloads, but this could have a serious knock-on effect on the artists whose music it is that iTunes relies on. For every artist who succeeds in the music industry there are many more who don't, and with smaller margins on digital sales record labels will have less money to invest in (and be less keen to take risks on developing) new talent. This will force them to sign fewer artists, or only those artists that they believe are more commercial, which will inevitably lead to less diversity and be bad for consumers in the long run.

### THE WAY FORWARD

In a market where music is increasingly perceived as a free commodity, record labels are struggling to turn a profit from record sales. It is clear, however, that as we head towards an era of digital-only sales, to continue making money from the sale of recorded music the record labels will find it difficult to charge consumers any more than they are currently paying.

They will find it even harder to make a profit if the government's proposal to make internet service providers (ISPs) liable for allowing illegal file-sharing to take place on their networks becomes law, as the costs incurred by the ISPs in preventing this activity will likely be passed on to consumers.

If the consumers won't pay more, then the record labels will inevitably have to address their own internal margins, by doing one or a combination of the following:

a) streamlining their operations (this has been Terra Firma's recent approach at EMI);

b) tapping into their artists' other income streams, such as live performance and merchandising revenues; and/or

c) completely re-aligning their artist royalty rates (either by reducing the rates or increasing the deductions on them).

The difficulty here is that artists are extremely wary of record labels who want to participate in their other income streams, as they feel that the record labels should only have rights in (and earn money from) recorded music. In addition, many have been quick to criticise Terra Firma on its attempt to streamline EMI, so without a change in record industry attitudes, perhaps c) really is the only viable option.

### CONCLUSION

Unless record labels can significantly reduce their operating costs or participate in alternative income streams, then the royalty rates payable to artists (or the deductions on them) will need to be reviewed and re-aligned to make them viable for digital sales. Until then, record labels will have to resist the pressure to remove packaging/format deductions on digital sales altogether.

If royalty rates are not going to be reduced outright, then perhaps there is even an argument that a larger packaging/format deduction should be applied to digital sales to make them viable. Ultimately, however, this will require the attitude of artists, their lawyers and even the record labels themselves towards the current level of royalty rates to change significantly.

While in-house lawyers at record companies may feel pressure to agree to remove a packaging deduction on digital sales in order to close a deal, they should really consider the impact of agreeing to this in a negotiation. Removing the deduction may have a direct effect on the number of digital units that will have to be sold to enable the record company to recover its indirect costs.

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