6
Music

Life in the fast lane's no fun if you're running out of gas.

That is exactly what people in the music business discovered toward the end of the 1970s, when after three uninterrupted decades of expansion, recorded-music sales stopped growing. A new spurt of growth started in the mid-1980s and then carried through to the late 1990s, when the industry peaked with aggregate worldwide revenues of some $40 billion per year.[1] Since then, problems have abounded.

Still, however, music is the most easily personalized and accessible form of entertainment, and it readily pervades virtually every culture and every level of society.[2] Indeed, prior to the advent of recording technology, music was an integral and inseparable part of the social fabric.[3] As such, music may be considered the most fundamental of all the entertainment businesses.

6.1 Feeling groovy

Experimentation with reproduction of moving images can be traced back to the early 1800s. But there was apparently limited interest in the mechanical reproduction of sound until the venerable Thomas Edison in 1877 developed yet another of his novelty items – a tinfoil-wrapped cylinder that was rotated

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with a handle.[4] While he cranked the handle and recited the nursery rhyme "Mary Had a Little Lamb" into a recording horn, Edison's voice vibrated a diaphragm to which a metal stylus was attached. The stylus then cut grooves on the surface of the tinfoil and – voilà! When the procedure was reversed, the stylus caused the diaphragm to vibrate and the amplified recorded sounds to emanate.

Although early investors tried to popularize the invention through demonstrations in concert halls, country fairs, and vaudeville theaters, the scratchy sound and the limited number of times the foil could be used before it deteriorated discouraged enthusiasm for Edison's "phonograph." So it was not until other inventors (including Alexander Graham Bell) got into the act and improved the original phonograph by using a wax-coated cardboard tube over the cylinder, and until electric power was added, that the popularly called "talking machine" (and forerunner of the jukebox) finally caught on.

At that stage, people would actually go to a parlor and pay a nickel to listen to these wax cylinders reproduce songs and comic monologues. And ludicrous as it now seems, "a brass band recording a two-minute march had to play that march over and over again, perfectly, to turn out hundreds of recordings."[5]

Already by the 1890s, though, home phonographs had begun to appear. By then, a German immigrant, Emile Berliner, had developed a prototype that cut recording grooves onto discs – a modification that within ten years led to the introduction of the gramophone, or the "Victrola," by the Victor Talking Machine Company.

Technological development, this time of radio and an electrical recording process, then led to further sound reproduction improvements and also to conflicts among competing interest groups. Composers encountered tremendous resistance when they tried to collect royalties for performances of their music. Radio station owners meanwhile insisted that once they had bought a recording, it was theirs to use without any further financial obligation to composers.[6] And throughout the 1920s, but especially in the early half of that decade, it was radio, not phonograph equipment, that experienced the greatest rise in demand.

The Great Depression triggered a collapse of record sales – from $75 million in 1929 to only $5 million in 1933 – and it was not until the late 1930s that recovery became evident. Recovery was, however, hindered by World War II and by a protracted musicians' union strike that prevented the manufacture of new records for over a year.[7] By 1945, industry sales were still only $109 million.

The postwar introduction of tape recordings, which replaced inefficient wax-blank masters, and introduction of the 12-inch long-playing (LP) vinyl record by Columbia Records in 1948, then initiated a tremendous wave of growth. But the new LPs, played at 33 1/3 revolutions per minute (rpm), could hold only 23 minutes of music per side and did not win out over older 45 and 78 rpm configurations until the late 1950s – when industry sales first exceeded $500 million. The 1950s were also a time of innovation. New low-cost recording equipment made it possible for many small independent companies to spring up in competition with RCA, Columbia, and Decca – the long-established majors of the time.[8] The independents were the catalysts in bringing traditional jazz, southern rhythm and blues, and gospel-based music styles into the American mainstream.

It was not until the mid-to-late 1960s, however, that the business soared. Universal introduction of truer-to-life hi-fi stereo sound recordings came at a time when the postwar baby boomers, then teenagers with lots of money to spend, were becoming ever more attracted to the expanding rock 'n' roll genre. The sixties were also a time in which the record business, paralleling the evolution of the film business some 30 years earlier, consolidated distribution (and the ownership of "independent" labels) into the hands of a few corporate giants, which included RCA, CBS, Warner Communications, and PolyGram. This high-growth phase lasted through the 1970s and was given a powerful boost by the introduction of the standardized portable cassette configuration. By the late 1970s, industry sales at retail list prices hovered at the $4 billion level.

Yet not all was well with the industry as it entered the 1980s in the fast lane and then promptly ran out of gas. A somewhat older population base with a diminished interest in the new recordings of the time, coupled with poor quality control of vinyl pressings, contributed to a noticeable decline in demand that was not to be reversed until the arrival of the compact (4.7-inch) disc (CD) configuration in 1983. Such digitally (computer) encoded and optically (laser beam) decoded discs provided consumers with distortion-free sound reproduction and good reasons to buy music again. By the early 1990s, CDs had become predominant and vinyl nearly extinct, while U.S. industry sales soared to $7 billion.

An important peak in both domestic and worldwide sales was, however, seen in the late 1990s, as access to low-cost computers, widely available access to Internet connections, and the introduction of file-swapping software enabled music to be readily copied at little or no cost to the consumer. The resulting global "piracy" problem was then only worsened by the stubborn state of denial and delusion that, at the time, characterized the industry's response and eventually led to the alienation of the most avid music fans as well as many of the most prominent recording artists. In the five years ending in 2004, industry sales (both domestic and global) had plunged by about one-third.

Although CDs, in standardized versions for use in audio, video, and personal computer applications, continue to be the primary physical configuration, they have largely been supplanted by more advanced DVD (digital video disc) formats and by portable digital streaming and storage devices, most prominently iPods and smartphones.[9] In fact, the industry structure has been altered to such a degree that music companies now merely own the songs, with everything else, including pricing, distribution, and format, basically controlled by firms (e.g., Apple and Amazon) based in other industries.

Key events in the history of the music business, of which recordings are only a part, are displayed in Figure 6.1. From this it may be inferred that the industry has gone through three broad and somewhat overlapping business-model phase transitions that are characterized by the ways in which music is performed, stored, and distributed.

In the wax cylinder days, the business model was that of a *performance* service. The model then changed into a *product* service in which the sound-carrier formats ranged from singles and album compilations on vinyl to cassette tapes and then CDs. This product service phase required an extensive physical and marketing presence through retail stores and distribution centers (including mail order). Now, in the age of wireless Internet and smartphones and everything digital, we are well into the *service* distribution phase, in which music is totally portable and available everywhere at any time via ubiquitous music service providers. The model is thus again changing, from ownership to a rights-to-access system based in digital lockers and computing "clouds."[10] It might even be said that people no longer collect music; music platforms instead collect us.[11]

Of the industry's major revenue streams, proceeds from physical recordings, historically the largest category, are thus being overshadowed by those generated from provision of services. Although publishing meanwhile remains the most consistently stable sector and live performances arguably the most cyclical, performances will always be the rejuvenating root source that nourishes and supports everything else. What hasn't changed is that recordings still drive careers and labels still provide financing, editorial, marketing, and branding services that leverage the value of recordings.

6.2 Size and structure

Economic interplay

The American scene. The United States has long accounted for a major portion of the world's recorded-music business, both as a place of origination of new music trends and as a consumer of music products. And despite the rapid growth of consumption in the rest of the world, and in developing countries in particular, the United States still absorbs (in dollar terms) about 30% of all the recordings produced. Moreover, the structure of the business everywhere largely follows that which has been developed in North America, which is illustrated in Figure 6.2. This historical structure and now rapidly changing business-model approach has evolved as a result of the need to efficiently compensate authors, composers, publishers, and performing artists for their work in creating the final product – be it a jingle, song, album, or opera.

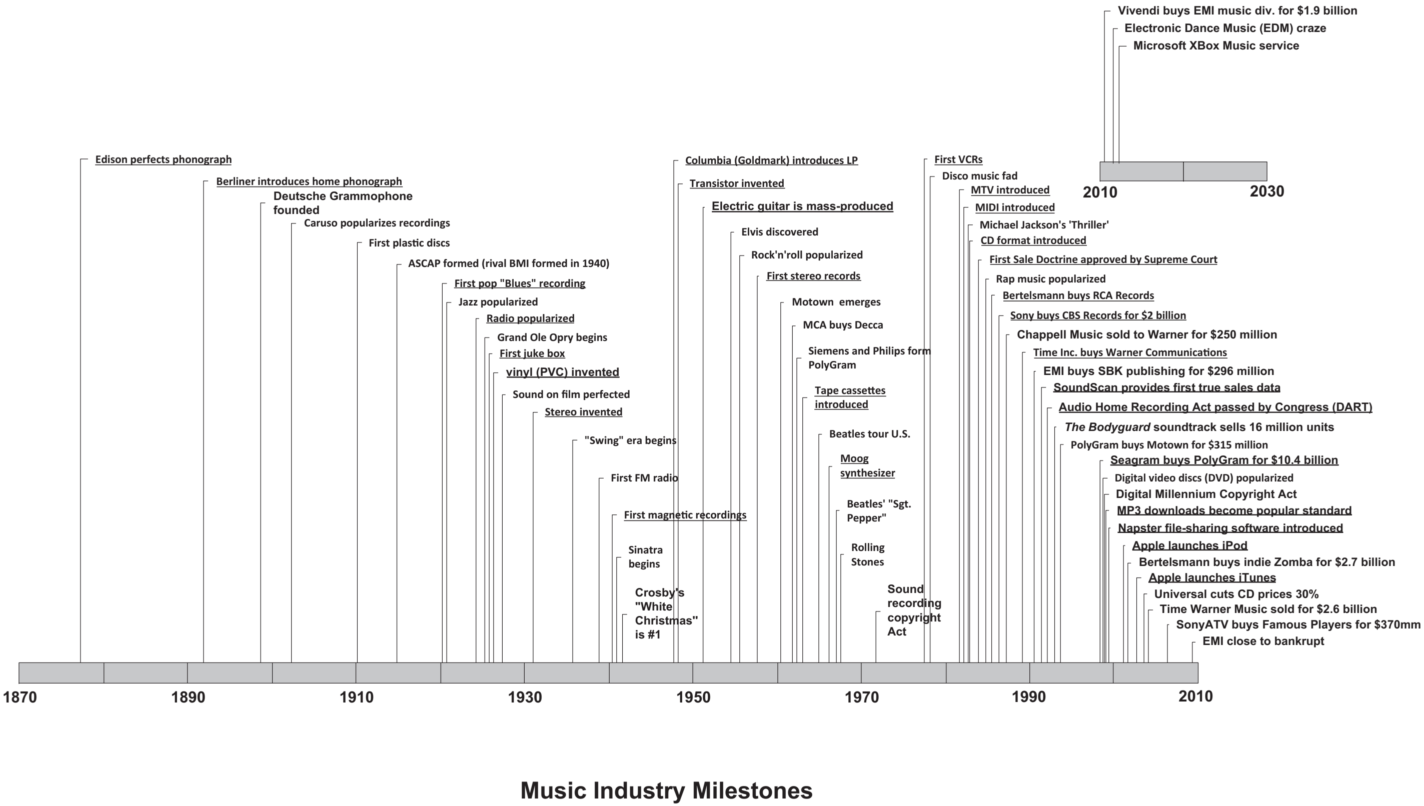

Figure 6.1. Milestones in the history of recorded music, 1870–2014.

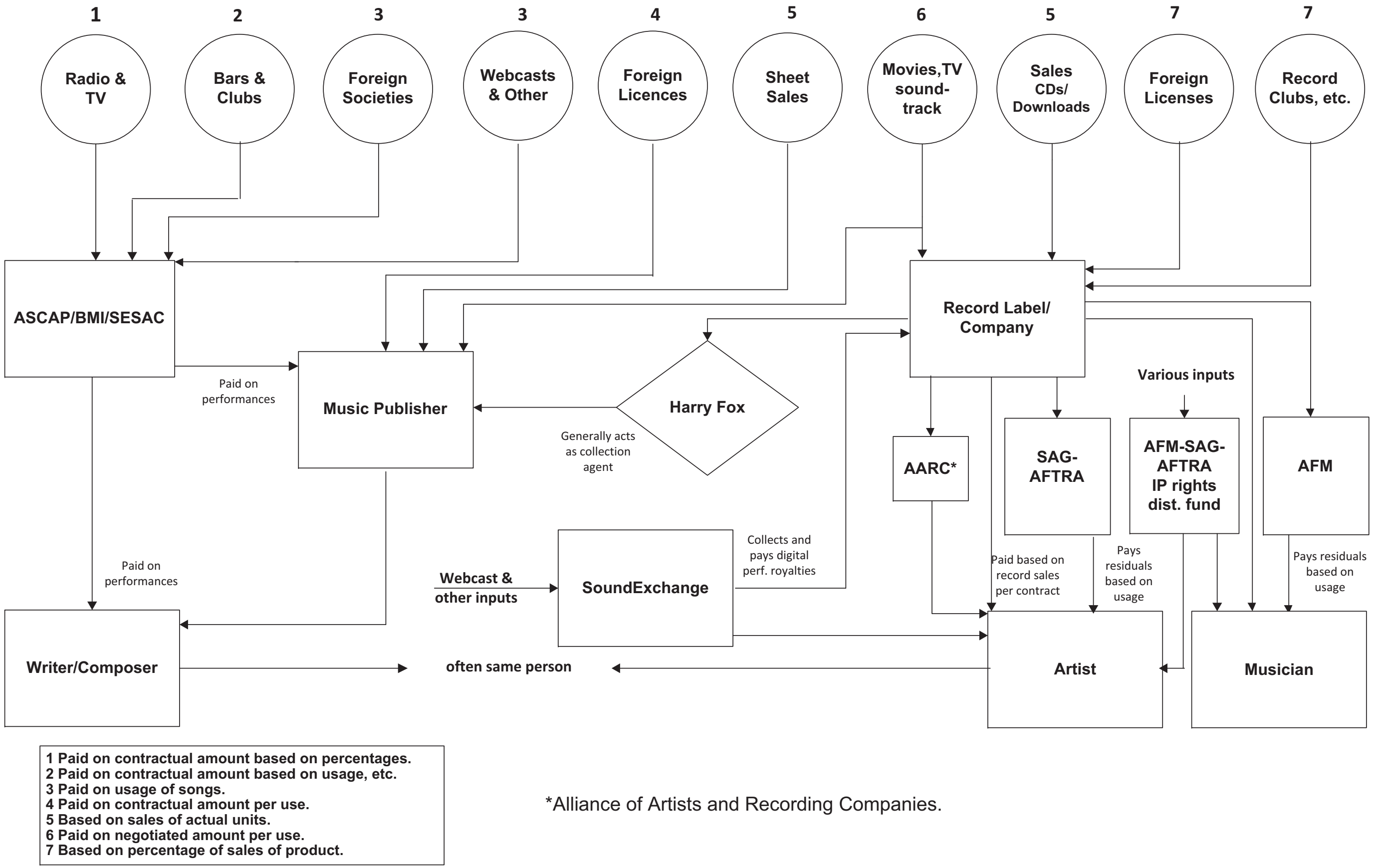

Figure 6.2. Music income flow in the entertainment field. *Source*: Adopted from E. Cook, Arthur Young & Co., with updating suggestions by J. Handel, author of *Entertainment Residuals: A Full Color Guide*.

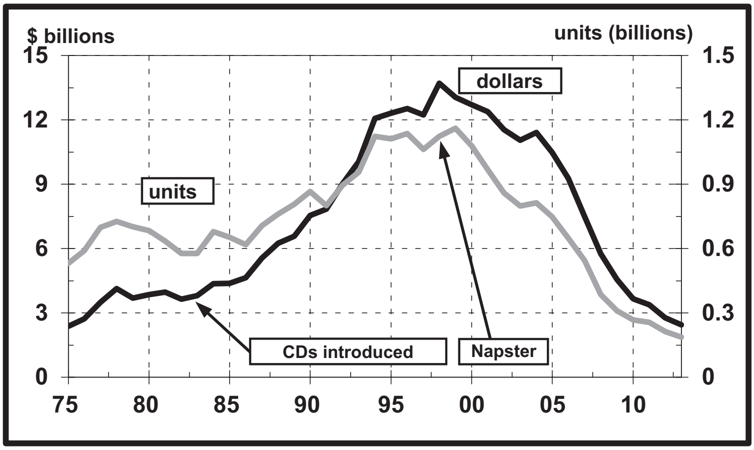

Figure 6.3. Trends in the American recorded-music market, 1975–2013. Manufacturers' physical shipments in units and dollars (at suggested list prices). *Source*: Recording Industry Association of America (RIAA).

In looking first at the market in the United States, it can be seen from Figure 6.3 that although demand for recorded music might have some sensitivity to general economic trends, there has been no growth in unit terms (including digital) since the late 1990s. The secular influence of new sound-carrier format introductions such as cassettes in 1973, compact discs in 1983, and digital downloading and streaming services (e.g., Napster) has been far more important than the business cycle in affecting demand (Figure 6.4).

The experience of the United States and Canada since World War II suggests that development of a strong and rapidly growing market for recorded music requires the conjunction of several elements. First and

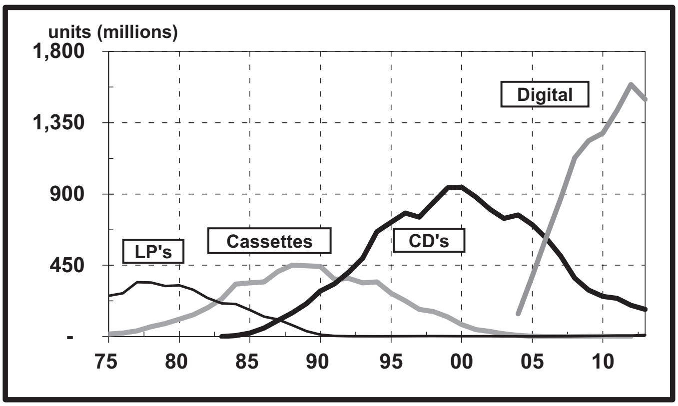

Figure 6.4. Physical unit shipments by configuration, 1975–2013. *Source*: Recording Industry Association of America (RIAA).

foremost is an expanding teenage/young adult population within a thriving middle class. Then it is essential that there be national advertising media in which large and cost-efficient marketing campaigns can be placed. Retail outlets ought to be plentiful and well stocked. And it also helps to have steady price and performance improvements in audio hardware and recording technologies.

All these elements were present in the postwar period in North America and, not surprisingly, the recorded-music business grew from $100 million to almost $6 billion in domestic (U.S.) retail sales in the span of 40 years. Because many of the same factors were present in other developed countries, sales of recorded music outside the United States have grown similarly.[12]

But changes in the system of distributing music products also had an important effect on the industry's sales. Until the late 1970s, records were essentially distributed on consignment: Unsold units were returnable for full (or nearly full) credit against new albums. This meant that many stores could be opened on shoestring capitalization and could pay their bills with "plastic" (i.e., returned records) instead of cash. Ultimately, however, as unit demand growth slowed and the major distributors sharply curtailed their returns policies, retailers were for the first time faced with a significant inventory risk. Retailers accordingly became much more cautious and selective in their purchases. And that, in turn, made manufacturers and distributors less willing to risk large sums on unproven new artists.

In addition, success up to the mid-1970s led to excess, as budgets and costs spiraled out of control, mostly in the areas of artists' royalty guarantees and marketing. Even the largest companies subsequently found that their stars could not consistently assure the ever-increasing "megaton" record shipments needed to underwrite large royalty advances.

Fortunately, by 1983, the advance of technology once again – as it had so often before – bailed the industry out of its funk. The catalyst this time was the introduction of low-cost, high-speed microprocessor and memory devices: In brief, the era of cheap computing power had arrived. And with this power came the ability to digitize sound; that is, to reduce sound to equivalent numerical data through frequent sampling and processing. As a result, undesired noises could be eliminated and a marked improvement in sound fidelity could be brought to the mass market in the form of inexpensively manufactured compact discs. The introduction of music synthesizers, computers capable of producing and mixing sounds in a manner not possible with traditional instruments, also soon followed.[13]

The emergence of MTV, the new rock-music cable channel started in 1981, was significant as well in reversing the early 1980s downturn in demand for recorded music. By 1984, MTV had gained wide distribution and influence both as a promotional platform for record labels and as a distinctive programming service.[14] And by the early 2000s, the growth of new online music stores, propelled by the great success of Apple's iPods and iTunes, yet again

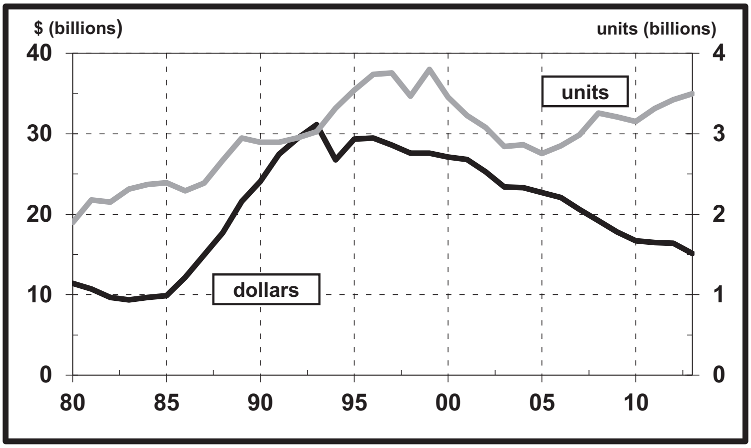

Figure 6.5. Worldwide recorded-music trade sales in billions of dollars, 1980–2013. Data beginning in 2004 includes digital single downloads.

changed and enlarged the way music could be bought and used. With these, a major transition to mobility and ubiquity and to changes in the way artists are compensated was begun. Thus the concept of possession of music on physical carrier media began to be replaced by the idea that the essential aspect is actually the right to access music anytime and anywhere.

The global scene. As nations emerge from under repressive or dysfunctional economic structures and then see discretionary incomes rise rapidly, one of the first areas to benefit is music – which is relatively low in cost to enjoy, yet highly personalizable. But although demand for music products is everywhere affected by the demographic, economic, and technological factors already discussed, development of local repertoire is now another important part of the international sales and marketing mix: Recordings of artists with a global following may account for only half to two-thirds of the total.

It can also be seen in Figure 6.5 that since peaking in the late 1990s, global trade sales have fallen by at least one-third and that the replacement of physical carrier formats with digitally distributed formats has not yet significantly reversed the decline (although it ultimately will). As a result, per capita unit demand (not shown), which had historically been relatively high in the United States, is now approximately the same in all developed countries.

Figure 6.6 further suggests that although rising GDP per capita is positively correlated with a country's percentage of international music purchases, factors such as language and culture, median age of the population, and relative creative strength of the local industry also play a role. Japan, for example, has a high GDP per capita but a relatively low percentage of international music purchases as a percentage of the total.

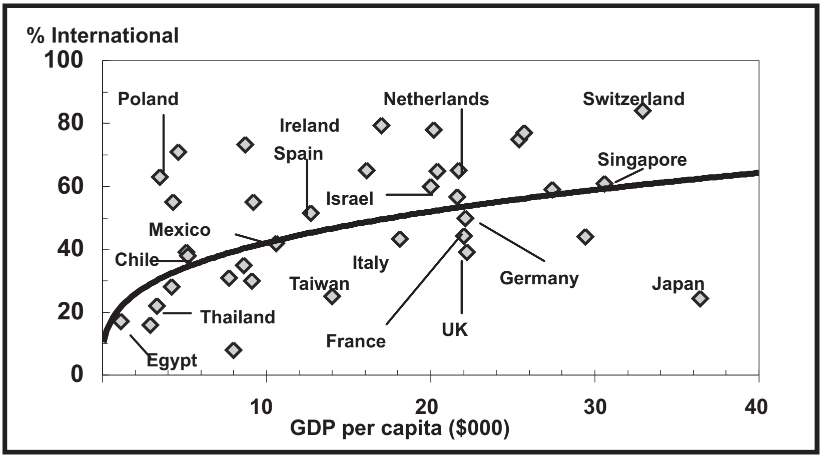

Figure 6.6. GDP per capita in thousands of U.S. dollars and percentage of international (nonregional) sales by country. *Source data*: IFPI, MBI World Report, 1999.

Composing, publishing, and managing

The process of creating a musical property and then exploiting it is in many ways similar to property development and exploitation in movies. In both areas, relative bargaining power is a key element. An important difference, however, is that in music an enterprise can be launched with fewer people and with far smaller commitments of capital.

A new composer has several avenues through which work may begin to generate revenues, but the first step is usually publication. The composer can attempt to interest an existing publisher or can establish a new publishing firm. In any case, the normal arrangement is for publisher and composer to share evenly any income from their joint venture.

The publisher's role is to monitor, promote, and generate revenues from use of music in everything from sheet-music sales ("paper" houses specialize in this) to live performances and recordings to digital downloads and ring tones. At each step, royalty income, which may have to be further shared by subpublishers and coauthors, is derived. For a new artist or composer, contract terms are largely standardized, but for a recognized talent, many complex variations depending on tax, managerial, and other considerations are negotiated. There are tens of thousands of publishers and self-publishers in the United States, but the business is dominated by the publishing affiliates (Warner/Chappell, Universal, and BMG) of the major worldwide record distributors.

The services of lawyers and accountants are required in most stages of a composer's career, but if the composer is also a performing artist, as is increasingly common, any degree of success will entail the hiring of a manager and an agent to book concerts, television appearances, and recording schedules. Managers will, in aggregate, generally take between 15% and 30% of a performer's income (with personal managers taking 15% of gross artists' earnings before deducting expenses), while talent agents extract another 10%. For a new artist or composer, the functions of manager, legal advisor, and talent agent may be handled by a single individual.[15]

Royalty streams

Performances. If a "demo" (demonstration) record or tape has attracted a publisher's interest, the next step is to work on a full-fledged recorded performance by the composer or to attract the interest of other performers in cutting a "cover" record of the material. Publishers and performers are always on the lookout for good, fresh material, but only a small fraction of what is offered is accepted, and only a small fraction of what is accepted for publication succeeds in the marketplace. Of hundreds of new works introduced each week, on average not more than five to ten seem to have any chance of receiving widespread recognition.

Whether the music is performed by orchestras, by college bands at football games, by radio stations, by nightclub singers, or by Muzak® speakers in elevators, it is entitled to performance royalties that are collected by two major agencies (and one smaller agency) in the United States. Of the two majors, the oldest and by far the largest in terms of billings is the American Society of Composers, Authors, and Publishers (ASCAP), but the larger as measured by number of "affiliates" is Broadcast Music Incorporated (BMI). These two agencies combined gather over 95% of all U.S. performance royalties, with the Society of European Stage Authors and Composers (SESAC) receiving the remainder. All three organizations are protectors of composers' rights and collectively license, and thus monetize, compensation to composers and authors.[16] Similar licensing and rights fee collection societies are the Performing Rights Society (PRS) in the United Kingdom, GEMA in Germany, and JASRAC in Japan. In satellite and Internet radio, however, royalties are collected and distributed to performers and copyright holders by SoundExchange.[17]

Because about 60% of performance royalties are derived from use in television, radio, and films, the major agencies have accordingly developed extensive computerized logging and sampling procedures to assure that composers receive proper remuneration for performances of their works anywhere in the world. To accomplish this, agencies in other countries cooperate with ASCAP, BMI, and SESAC.

The formulas used to determine royalty rates depend on the frequency of use and the length of time the music is used, the estimated size of the audience, and other factors. For example, classical compositions are accorded more weight than popular jingles. Greater weighting compensates for the relatively greater expenditure of effort in classical composition and for the probable smaller size of the audience and less frequent play.

However, the sizes of royalties and the ways in which licenses are granted to television and radio stations (i.e., blanket versus specific performances) have often been subject to proposed legislative changes.[18] Also important is the distinction between the two different copyright contracts on which royalties are based. A performing arts (PA) copyright (which can be registered using the eCO, or electronic copyright office system) includes musical and dramatic works, scripts, and dance. The second type of copyright, the SR or sound recording copyright, covers the fixation of musical, spoken, or other sounds in or on a recording medium. Labels often pay for use of both the PA and SR copyrights.

Mechanical royalties. Under so-called compulsory licenses, mechanical royalties (named for sounds that were mechanically reproduced at the time of the 1909 Copyright Law and up until the early 1940s) are derived from sales of recordings and from publication in sheet-music form (normally at a rate between 3% and 10% of the retail price per copy in the United States). Of the two sources, recordings are far more important and, as of 2007, the statutory rate (i.e., the rate set by the Copyright Statute) for each recorded copy of a song was raised to the larger of 9.1 cents or 1.75 cents per minute of playing time or fraction thereof, whichever is greater. Outside the United States, however, royalties are instead taken as a percentage of an album's wholesale published price to dealers (PPD), which means that the rate has no relationship to the length of the compositions or to the number of songs per album.

Mechanicals were introduced early as statutory royalties on piano player rolls that "mechanically" reproduced music. To keep pace with changing marketplace conditions, however, they are now subject to upward revision over time and either are negotiated by the interested parties or go to review by the Copyright Royalty Board (CRB).[19] Publishers generally split such royalties 50:50 with new writers and 25:75 (or 20:80) with more established composers. These royalties, which typically account for around 45% to 55% of all publishing revenues, are taken after deduction of a 4 1/2% collection charge (on gross amounts collected) by the Harry Fox Agency in the United States or a 5% charge by the Canadian Mechanical Rights Reproduction Agency (CMRRA) in Canada.

Synchronization fees. In addition to paying a performance fee, anyone using music in films requires a synchronization license, which is a license to use music that is timed to the display of visual images. The various parties individually negotiate these royalties, which are normally based on established standards for music length, potential audience, and frequency of use. In radio commercials, similar user fees are gathered from the granting of transcription licenses.

Publishers' synchronization and mechanical fees usually are collected from film and record companies by the Harry Fox Agency, a wholly owned subsidiary of the National Music Publishers Association, or one of its smaller competitors such as AMRA, the American Mechanical Rights Agency. These agencies license copyrights for commercial recordings, music used in television and movie productions and commercials, and background music used in public places. And they also audit the books of record companies. The commission charged to affiliated publishers and writers is 4.5% of the royalty money collected.

Copyright. The aforementioned royalty streams, including license fees from jukebox and other uses (e.g., wired music services such as Muzak®), were adjusted by Congress in a 1976 revision of the original, but technologically outdated, 1909 copyright law. The 1976 law grants copyright owners of a musical composition the exclusive right to be the first to record and distribute (or to assign to someone else) recordings embodying that composition.[20] In the case of music, there are thus actually two copyrights involved – one for the recording and another for the composition – and each is not necessarily owned by the same entity.[21]

Another issue of particular importance that emerged in the era of video-cassette rentals involved the doctrine of "first-sale" rights: rights that allow the person or company initially purchasing a product to resell or rent that product to other parties without further obligation or compensation to the original seller.[22] Because of first-sale rights, producers do not receive compensation each time a tape, CD, or DVD is rented; they are compensated only at the first sale to the rental store.[23]

In all, copyrights, and the protection of intellectual properties from counterfeiting and piracy, have played an important role in the evolution of the music and home-video businesses.

Guilds and unions

The effects of labor union contracts, primarily those of the American Federation of Television and Radio Artists (AFTRA) and the American Federation of Musicians (AFM), extend to every area of the music-making business. Singers, soloists, and choral ensembles are generally represented by AFTRA, whereas other musicians, including conductors, arrangers, copyists, and instrumentalists, are members of the AFM. The American Guild of Musical Artists (AGMA) may cover opera, ballet, and classical concert and recital performances, while other representations may be made through the Actors Equity Association or the Screen Actors Guild. The New York Dramatists Guild is a trade association representing lyricists, composers, and writers for the Broadway musical theater (see also Chapter 13).

As in any other industry, labor unions help their employed membership by bargaining for higher wages and benefits. But it can also be argued that, if it were not for the high production costs inherent in using union performers, there might be many more productions in which musicians could find work, albeit at lower average wages. It is not unusual for new artists and new record companies to attempt to circumvent the use of union labor, or for background-music recordings to be made in Europe, where labor costs are lower.

Both AFTRA and AFM have tried to maintain strict union shops, but right-to-work laws in various states have reduced union influence, especially in the rock, country, and rhythm and blues (R&B) segments. However, if a record master copy is transferred from a nonunion independent producer to a record company that is party to AFM agreements (which most record companies of any significance are), then union control over wages is reasserted. This control also appears in areas such as voice overdubbing, a situation in which a union contractor will charge a producer for an additional voice even though it is only electronically mixed.

Royalty artists, who are entitled to AFTRA scale plus royalties based on the number of records sold, must also conform to union-negotiated rules. For musicians who participate in making broadcast commercial spots, there are, of course, extended repetitive payments. Whenever an AFTRA member performs on tape for one medium and that tape is used in another medium, the performer receives additional payments.

Concerts and theaters

Concerts by popular performers (in which an advance against a percentage of anticipated gate receipts may be obtained) may be profitable for their organizers if they are skillfully budgeted and planned. Most of the time, however, the purpose of a concert tour (which is typically arranged by an agent) is to provide artists with exposure that can leverage sales of records and other licensed merchandise.[24] With such performances, artists can burnish their brand while often earning substantial income that is largely not shared with recording companies. Such income can be generated without taking the risks that are incurred in renting concert venues and taking care of numerous administrative details, which include advertising and marketing of tickets and merchandise, payment of royalties, and catering and stagehand preparations. Concert tours generate at least $4 billion a year from North American ticket sales of around 40 million admissions (and twice as much worldwide) and, in a sense, have become the tail that now often wags the music business dog.

Theater presentations on Broadway, summer musical theater, classical music concerts, and opera are additional forms seen in the live concert area. But these are often less profitable than live performances by popular artists. It has been estimated that, on average, performing-arts organizations, including symphonies, operas, and ballet companies, earn less than 40% of their costs of operation (Baumol and Bowen 1968).

Moreover, an increase in the number of performances, or in ticket and subscription prices, will not ordinarily reduce operating deficits (see Chapter 13). Instead, financial support from municipal and private sources is normally required to sustain these activities. Through the creation in 1965 of the

National Endowment for the Arts (NEA), Congress has also provided support by allocating federal funds to match local contributions. Some 1,500 orchestras and 600 opera companies, plus individual artists, are eligible for grants. (The NEA's legislative mandate is limited to support for individuals and organizations that are tax exempt.)

6.3 Making and marketing recordings

Deal-maker's delight

Large record companies have traditionally provided several different services, all of which are somewhat comparable to those provided by major film studios. These companies – which earn most of their profits by selling millions of recordings of only a relatively few artists – are, for instance, involved in the manufacturing, distribution, and marketing of music. They also finance recordings, lend and advance funds for expenses, and attempt to guide the careers of artists. As the costs of recording, manufacturing, and distribution have declined significantly, the value of such service functions to artists has been much diminished.[25] Nevertheless, many of the essential elements of traditional production and distribution arrangements are unlikely to soon be fully replaced.

Production agreements. As seen in previous chapters, creativity is not limited to finished products; it also appears in financial and manufacturing arrangements. In fact, the scope for deal-making in records as compared with movies is potentially even greater because of the relatively smaller capital commitments and fewer people involved in making a recorded-music product. Still, most record companies are highly selective in signing talent, and fancy deal-making is a privilege mostly reserved for already established artists.

Whereas in the early days of the business the record companies simply signed an artist and had an in-house producer known as an artist-and-repertoire (A&R) man guide the project, there now is a tendency for artists to work with independent producers. Like record-company A&R people, these independents will help the artist select material and a music style, decide where and how the recording is to be made, and generally watch over budgets for studio recording and rehearsal times, mixing, and editing. Sometimes they also become involved with the design and artwork for CD-album liner notes.

Variations in financial arrangements usually develop as independent producers and independent "labels" (companies) work with an artist as subcontractors for the major record companies.[26] Deals are typically structured in one of the following ways:[27]

1. The label signs the artist and an in-house producer, compensated through salary plus perhaps some royalties, to handle the project.

2. Talent is already under contract with a label, and the label retains an independent producer or company to deliver a master tape. The outside producer will initially receive a production fee and also negotiate a royalty of 1% to 5% based on retail sales. The record company will normally set the budget to which the independent will adhere.
3. Independent artists and producers make a master tape and then try to sell the master to a label. If the master is accepted, the label compensates the artist-producer team through royalties perhaps earned against an advance.
4. A label may form a joint venture with an independent producer or artist. Royalties will then be shared in proportion to the size of the respective financial commitments. Here, a modern variation is for major labels to outsource talent discovery and development to smaller labels, which through upstream deals then enables the major to participate in any commercial success.
5. An artist may form a production company to make and deliver a master tape to a label. A freelance producer may then be hired by the artist's production company.
6. An artist may be employed by a corporation (his/her own) that then sells (i.e., loans out) the artist's services (through a "loan-out" corporation) to a label in return for royalty considerations.
7. An artist may have a self-owned recording and producing company that makes a pressing and distribution agreement (P&D deal) wherein a large record company handles manufacturing and wholesale distribution (for a fee of around 20%). This is analogous to the "rent-a-studio" distribution deals seen in films.

Within the context of these variations, many "independent" labels emerge. But few are truly independent, because the initial financing, manufacturing, and distribution of the final product are much more efficiently handled by large record companies that are able to diversify their risks over many different labels while enjoying many other economies of scale.[28]

Independent labels and producers may also negotiate adjustments when, as is often the case, an individual functions in several different capacities. The producer may be trained in both music and audio engineering; the performing artist may be a coproducer and fund-raiser. In the end, however, whether the producer or artist receives the most compensation depends on relative bargaining strength. Important producers may receive several percentage "points" from the label in addition to production fees, often between $25,000 and $150,000 (half paid on signing), that are nonrecoupable against royalties. In total, this may be more than what the artist receives.

Talent deals. Talent royalty rates depend on the degree to which the artist is in demand. Major artists often can command over 15% of retail price, which would amount to well over $1 per album, but minor players will be signed at a rate of 10% or less of retail. A sliding scale may be used whereby the first 100,000 units sold are at 9% and for every 100,000 units thereafter the royalty rate is scaled upward by one or two percentage points. In most cases, record companies will estimate the artist's annual royalties and then advance about one-half that amount.

For *all-in deals*, however, the artist is also responsible for paying the producer (perhaps 3% of retail) out of the artist's share of royalties. An artist entitled to a royalty of 15% of the suggested retail list price "all-in" might thus have to share at least one-fifth of such income with the producer, who is the functional equivalent of a director and producer in the movie industry. Moreover, unlike artists, producers are paid for all records sold and recording costs are not against producer royalties.

An important reason for the decline in record-industry profitability during the late 1970s was excessive royalty bidding by major companies for popular artists whose contracts were up for renegotiation. Significant losses ensued when large royalty advances were not covered by subsequent album sales. To partially protect themselves from such potential losses, companies may sign an artist to deliver several albums over a certain period of time and then, as in films, partially cross-collateralize royalty advances over those albums. Newer deals, however, also recognize that the album format is of diminished importance as most consumers have, as in the earlier years of the music business (mainly the 1950s), returned to purchasing single songs rather than compilations.

Production costs

Once the deal-making phase is completed, musicians and producers begin a long process that leads to delivery of a completed master. Decisions concerning the time and place of recording and the number of backup singers and musicians must be made. Rehearsals must be scheduled.

Production costs for popular albums are generally budgeted for at least $250,000, and, if much studio time is used, costs can soar well past $400,000. As production costs rise, it naturally becomes progressively more difficult for the record company to make a profit from the album (no matter what the sound-carrier medium).

Having delivered a master tape mixed down to two-channel stereo and formatted for an album, the producer will then typically be paid the remaining half of the production fee or an advance on royalties. But for the record company, other expenses are just beginning: A marketing campaign must be planned, artwork must be commissioned, and a timetable for production and distribution – be it downloaded or shipped physical product – must be established.[29]

Marketing costs

Marketing campaigns for albums may frequently involve concert tours, cooperative advertising with local retailers, in-store merchandising aids (e.g., displays, posters, and T-shirts), radio and television commercials, and "promo" press kits. Also, free records (or digital files) may be sent to hundreds of radio stations. But none of this comes cheap: Marketing costs can often exceed $100,000 for a fairly standard release and in excess of $500,000 for one by a major artist.

Promotional efforts are generally aimed at the most influential reporting stations; that is, some 200 to 300 stations monitored by tip sheets and trade papers such as *Billboard*. And indirect spending for promotional purposes also used to include significant sums for bribery of station managers and program directors until such "payola" was publicized and then outlawed in the 1960s. Nowadays, any station of importance is careful to set policies limiting the size and frequency of gifts or favors that employees are allowed to accept.[30]

Record companies will also have their own staffs of "trackers," whose job it is to aid in promotional efforts by knowing which songs and albums radio stations around the country are adding to or deleting from their play lists. With popular-music stations able to add at most three or four new cuts per week to their lists, competition for airplay is intense: Every year an estimated 11,000 (nonclassical) major-label albums averaging some ten cuts per album are released, but it is now unusual for more than around 100 of these to sell more than 500,000 units in physical (i.e., CD) format.

Perhaps as little as 10% of new material must thus make a profit large enough to offset losses on the majority of releases – a situation that is even worse than in films, where, on average, 70% of projects are losers. Labels will encourage production of much more material than can possibly succeed, in essence diversifying their portfolio of bets on new releases. This is done because upfront investments are at this stage relatively small as compared with later costs of promotion and distribution, a hit can come unexpectedly, and the most popular recordings – especially those by newly trendy artists starting at relatively low royalty bases – are immensely profitable. Again, as in other entertainment industry segments, a small part of the product line will generate a large part of the profits.[31]

Distribution and pricing

Through most of the music industry's history, there has been only one important distribution model, but the Internet has increased the number of possible arrangements. For example, advertising-supported "free" music and a do-it-yourself (DIY) approach have become much more feasible than ever before. Via the Net, almost all music will ultimately be available on demand anywhere and at any time based on a variety of pricing models.[32] Indeed, music is in the forefront of providing *rights to access* to content through cloud computing as opposed to ownership (on CDs, vinyl, MP3 players, etc.), which had been the model throughout the industry's history.[33]

Structure. However, none of the various deal forms changes the fact that the rate of project failure for music products is extremely high, and that all but the most successful recorded-music products have a relatively short life cycle, lasting at most a few months. The traditional structure of the record business evolved in response to such considerations as well as to the need to constantly manufacture and ship units from factories to stores and, when unsold, often back again to distribution centers. This structural arrangement, although of obviously diminishing importance, remains operationally relevant.

When the music business was dependent on sales of LPs, tape cassettes, and CDs, it had been essential for retailers to have their inventories of hits quickly replenished. Most records are thus distributed by large organizations with sufficient capital to stock and ship on a moment's notice hundreds of thousands of units to widely dispersed retailing locations. In the United States (and globally), the industry has consolidated into three major companies: Universal Music Group (UMG), Sony/BMG, and Warner Music Group (WMG).

Two major record distributors in the United States have long been Warner Music Group, the former distribution arm for the Time Warner Inc. labels (including Warner Bros., Elektra, Atlantic, Asylum, Nonesuch, Reprise, Giant, and Sire), and Sony (including the Columbia, Epic, and Masterworks labels, which were bought from CBS by the Sony Corporation of Japan in 1987).[34] These companies have together often handled up to half the albums sold in North America and about 35% of the total elsewhere.

The combination of Sony and Bertelsmann in 2008, however, raised the total Sony/BMG share of U.S. music album sales to around 25%, compared with the 32% share held by Universal Music Group (owned by the French company Vivendi). UMG labels include, from the PolyGram side (acquired by Seagram in 1998), Deutsche Grammophon, Mercury/Island, Polydor, London, A&M, Def Jam, and Motown, and also, from the predecessor companies, MCA and Geffen. The other major distributor was the British EMI Group (CEMA), whose labels included Capitol, Angel, EMI, Chrysalis, Virgin, Manhattan, and Blue Note. EMI's music division was bought by UMG in 2012 for $1.9 billion, with the EMI publishing division (holding more than 1.3 million copyrights) bought by Sony/ATV and other investors for $2.2 billion.[35] For the most part, the market shares of these major distributors tend to be fairly stable over long periods.[36]

Success in distribution depends on the size of the capital commitment and on the ability to sense where and how well new music is selling. To this end, distributors employ large staffs of sales and promotion people and rely extensively on outside intelligence-gathering sources. Although this structure works well in large regions, it is not nearly as efficient in servicing smaller stores and out-of-the-way territories. Thus, there had existed a second tier of smaller independent distributors, known as *one-stops*, that handled all labels, including those of the majors. One-stops evolved in the 1940s to accommodate the needs of jukebox operators; those that might remain today would work with orders from small stores and/or Internet-based promotional and marketing sites.[37]

Rack jobbers had also substantially contributed to the growth of the music business since 1950 and, more recently, to the growth of the home-video industry.[38] "Racks" may operate record departments in space leased from department stores. Or, for maintaining inventories and promotion displays in record departments owned and operated by other parties, they may earn fees based on a percentage of sales.[39]

Last in the distribution chain is the cutout wholesaler, who buys, at or below cost, records that have been returned to the distributor. *Cutouts* – which appear as secondary merchandise in discount stores – are the industry's errors in judgment as to production quantity and/or quality, and they often provide real bargains for patient and knowledgeable consumers. But because contracts are normally written in terms of royalties on the number of recordings *sold*, not the number manufactured, cutouts and overstocks have long been an area of dispute and litigation between artists and record companies.[40]

Pricing. As might be expected, major-distributor pricing policies have an important effect on firms further downstream in the distribution chain. There is, nevertheless, no easy method by which to analyze such policies, because all major companies now have different scales for quantity discounts and return-privilege limits; the sizes of discounts are normally proportioned according to order quantities (which means that jobbers and one-stops operate in wholesaler price niches). From the artists' standpoint, top-line pricing is defined by contract to be of limited duration, and after the product goes into the company's catalog classification (i.e., it no longer qualifies for specific promotional efforts) it will then likely be sold at midline and then later still as a budget-priced album – with royalty rates also accordingly diminished.

Although wholesale pricing is relatively straightforward, in retail pricing there is also often an interesting economic anomaly in that, to attract impulse buyers, the newest products in strongest demand may be priced lower than older items that are in lesser demand.[41]

6.4 Financial accounting and valuation

As might be expected, the corporate financial-accounting perspective is different from that of the artist. From the corporate view, enough profit must be generated to compensate shareholders with a competitive return on investment and also to underwrite development of as many new talents as possible simultaneously. Individual artists, of course, are concerned primarily with their own financial statements.

Artists' perspective

Among the basic issues that need to be negotiated between artists and record companies are the date of contract expiration, the number of albums committed, exclusivity, foreign-release intentions, and royalties and advances. For example, a contract may require that three master tapes be delivered within three years of signing and may further stipulate penalties to be paid if the albums are not released. Throughout, however, it is important for the artist to recognize that record companies do not actually give money to their artists: In effect, the companies instead lend (i.e., advance) the money and expect that artists will pay back the loans out of royalties earned.[42]

With the possible exception of contracts in the jazz field, labels generally require their artists to provide exclusive services, which may extend to music-video performances. Artist contracts may also delineate the foreign countries or territories for which album release is planned. This can be significant in that a major portion of sales may occur outside the United States (sometimes at royalty rates 75% of the domestic rate).

The greatest attention, however, is usually focused on negotiations for performing-artist royalties and advances.[43] Ten percent of the suggested retail price (SRP) has historically been a normal starting point and percentages are often scaled upward from this level in proportion to the artist's sales potential.[44] Even in the age of iTunes, such royalties have been counted as a percentage of a sale price, so that on a 99 cent download, a typical artist might earn 7 to 10 cents after retailer deductions. But as listeners have migrated to cloud-based streaming services (e.g., Spotify, Pandora, Vevo, iHeartRadio, and iTunes Radio), the structure of artist royalty payments has dramatically shifted: In streaming, only a fraction of a cent is generated each time a song is played – with performers and songwriters each sharing a portion of this much smaller micropayment (averaging perhaps 0.5 cents per play).

These changes have heightened the interest of record companies in "360 deals," in which the label can share in multiple revenue streams and be thereby incentivized to participate in the longer-run development of artists' careers.[45] Basically, the label invests more upfront for marketing and other services and sometimes higher royalty rates and fewer album options in exchange for a cut of touring revenues, merchandise sales, and other earnings that artists had previously fully retained. Such arrangements will in the future likely be dominant, with recording becoming a secondary-income activity that serves the purpose of opening the more lucrative live concert promotion and merchandising opportunities to artists.[46]

Rates for new artists signed to independent companies might range from 9% to 13% of SRP, while rates for new artists signing with a major label might be 13% to 14%, and rates for superstars 18% to 20%. Yet for Internet downloads, such rates will often be 20% to 50% less. In classical music, where typical expected unit sales are much lower, royalty rates are perhaps 7.5% to 10% of SRP and advances are well below those in pop music.[47]

Royalties and advances may, however, also be based on a published dealer (wholesale) price, which is actually a better benchmark given that record companies cannot set retail prices and that such "retail" (SRP) prices are largely fictional. In fact, outside the United States, the wholesale price is called Published Price to Dealers (PPD) or the Base Price to Dealers (BPD). Either way, though, using SRP or an imputed ("uplifted") multiple of PPD, payout increments are frequently contingent on attainment of a Recording Industry Association of America (RIAA)-certified sales level of gold (500,000 unit sales for albums and singles), platinum (1 million albums and singles), or diamond (10 million albums).[48] The International Federation of the Phonographic Industry (IFPI) has a similar award program in many other countries, excluding the United States.

Contract discussions may furthermore involve issues of creative control, ownership of masters, publishing-rights ownership, production-budget minimums, conditions under which a contract can be assigned to another person or company, the artist's right to audit the firm's books, and the label's minimum commitment to spend on promotion, tour support, and music videos. Charge-back items such as production expenses that the record company has the right to recoup before paying royalties beyond the negotiated advance will always have significant financial effects on the artist's compensation. Also, default and arbitration-procedure clauses are included in many contracts in case of unforeseen disagreements or problems.

Such situations will readily arise if the label and artist do not have a full understanding of the numerous deductions that are taken after the royalty rate has been established. For example, the record company will usually specify a discounting of the sales base on which royalties are to be applied by up to 15% for free goods (i.e., for promotional copies that are given away to radio stations or that represent a quantity discount to retailers). Other discounts to royalties might include 20% for packaging (a "container" charge) on cassettes and 25% for CDs (but only 10% on vinyl), or 50% for record-club sales.[49] And clauses involving merchandising, production costs for music videos, and cross-collateralizations of one album's financial performance against another's (see Section 5.3) may further affect the royalties paid to artists. Only recently have companies, in response to criticism, begun to change contract stipulations by basing royalties on wholesale prices actually received from retailers and by eliminating archaic packaging and new media deductions.[50]

Recording agreements generally take all such factors into account by structuring themselves as funds in which a fixed amount is set aside to accommodate the estimated costs of recording and of the artist's advance (the "recoupment fund," which is also sometimes called "the aggregate sum"). Advances may, in turn, be further governed by formulas that include floor and ceiling payments contingent on performance. Funds can range from as little as a few thousand dollars for beginners to well into the millions for superstars.

Royalties are paid only on the number of units that are sold, not the total units shipped. In addition, however, as described earlier, pop-music artist royalty rates are usually calculated as "all-in," which means that the artist is responsible for paying the record producer out of the artist's share of royalties. A typical payment to a producer out of the artist's share would be 3% or 4% of the SRP.[51] Therefore, even if an artist were to recoup record company advances for marketing and production, he or she might still end up owing money to the producer and chasing a moving recoupment target. Unless it is specifically written into the contract, it is also possible for an album to be produced but not released (or not even to be produced). These situations usually fall under "pay or play" clauses that are similar to those used in the film business.

To recoup an advance against royalties fully and to begin to earn on incremental unit sales, artists will thus normally have to sell one album for every dollar spent on production and marketing and generate 1 million unit sales. Recoupment terms in standard industry contracts, in fact, imply that "most of the costs of making a record are to be repaid out of the artist's royalties rather than gross receipts."[52] Given that probably fewer than 10% of artists recoup their royalty advances, a recording contract is thus essentially a loan from the label to the artist, who is expected to pay the loan back out of the royalties that are earned.[53] However, a newer alternative for raising capital for experienced musicians is the Royalty Exchange.[54]

How a relatively new artist with a first gold album might fare financially can be seen from the hypothetical example in Table 6.1, in which the significant leverage for sales above 500,000 units is apparent. Although cassettes (and increasingly CDs) are an obsolete carrier format, the structured payment arrangements are nevertheless still illustrative, and are typical of deals that would likely be signed today. The artist makes more on the incremental 300,000 units than on the first 500,000 units.

Even so, the artist may initially receive only partial payment because the record company will hold back some funds in reserve for returns, perhaps as much as 50%, until it knows how many units in all formats have actually been sold through to consumers. The size of this holdback is determined in part by how well the artist's previous works have fared, because recordings that do not sell through (and thus become nonroyalty-earning "cutouts") are shipped back to the distributor at a charge to the artist. Once sales to the retailer are deemed to be final, the held-back monies are paid to the artist (within two years of shipment); that is, the return reserve is "liquidated." Additional deductions may further include those for independent promotions and for half of video costs.[55]

In addition to artist royalties shown in Table 6.1, the income of an artist may also be greatly affected by the terms of what is known as the controlled composition clause, which governs songwriting/publishing payments to the artist. A *controlled composition* is a song that is owned, written, or otherwise controlled by the artist (and sometimes the producer, too). The clause applies a schedule for payment of mechanical royalties out of which no recoupment

Table 6.1. *Artist's financial perspective, first cassette gold album*

Cassette's SRP	$10.98	
Less: Packaging (20%)	(2.00)	
	$8.98	
Net royalty rate to artist 16% "all-in" less 4% to producer	12%	
Gross royalty per unit	$1.08	
Number of albums	500,000	
Subtotal	$538,800	
Royalty-bearing percentage after "free goods" deduction	85%	
Gross royalty	$457,980	
Less: Recording costs and advances	(250,000)	
Total artist's royalty with 500,000 units[a]		$207,980
Additional units		
Additional royalty/unit of 18% on next 300,000 units	$1.26	
Number of units	300,000	
Royalty-bearing percentage	85%	
Total artist's royalty on additional 300,000 units		321,300
Total artist's royalty with 800,000 units[a]		$529,280

[a] From these amounts, half of independent promotion and video costs would be further deducted.

and no recording cost deduction is taken, but it generally places limits on the amounts that the artist will receive for each album. These limits normally begin at ten times the single-song rate, which itself might begin at 75% (the "three-quarter rate") of whatever statutory rate is in effect, according to the Copyright Statute, at the time the song is recorded, mastered, or released. For example, if an album contains ten controlled songs and the statutory rate is 8 cents taken at 75%, the royalty per album would be 60 cents ($10 \times 8 \times .75$).

Unlike the artists' often fruitless and futile recoupment situation in regard to recording contracts, publishing deals can provide artists with significant monetary advances relatively early on. However, this is in exchange for the right of the publishing company to control 50% of the song's copyright (i.e., money that it earns). Publishers charge around 10% for administrative costs, which are also deducted before the 75% rate is applied to recoupment of the songwriter's advance.

In sum, it is evident that recording contracts are unusually complex and reflect artifacts of previous technologies that are of diminishing importance or that have already become totally irrelevant. In recognition of this, contracts are slowly beginning to change to a more artist-friendly format.[56]

Table 6.2. *Estimated cost breakdown of a major record label CD retailing for $15.99, circa 2013*

Cost Category	Dollars	Percentage of total
Musicians' unions	$0.16	1%
Packaging/manufacturing	0.80	5
Distribution	0.96	6
Publishing royalties	0.80	5
Artists' royalties	1.60	10
Marketing/promotion	2.40	15
Label overhead	2.88	18
Label profit	1.76	11
Retail overhead	3.84	24
Retail profit	0.80	5
Total	$15.99	100%

Source: Based on Byrne (2008) and similar to Avalon (2002, p. 90).

Company perspective

Major record companies, in the aggregate, maintain a sophisticated, difficult-to-replicate infrastructure that provides relatively efficient financing, marketing, artist development, and distribution services. In return for providing such services, the companies benefit from pockets of potential profit at many different levels, including markups in the form of production fees, recoupment of recording costs (and some portion of video production costs) out of royalties, charges for equipment rental and packaging, and interest on royalty payment holdbacks.

The production and distribution cost structure for a digital download is, of course, quite different from that for a CD because manufacturing, packaging, and shipping expenses are largely eliminated. However, costs for overhead, royalties, promotion, and marketing would likely remain the same. Table 6.2 indicates that more than half of the costs of a CD are related to overhead and marketing.

Given the nature of the business, the companies also face a substantial risk of capital loss because, after all, the degree and longevity of success for the artists they sign are highly uncertain: The distribution company customarily pays for an album's nonrecoupable manufacturing, promotion, marketing, and shipping costs and also finances (carries) the artist's unrecouped (and nonreturnable) advance (i.e., deficit). As previously indicated, large profits from a few winners (usually fewer than 10% of all releases) must more than offset losses on the many others.[57] The corporate financial-accounting perspective thus differs considerably from that of the artist.[58]

From study of publicly owned recorded-music company reports it can be seen that pretax operating profits and margins for distributors of major labels have historically fluctuated unpredictably and that steady growth for even the largest organizations is far from assured. Although the basic financial operating structures are similar for all the major distributors, there are, nevertheless, differences in how interest and overhead expenses are charged to music divisions and also differences in "return reserves." Such reserves are set aside as a fixed percentage of domestic sales (with much less need for them outside the United States and Canada) and are closely related to recent experiences with records returned by retailers.

The following excerpt from the 1982 Warner Communications annual report illustrates return-reserves accounting policies:

> In accordance with industry practice, certain products are sold to customers with the right to return unsold items. Revenues from these sales represent gross sales less a provision for future returns. It is general policy to value returned goods included in inventory at estimated realizable value but not in excess of cost.

As a cushion against potential product returns from retailers, it is therefore not unusual for companies to retain 30% to 50% of artists' royalties (and 50% to 75% of mechanicals) for up to two years after initial shipment to retailers. These retentions provide an important source of working capital liquidity to the companies (but are, of course, a source of friction with the artists).[59]

Industry practices in this area are delineated by Financial Accounting Standards Board (FASB) Statement 48, which specifies how an enterprise should account for sales of its products when the buyer has a right to return the (nondefective) product. The key condition that must be met for applicability of this statement is that the amount of future returns must be reasonably estimable. In the case of music products, there is generally enough volume and historical experience to make such estimates.

Other corporate accounting issues are largely governed by FASB Statement 50. In particular, under this statement, royalties earned by artists, as adjusted for anticipated returns, are charged to the expense of the period in which sale of the record occurs. But advance royalties paid to an artist are to be reported as assets (i.e., are capitalized) if the past performance and current popularity of that artist provide a sound basis for forecasting recoupment of the advance. Amortization of the asset would then, as in films, be related to the amount of net revenue expected to be realized over the estimated life of the recorded performance. Royalties and advances for new artists with unknown potential would thus normally be expensed in the period of payment.

In accounting for license agreements, minimum guarantees, and advance royalties, FASB Statement 50 also specifies that licensors should initially report minimum guarantees as a liability and then recognize the guarantees as revenue as the license fee is earned under the agreement.

Valuation aspects

Valuation of music company assets must always begin with an assessment of the breadth and depth of the company's catalog of past releases: A catalog in recorded music – whether in the form of publishing rights or of ownership of master recordings – plays a role in valuation that is analogous to that of a film library in the motion picture business. The catalog, which is often nothing more than a bundle of rights, is usually the starting point for assessment; it can often account for half of revenues and three-fourths of profits at a major label.

As in other areas, music-related assets will generally be evaluated on their ability to generate cash in future periods. A multiple of such projected cash flows (defined as operating income before amortization, interest, and taxes) is always a function of interest rate levels and the economic, political, and technological background at the time of assessment. But, of these factors, the interest rate is usually the most significant, because it inversely affects the discounted present value of the future expected cash flows and also the ability of the purchaser of the asset to obtain or to service financing obligations.

This suggests that the value of music company assets can generally be found by taking the going multiple of projected cash flow as determined from recent sales of similar properties and then subtracting net debt – a formula that is identical to the one shown in section 7.4 for evaluating broadcast properties.[60]

A variation on this is found, however, in the evaluation of music publishers. Here, the key figure to which the multiple is applied is called the *net publisher's share* (NPS), which is equal to all the royalties the company takes in minus everything it must pay out to writers and artists.[61] NPS thus would be broadly defined as gross income minus deductions for administration fees (usually 10% to 20% of gross income), songwriter royalties, and other expenses, including those for preparation of lead sheets, demos, collection costs and subpublisher fees, and copyright registrations.

Publishing margins are typically at least twice those in recording activities. And with about half of gross revenues being royalties payable to artists, some 80% of publisher costs can be classified as variable.[62] Although publishing assets have historically held their value relatively well, significant declines in mechanical and sync licensing revenues (from film, TV, etc.) have occurred even as the number of uses for music has increased. As a result, multiples of NPS no longer seem to be rising.

Other assets of value might include record masters. Masters having a useful commercial life of more than a year from date of indicated release are uncommon.[63] Nevertheless, for major acts and labels, masters can provide streams of income over long periods. And a provision in the 1976 U.S. copyright law revision allows musicians, like creators of other works of art, to exercise "termination rights" and thus regain control of their work after

35 years. If and when such rights are exercised, the enterprise values of major publishers are accordingly impaired.[64]

6.5 Concluding remarks

The music business never stops changing. And never has this been more evident than over the last half-century. The industry now has a truly global dimension and systems of distribution and finance have essentially been consolidated into three giant companies.

But just as significantly, we have recently witnessed a time of major technological advances in the way music is produced, reproduced, packaged, and distributed. Until the computers of the 1980s, for example, sound was recorded and replayed using only embellishments of the processes discovered by Thomas Edison 100 years earlier. Now, thanks to new technology, most recently embodied in the Internet and mobile computing devices, we can be assured that the potential for creation, enjoyment, and use of music has never been greater.[65]

Notes

1. According to the International Federation of the Phonogram Industry (IFPI), an international industry trade organization, world trade revenues of CDs, records, cassettes, and digital formats in 2010 were around $15.9 billion, which translates into around $25 billion of direct sales. See Figure 6.5.

2. Palmer (2008, pp. 79–80) explains that music is a personal choice: "Psychological ownership of music makes it vastly different from movies and television. In many ways, music is a fashion accessory to your lifestyle." People either like or don't like a song, but they usually can't say what makes them like it. Belluck (2011) notes that "our brains understand music not only as emotional diversion, but also as a form of motion and activity . . . what really communicates emotion may not be melody or rhythm, but moments when musicians make subtle changes to those musical patterns." See also Doucleff (2012) about why some music makes people cry.

3. Byrne (2008) provides keen insight, saying:

> Epic songs and ballads, troubadours, courtly entertainments, church music, shamanic chants, pub sing-alongs, ceremonial music, military music, dance music – it was pretty much all tied to specific social functions. It was communal and often utilitarian. You couldn't take it home, copy it, sell it as a commodity . . . or even hear it again. Music was an experience, intimately married to your life. You could pay to hear music, but after you did, it was over, gone – a memory.
>
> Technology changed all that in the 20th century. Music – or its recorded artifact, at least – became a product, a thing that could be bought, sold, traded, and replayed endlessly in any context. This upended the economics of music, but our human instincts remained intact.

See also *The Economist*, December 18, 2008, "Why Music?," and Blood and Zatorre (2001) on ties to brain functions.

4. In 2008, it was discovered that Edison was preceded by around 17 years by the Frenchman Édouard-Léon Scott de Martinville, who made a stylus move on a sheet of paper blackened by smoke from an oil lamp. The song, "Au Claire de la Lune" could be heard. See Rosen (2008).

5. As noted by Eliot (1989, p. 15). For a detailed history of recorded sound, also see Gelatt (1977), Read and Welch (1976), Welch and Burt (1994), and White (1988).

6. It was not until 1941 that the originally formed ASCAP (American Society of Composers, Authors, and Publishers) settled on the same royalty formula (based on 2 3/4% of radio stations' annual advertising revenues) that had been standardized by BMI (Broadcast Music Inc.), the organization that had been formed in 1939 to compete with ASCAP.

7. The musicians' union (American Federation of Musicians) sought compensation from the record companies for income lost as demand for live performances declined as a result of the increasing use of recorded performances.

8. New majors of the latter half of the 1950s included Capitol, MGM, and Mercury, for a total of six dominant companies in all.

9. Crockett (2005) reviews how the mobile phone, through ringtone sales and instant downloads, began to supplant and/or compete with Apple Computer's iPod, which ushered in the modern portable music era. Since its introduction in October 2001, hundreds of millions of units have been sold, and in the first three years after introduction of the iTunes online Music Store in April 2003, more than 1 billion songs were downloaded. Apple's iPhones and iPad tablets (first appearing in 2007 and 2010, respectively) and similar products by other companies (Kindle, Nook, Samsung Galaxy, etc.) have changed everything again.

In 1999, DVD for audio purposes was introduced in two versions – Super Audio (SACD) and DVD audio. These were then followed a few years later by DualDisc and DVD album formats, none of which ever became widely used. See also Brinkley (1999), Rothman (2003), Belson (2003), and Smith (2006).

10. Wikström (2013) observes that in previous eras, consumers and artists had relatively little connectivity with each other and with distributors. The major labels were able to tightly control the production, publicity and marketing, and availability of music. Although labels now have much less control, there is instead much more connectivity, and rightsbased access and distribution has evolved into a cloud-based service (in which low-cost production tools also encourage and enable amateur creativity). All of this has made music more widely available than ever before, but it has also increased audience fragmentation and the importance of gaining audience attention. Wikström argues that the power of publishers relative to labels has increased as a result and that the difference between amateur and professional performances and recording has narrowed.

11. This paraphrases Carr (2014). See also Carr (2008b).

12. In the United States, unit shipments of albums increased at a compound annual rate of 3.9% between 1971 and 1980. But the combination of economic recession, higher prices, more off-the-air taping, and other factors caused shipments in the 1980s to decline. Over this period, however, the prerecorded-cassette format gained steadily against the vinyl disc and eight-track and open-reel tape configurations, and by 1984, cassettes accounted for over half of total album units.

Moreover, according to surveys, the largest group of record buyers in the 1980s was not teenagers but young adults. Teens of the 1950s and 1960s thus apparently carried an interest in music well into their twenties and thirties, thereby broadening the market's demographic boundaries. In addition, there was a substantial increase in the number of new households as the relatively large post–World War II population cohorts matured. Major improvements in semiconductor technology had, by this time, also brought down the prices of stereo components for home and car. Accordingly, the emergence of FM stereo radio as the popular music medium of choice was of considerable importance.

Note, too, that because of the much higher costs of petroleum-based products such as vinyl, record prices in the late 1970s were sharply increased, even as the quality of vinyl pressings decreased. For a while it was not uncommon for consumers with top-of-the-line stereo receivers located in strong-signal areas to make off-the-air recordings whose quality matched or surpassed that of some store-bought records.

13. After the 1982 introduction of a so-called musical-instrument digital interface (MIDI) that converts musical control information into a uniform computer code, the productivity of recording studios, musicians, and composers increased substantially. MIDI standardization was introduced through the efforts of Yamaha Corp., Kawai Instrument Manufacturing Co., Roland Corp., and Sequential Circuits Inc.

14. Music Television (MTV) is a 24-hour network that bases its programming on a mixture of music videos, music news, and specials. Owned by Viacom Inc., MTV now attracts a global audience measured in the hundreds of millions. MTV's development was accompanied in the early 1980s by the introduction of low-cost videocassette machines, which enabled a whole subindustry of music-video recordings to spring up. MTV also ignited interest in cable subscriptions, changed the way in which records are promoted, and practically defined a generation of young people. MTV's history is discussed in Banks (1996).

15. The role of managers is covered in Frascogna and Hetherington (1978) and in Passman (2000, pp. 49–50). The personal manager's role will usually be to decide which record companies to sign, to select producers, to coordinate publicity, and to assemble lawyers and business managers. The length of the manager's contract is now generally geared to the term of an album cycle (production through touring), and compensation relates to number of albums sold rather than dollars of gross generated.

16. In Spain and Latin America, the Sociedad General de Autores y Editores (SGAE) handles rights collections and payments.

17. SoundExchange, founded in 2000 as part of the Recording Industry Association of America (RIAA), is a nonprofit agency in Washington, D.C., that is authorized by the United States Copyright Office to collect royalties from digital broadcasters (e.g., Sirius XM in radio, Pandora, and other online streams) and pay them directly to performing artists and copyright holders of the recording, usually a record label. Spotify and Rhapsody, however, generally pay directly to record companies. Since its founding, SoundExchange has paid more than $1 billion to artists and record companies.

As explained in Sisario (2004), this is a new category of payment in that artists in the United States, unlike those in Europe and elsewhere, have never before received performing rights royalties. Royalties from terrestrial radio have normally been paid only to song publishers and composers, not performers or owners of the recording. The Digital Performance Right in Sound Recordings Act of 1995 and the Digital Millennium Copyright Act of 1998 established this special royalty apart from those paid to publishers and songwriters. Compensation for songwriters is tied to the 1917 Supreme Court case *Herbert v. Shanley Co*.

The Library of Congress sets the rate (7 cents per 100 listeners as of 2005), with 50% of the royalty going to the recording's copyright holder, 45% to the "featured" performer(s), and 5% to backups. Carvajal (2007) discusses royalty rate issues, and McBride (2007) mobile Internet radio. As noted in Smith and Stewart (2012), artists are now able to collect royalties when songs are broadcast on radio and also online. Sisario (2012a) covers the dispute between artists who are demanding royalties and music-streaming companies such as Pandora, which require lower royalties to remain viable enterprises. The United States is almost the only country where radio stations pay royalties only to publishers. See also the Internet Radio Fairness Act and Karp (2013a).

18. Disputes in this area have mostly concerned music rights in syndicated television programming and commercials. Stations generally do not receive music rights along with the other rights conveyed in consideration of their broadcast license fees. Instead, they normally operate under blanket music licenses – by definition nonspecific as to the music used in the show – for which they are charged by ASCAP and BMI about 2% of adjusted station gross receipts and entitle stations to use any of the more than 5 million titles in the ASCAP and BMI catalogs. For example, BMI has indicated (in *Broadcasting & Cable*, October 25, 1999) that a radio station blanket license was 1.4% of revenues after deductions. Revenues for BMI and ASCAP in 2014 were each approximately $900 million.

A *blanket license*, however, is only one of four ways in which to license music for a show. A blanket license can cover any music used in the composers' rights catalogs through licenses issued to each composer, on a per-program basis, and through the producer, who has already obtained a license. See Boucher (1986), *Broadcasting*, February 1, 1988, p. 44, and especially Flick (1988), who provides a cogent description of the situation, and Zollo (1989). As described in *Broadcasting & Cable*, May 17, 1993, SESAC is now also offering Hispanic broadcasters a niche blanket license or per-program license.

Performing rights royalties, however, are negotiated with Internet site owners. A music robot ("bot") goes into Internet sites all over the world and brings back information about music files on those sites. Moreover, great controversy was seen in the early 2000s as the business of Internet radio broadcasting ("webcasting") began to grow rapidly. The Copyright Arbitration Royalty Panel (CARP) initially proposed to set royalty rates of 0.14 cent per streamed song per listener for webcasts that aren't retransmissions of radio broadcasts, and 0.07 cent per streamed song per listener for webcasts that are retransmissions of radio broadcasts. Radio stations argued that they shouldn't have to pay royalties when they put their regular programming online. The ruling, as of June 20, 2002, was for the royalty rate to be set at 0.07 cent per song per listener (about $92 per listener per year) for both types of transmissions. Although radio stations already paid royalties to songwriters, as of that time no fees had been paid to labels and recording artists. However, in 1998, Congress ordered online stations to pay royalties to labels and artists for songs transmitted digitally. See Angwin (2002), Holland (2002), and the *Wall Street Journal* and *Los Angeles Times* of June 21, 2002.

By 2007, artists and labels had begun to seek royalty payments from broadcast radio stations, which until then had paid royalties to composers and publishers but, because of a federal exemption, not to performers and labels. Such performance royalties are collected from radio stations in most other countries but not in the United States, where only Internet broadcasters and cable-television companies offering digital music channels currently pay such royalties. See the *Los Angeles Times*, May 21, 2007.

19. The Copyright Royalty Tribunal, created by the 1976 Copyright Act, was abolished in December 1993, when its functions were transferred to the Library of Congress and the Copyright Office. After January 1988, this rate had been adjusted every two years in proportion to changes in the Consumer Price Index. See *Billboard*, October 1, 1994. In October 2008, the Copyright Royalty Board for the first time set a rate for ringtones (at 24 cents). Also, record companies were to continue paying the compulsory rate for mechanical royalties at 9.1 cents a song sold, whether via digital download or CD. The guidelines issued by a panel of federal judges kept the rate on CDs and download sales fixed at the same level as in 2006. See Smith (2008a).

20. This compulsory license system, in which the copyright owners have the opportunity to be the first to record and distribute their works, is intended to provide such owners with fair remuneration while preventing the owners from retaining a monopoly over all future uses of a particular musical composition. According to the 1976 copyright law, which largely parallels those in other countries, an author retains a copyright for life plus 50 years.

A license to use a song *must* be granted by the copyright (i.e., limited duration monopoly) owner if the song is a nondramatic musical composition and has been previously recorded and distributed publicly in phonorecords with the copyright owner's permission and the requested license is for use in phonorecordings only. There is no compulsory license for songs used in home videos and movies.

21. The Copyright Royalty Board of three permanent judges meets to arbitrate disputes and to make adjustments for the effects of technological developments in music, cable, and other areas. Predictably, many such changes will, over time, alter allocation formulas for the industry's income. The Copyright Royalty Tribunal, established in 1978 and disbanded in 1993, had also collected and distributed license fees from cable-television operators. Of the pool of $161 million in 1990, 60% went to the MPAA and 24% to sports. See Carlson (1984).

22. As Lardner (1987) describes, legal and marketing battles fought over the introduction of home videocassette recorders were intense until the U.S. Supreme Court ruled in January 1984 that off-the-air taping of movies for noncommercial purposes is legal.

See also Johnson (1985).

23. However, several pay-per-transaction schemes have been developed that would allow producers and distributors to participate directly in the revenues from each and every rental transaction. With pay-per-transaction services, video suppliers such as movie studios receive a cut of every rental transaction and, in return, participating stores buy tapes at very low prices, which allows them to stock more hit titles. See also Section 4.4 and *Billboard*, July 10, 1999.

24. The financial dynamics of a concert tour are discussed by Kronholz (1984), Newcomb (1989), and Kafka (2003). See also *Variety*, March 22, 2004. As of 2008, the two major concert companies were Live Nation and AEG Live. In early 2009, Live Nation and Ticketmaster agreed to merge (into Live Nation Entertainment), with the deal completed a year later under the Justice Department's condition that Live Nation's ticketing software be licensed to rival promoter AEG Live. Live Nation, with 70% of the concert ticket market in the United States and running 21,000 events a year with annual attendance of more than 140 million, was also forbidden to bundle ticketing with other parts of the business and prohibited from retaliation against venues not using its ticketing services. As described by Smith (2011b), AEG had by 2011 entered into a joint venture called Outbox Enterprises. See Smith (2009) and Segal (2010), in which it is noted that Live Nation earns no profit from ticket revenues but from beer, parking, and advertising. Artists take nearly all (perhaps 90%) of the ticket revenues. See also Courty (2003), Sisario (2010), Jurgensen (2010b), Karp (2013b), and Burkitt and Karp (2013) about expansion into China.

According to Pollstar, the average cost of a concert ticket in 2008 was $67.33 ($73.83 in 2009 and $76.69 in 2010), and total industry revenue was $4.2 billion. But the box-office take for the 50 largest-grossing world tours had fallen 12% from $3.34 billion in 2009 to $2.93 billion in 2010. By 2010, recorded music had declined to 6% of a major act's income, down from 50% in 2000, according to Smith (2010a). And in 2013, the top 20 world tours generated $2.43 billion. See also Jurgensen (2011).

A related area involved electronic dance music festivals and venues, which feature star disc-jockeys and had grown by 2013 into an estimated $4.5 billion business, emphasized in Las Vegas hotels. However, a string of drug-related deaths have become an important constraint on further growth. See *New York Times*, "Drug Deaths Threaten Rising Business of Electronic Music Fests," September 10, 2013 and Eells (2013).

25. In attempts to thwart piracy, the major distributors launched the Secure Digital Music Initiative (SDMI) in 1999. Under this plan, those who try to copy a music file must first get permission from a clearinghouse of central server computers run by the record labels or their technical affiliates. However, with such authorization, a listener might not be able to send a downloaded song from one home computer to another, even though taping for personal use is legal in the United States. Because MP3 is unrestricted and the majors appeared to have lost control over much of their catalog, there was doubt that SDMI could succeed. Harmon (2002c) has observed that such copy-protected discs do not play well on MP3 and portable or computer CD devices. By 2007, digital rights management (DRM) copy-protection schemes were beginning to be viewed as ineffective. See Wingfield and Smith (2007).

Napster was a software system developed in 1999 that enabled interconnected computers to search for songs on a peer-to-peer basis. Because it posed serious intellectual property rights threats to the industry, Napster subsequently faced severe legal challenges. Nevertheless, other free-music sites such as the Fast Track network based outside the United States and programs called Morpheus, Kazaa, and Grokster sprang up and allowed users to exchange music freely online as well as download or transfer it to portable players. See Goodell (1999), Harmon (2000), Varian (2000), the *Wall Street Journal* (July 28, 2000), *The New York Times* (November 29, 2001), and especially Kelly (2002), who places free music in a historical and technological context. The threat is similar for movies in that so-called DeCSS (de–Content Scrambling System) software, which allows the copying of digitally encoded full-length features, is available on the Internet. However, as described in Richtel (2003), a U.S District Court eventually ruled that Grokster and Morpheus, offered by StreamCast Networks, are not guilty of copyright infringement. Economic analyses of free-downloading effects are in the early stages and are discussed in Gross (2004).

MusicNet was formed by AOL Time Warner, Bertelsmann, and EMI and Pressplay by Universal Music Group and Sony. Both were launched in late 2001, partially in response to the threat posed by Napster. The systems were strongly opposed by artists because they provided minuscule compensation. As Strauss (2002) writes, "when their music is used in movies, in commercials and on Internet sites, artists are paid a licensing fee, which, after payments to the producer and the publisher, is split 50–50 between artist and label. Although Pressplay and MusicNet licensed the music, the bands are not paid a licensing fee. The labels instead paid their artists a standard royalty for each song accessed, as they would for a CD sold. Goodman (2010, p. 150) writes that, "Pressplay and MusicNet were designed to protect the record business and preserve the sanctity of its copyrights and contracts, not to help people find and enjoy music." As reported by Mathews, Peers, and Wingfield (2002), the systems were also initially not much liked by consumers. Pressplay was acquired in 2003 by Roxio and renamed Napster after the predecessor had gone bankrupt.

By mid-2002, distributors had begun to offer songs for 99 cents (the same profit per track as on a CD) on Listen.com (later acquired by RealNetworks). Some observers suggested that the actual price might end up being 25 cents, and at that price many more songs (around 50) would have to be downloaded to reach the average profit of $5 per CD. See also Harmon (2002a and 2002b). As for Apple's iTunes, discussed in Leonard (2003), the initial price per song for largely unrestricted use was set at 99 cents, with record companies receiving around 65 cents. Wingfield and Smith (2003) doubt profitability at 99 cents given that providers pay 65 cents to 79 cents wholesale to music companies and also incur many other costs. As of 2009, Apple's price schedule rungs were 69 cents for older titles, 99 cents, and $1.29.Levine (2011) covers this history. See also Hansell (2003) and Smith and Kane (2009). Iyengar (2009) discusses optimal pricing plans.

By 2010, major licensed streaming companies, including imeem and Spotify, had finally begun to replace rogue, unlicensed services. The licensed companies provide ad-supported free and faster downloads, and playability on any device at any time. By 2011, streaming and storage cost had grown to the stage where Amazon, Google, and Apple all moved services into cloud computing; that is, into massive third-party servers that are device-independent and operate with digital lockers such as Ultraviolet. Both in the United States and Europe, Spotify is offered in three tiers: free ad-supported, basic ad-free for $5 a month, and premium for $10 a month that is accessible on mobile devices and provides higher audio quality. Spotify's history is covered in Bertoni (2012b). See also Stone (2009a), Sisario (2011a, 2013c), and Pfanner (2012) about Deezer, the French music-streaming service. Other streaming services include Anghami for the Middle East and Dhingana and Saavn for India. Muve Music, a subscription service launched in 2011, allows unlimited downloads of songs, ringtones, and ringback tones to mobile phones. Streaming services typically return 60% of their revenues to labels and about 10% to publishers.

By comparison, Internet radio is far cheaper for the online services to offer, costing stations seven one-hundredths of a penny a song for each listener, a royalty arrangement that conforms to federal government guidelines set in 2002.

By late 2004, the music industry had begun experimenting with digital-only releases in which the company does not pay artists an advance or cover the cost of producing an album, which is financed by the musicians. The artists, however, retain ownership of their master recordings and are paid around a 25% royalty on the retail price of downloads, without standard deductions for CD packaging and promotional giveaways. The license is for a limited time, with the company having the option to pick up distribution of the CD if certain unit sales targets are exceeded. The industry appears to be moving toward a model in which artists will, instead of signing long-term contracts, license individual projects to labels. With online subscription services, consumers already lease rather than buy access to company libraries. See also Leeds (2004), and Stone (2009b), who describes how labels are now treating new music start-ups with much greater flexibility.

26. It is estimated that there are 1,200 record companies and over 2,600 labels in the United States. However, most of the recording activity is concentrated with the largest dozen firms.

27. Deal structure is as described by Baskerville (1982, p. 300), Passman (2000, p. 203), and Byrne (2008). Byrne's listing, which follows, is similar.

(i) The *standard distribution deal*, in which the record company bankrolls and handles recording, manufacturing, distribution and promotion, after which a royalty is paid to the artist after related costs are recovered (but the label retains ownership of the copyright).

(ii) A *license deal*, which is similar, but in which the artist retains copyrights and ownership of the master recordings. Here, the label has rights to exploit the material for a limited time, usually up to seven years.
(iii) An *equity* or *360 deal*, in which the artist, in effect, becomes a brand that the label owns and supports by employment of producers, managers, promoters, and marketing experts.
(iv) A *profit-sharing deal*, in which the label provides a minimal advance, profits (and thus costs) are shared, and the artist retains ownership of the master.
(v) A *manufacturing and distribution (M&D)* deal (similar to rent-a-studio deals in film), in which the record company is essentially involved only in the manufacturing and distribution functions. Large labels are generally averse to such agreements.
(vi) A *self-distribution (do-it-yourself, or DIY) model*, in which the artist plays, produces, promotes, and markets through Internet downloads (which eliminate the costs of physical manufacturing, shipping, and handling but add to costs for Web site design and maintenance as well as for leasing and/or purchase of servers).

This last and newest method has potentially great appeal, as it enables artists to circumvent company distributors, retain control of the master recordings, and capture a significant part of the distributor's margin – perhaps up to 50% of the retail price. Yet for many artists it may not be ideal because it does not make use of a major record company's sophisticated financing, marketing, and promotional expertise. Moreover, most artists would presumably be devoting most of their time to the creation of music and, especially when young and just beginning a career, would not have any relevant experience or time to be heavily involved in these operational and business aspects. An IFPI 2010 report, *Investing in Music*, indicates that for a new pop act, a record company might typically invest $1 million (advance $200,000, and then spend $200,000 on recording, $200,000 for three videos, $100,000 in tour support, and $300,000 in promotion and marketing). For superstar acts, the advance might be $1.5 million or, with marketing and promotion, $2.3 million.

28. The Alternative Distribution Alliance (ADA), owned by Warner Music, formed in the mid-1990s, is an important one-stop distribution arm for independent labels. It charges distribution fees of as much as 25% of an album's wholesale price for the service. Other majors have similar independent-label distribution arms. See Duhigg (2005).

29. With the costs of manufacturing a typical CD (or DVD) well under $1 a unit, the profitability of the CD configuration was most impressive (and is further enhanced by an artist's royalty rate, often 80% to 85% of that paid on cassettes).

Release strategies have occasionally been hampered by production or distribution bottlenecks. At CBS and Capitol Records, the major domestic pressing companies of the late 1970s, short-run demand outstripped production capacity when release of the until-then all-time best-selling (20 million plus) *Saturday Night Fever* album and the deaths of Elvis Presley and Bing Crosby occurred within an 18-month span. The industry has since experienced no significant problems in servicing demand, as could be seen when Bertelsmann's Arista label soundtrack album to the film *The Bodyguard* sold over 20 million units (and made an estimated $60 million in worldwide profits) in 1993.

As noted by Bialik (2009), however, album sales totals are known to be unreliable in the United States and often unavailable in many countries. And there is frequent confusion in counting the number of songs rather than the number of albums. Michael Jackson's 45 million worldwide sales of *Thriller*, issued in 1982, are generally considered to make it the global all-time top-selling album. Official selected RIAA domestic unit-sale certifications (in millions) as of 2014 from RIAA.com are as follows:

Eagles, *Greatest Hits, 1971–75* (Elektra/Asylum, 1976)	29
Michael Jackson, *Thriller* (Epic, 1982)	29
Led Zeppelin, *Led Zeppelin IV* (Atlantic, 1971)	23
Pink Floyd, *The Wall* (Capitol, 1979)	23
Billy Joel, *Greatest Hits*, vol. I & vol. II (Columbia, 1985)	23
Fleetwood Mac, *Rumours* (Warner Bros., 1977)	19
The Beatles, *The Beatles* (Capitol, 1968)	19
Bodyguard soundtrack (Arista, 1992)	17
Boston, *Boston* (Epic, 1976)	17
Eagles, *Hotel California* (Elektra/Asylum, 1976)	16
Metallica, *Metallica* (Atlantic, 1991)	16
Pink Floyd, *Darkside of the Moon* (Harvest, 1993)	15

Hootie & the Blowfish's *Cracked Rear View* (Atlantic, 1994) and Alanis Morissette's *Jagged Little Pill* (Maverick/Reprise/Warner, 1995) are tied at 16 million units, with Bruce Springsteen's *Born in the U.S.A.* (Columbia, 1984) at 15 million. Until Elton John's 1997 version of *Candle in the Wind*, with sales of 33 million units, Bing Crosby's *White Christmas* of 1942 had been the best-selling single, with 30 million units sold. However, as of 2004, Elvis Presley was the best-selling solo artist in U.S. history. And the *Titanic* film soundtrack of 1997 was the second-largest movie-based album.

30. Nevertheless, as documented by Dannen (1990), in the 1980s, payola again tainted the industry – this time through the hiring of independent promoters, who remain important middlemen in the selection of music for radio airplay through legal payments to stations. The laxity of enforcement of laws against payola and the tremendous pressures on artists and their managers to obtain broadcast exposure of their songs led the largest record-distribution companies to come to depend on the services of independent promoters, some of whom had alleged ties to organized crime families. As Dannen (1990 p. 9) noted, "promotion, the art and science of getting songs on the air, drove the record business. Not marketing, because no amount of advertising or even good reviews and publicity were enough to sell millions of albums. Not sales, because record stores only reacted to demand and did not create it. Even the best A & R – artist and repertoire – staff in the world couldn't save you if radio gave you the cold shoulder."

Dannen (1990, p. 15) further explains, "For all its power, the network (of independent promoters) could not make a hit record. No one could do that except the marketplace. You could saturate the airwaves with an uncommercial song and have some moderate success, but in the end you could not force people to buy a record they did not like." This "new payola," as it has come to be known, which involves large fees paid to promoters for getting songs added to station play lists, is also described by Goldberg (1988). Knoedelseder (1993, p. 305) indeed notes that the "payola law was poorly written, taking into account primarily money. . . . [B]ut record promotion practices had become increasingly sophisticated in the years since the law was passed." ABC's *20/20* program "Pay for Play?" (May 24, 2002) showed that the independents legally pay radio stations for access, and record companies appear to have little choice except to pay these "indies." Leeds (2002), however, suggests that both record companies and stations seem to be reducing the role of independent promotion. Further reductions were forced in 2005 by the $10 million fine paid by Sony/BMG Music to settle with the New York attorney general, who alleged improper practices (i.e., bribes, including cash, vacations, and gifts) to influence radio programmers. See *New York Times* and *Los Angeles Times* articles, July 26, 2005, and *Wall Street Journal*, July 25, 2005. In all, record companies follow the letter of the law, as they no longer pay stations *directly* or for specific additions to their playlists. See also Blumenthal (2002) and Mathews and Ordonez (2002).

Another form of payola may also occur when stations (and sometimes also record stores) overstate a song's popularity to the chart services in return for record-company advertising. Because such overstatements were not based on actual sales but just on inflated figures put down on paper, they had been known in the industry as "paper adds" (Hull 1984). Today's computer-scanned retail sales reports make this more difficult but, as Philips (2001) writes, not impossible to do. See also Sorkin (1997).

31. As shown in Ordonez (2002), on the basis of Soundscan data, in 2001 major-label distributors released 6,455 new albums. Of these, 60 sold more than 1 million units, 52 sold between 500,000 and 999,999 units, 95 sold between 250,000 and 499,999 units, and 208 sold between 100,000 and 249,999 units. However, as noted by Smith (2007b), by 2007, prices and unit sales for CDs had begun to fall noticeably as retail chains closed stores and Wal-Mart and Best Buy came to dominate, with a 65% combined share of the hit CD market (up from 20% ten years earlier). See also Smith (2008b) and Levine (2008), which discuss Wal-Mart's strategy for signing exclusive deals.

32. Companies that have provided listeners with "free" music that is advertising-supported include Rcrd Lbl, which is a hybrid record label and blog; FreeAllMusic.com; and Ruckus. Newman (2009) describes the advertising arrangements in support, and Smith (2007a) describes how artists signed with Rcrd Lbl receive per-song advances that range from $500 to $5,000, after which Rcrd Lbl then shares with the artist any further income generated from licensing of the music to television, movies, or commercials.

See Morrisey (2011b) about Qtrax and Byrne (2008) about the DIY model pursued by the group Radiohead in 2007, in which fans were able to set their own price for a download of the *In Rainbows* album. The band, of course, retained ownership of the master, and was later able to license the album for distribution on CDs through the traditional distribution system. The album, selling 122,000 units, topped the U.S. sales chart in CD format in the first week of 2008. Elberse (2010) found that because favorite tracks on albums become available as singles, revenues decrease significantly as digital downloading becomes more prevalent. Such unbundling effects can be somewhat mitigated by a strong reputation of the producer. According to Nielsen, it requires about 1,500 song streams to equal revenue generated by one download album sale because streaming services pay fractions of a penny in royalties each time a song is listened to. Albums are defined as 10 downloaded tracks.

33. As of 2010, the streaming of music began to move consumption of entertainment products in this direction, where ownership is no longer the dominant form. Companies such as Spotify in Europe and Apple Computer in the United States led the way. See Stone and Miller (2009).

34. The transaction is described by Boyer (1988). As with most other entertainment company assets, including film libraries and broadcast stations, music-related assets are generally evaluated on the basis of projected pretax, preinterest cash flow multiples.

Although there have been several significant corporate asset transfers in recent years, which include the sale of CBS Records to Sony, of RCA Records to Bertelsmann, and of Chappell Music Publishing to Warner Communications, financial data as to the precise cash flow multiples used in these transactions have been difficult to obtain. A rough estimate of the Sony/CBS deal is that the transfer price was probably around nine times projected cash flow. Measuring transfer prices as a multiple of revenues provides another valuation angle. In 1992, for example, Thorn EMI paid approximately $960 million to acquire Virgin

Music. This was 1.6 times Virgin's 1991 sales. By comparison, PolyGram paid about 2.1 times sales for A&M Records in 1989 and 2.3 times Motown's (prior year) sales in 1993, whereas MCA paid about 2.6 times sales when it bought Geffen Records in 1990. The aforementioned sale of CBS Records to Sony in 1987 was at 1.3 times sales. PolyGram was itself bought by Seagram in 1998 for $10.4 billion. In 2011, Warner Music sold itself to Access Industries for $3.3 billion, which was around 1.1 times sales. See also Leeds (2005) for a review of the Warner Music IPO.

35. EMI's Parlophone Group and Chrysalis and Ensign labels were sold to Warner Music Group for $765 million in early 2013 as part of mandated European-regulator divestiture from Universal Music Group's $1.9 billion purchase of EMI in 2012. EMI had also signed The Beatles, which Universal retains in addition to EMI's Capitol, Blue Note, and Virgin labels and artists including The Beach Boys, Katy Perry, Robbie Williams, and Frank Sinatra. WMG adds Coldplay, Pink Floyd, Jethro Tull, Radiohead, and others. See B. Sisario, *New York Times*, February 8, 2013.

The German-owned BMG, or the Bertelsmann Group (RCA, Ariola, Arista), had long been an important distributor outside the United States. But a joint venture with Sony (which has had a strong American presence through Columbia Records) ended in 2008, with Sony buying most of the BMG assets (50% of the joint venture) for $900 million. See Landler (2008). Kronemyer and Sidak (1986) analyzed the industry for the years 1970 to 1984. As for PolyGram, it was almost merged with Warner Communications in 1984, but the Federal Trade Commission blocked the merger. At the time, PolyGram had sales of around $700 million. PolyGram, with 1989 sales of over $1.5 billion, sold 20% of its shares to the public in December 1989 and was acquired by Seagram for $10.6 billion (plus $400 million in debt) in 1998. See also Pfanner (2011) and Sisario (2012b, c) about regulatory scrutiny of the split of EMI.

36. Around 2011, the American Association of Independent Music, or A2IM, campaigned to measure market share via ownership of master recordings, and not through the traditional share attribution to the distributor. Thus market share credit is retained by the independent label. With the new measurement scheme, SoundScan found the 2011 U.S. share of indies rising from 12.1% in the old way to 30.4%.

37. Another formerly significant distribution channel for records and CDs had been through clubs. Columbia House, originally part of CBS Records and the largest club in the United States, was combined in 2005 (at a price of $400 million) with BMG, the second largest. In 2007, Bertelsmann then bought out for $150 million the Time Inc. interest in Bookspan, a joint venture that includes Book-of-the-Month Club. In 2008, Bertelsmann then sold Columbia House and the Club to a private investor for an undisclosed sum. Clubs account for well under 5% of total dollar volume but had been above 10% in 1997.

Unlike retailers, such clubs do not buy product directly from labels but instead license it, and they typically give away one album for every one sold. See *Billboard*, January 30, 1999.

38. In the 1970s, Pickwick International was the largest rack jobber in the United States. It was largely acquired by Handleman, another large jobber.

39. Agreements with rack jobbers might take many different forms and may include such diverse retailing environments as drugstores and supermarkets. But the main attraction is always that the jobber can obtain quantity discounts and provide expertise in the rapid selection, display, and maintenance of inventories (i.e., warehousing) of products that have a relatively short life cycle. Rack jobbers, in effect, thus absorb the nonspecialized retailer's risk of purchasing too much of the wrong product or too little of the right product. In return, jobbers operate on the spread between the large-quantity discount prices of major distributors and their own higher quasi-wholesale prices. The margin for error, though, is not large.

40. Such excess recordings may be used in barter for other goods and services or to raise cash for the record company. Yet only major artists have the bargaining power to negotiate that excess inventory be destroyed rather than disposed of as cutouts.

41. Although suggested retail list prices are used to compile industry sales figures, these numbers are misleading because record stores normally do not charge the suggested list. Universal Music's uneven attempt to lower wholesale prices in 2003 in response to Internet downloading is discussed in Smith (2004b).

42. Avalon (2002, p. 55) explains that such loans/advances are forgiven debts if a record flops. However, in return for this privilege, record companies "have the right to ask for a disproportionate split of the proceeds. For a new artist, typically the split is 12% artist, 88% record company," with the artist repaying the advance out of the 12%, which is really usually 9% after the record producer is paid (from the first record sold and without needing to wait for recoupment).

43. Songwriters have issues different from those of performing artists. Performing artist royalties may be greatly diminished if outside songwriters are used because the outsiders are not subject to what are known as *controlled composition* contract clauses. A controlled composition clause applies to a song written, owned, or controlled by the artist. The companies usually ask the artist to license the songs they control for 75% of the minimum statutory mechanical rate. Naggar and Brandstetter (1997, p. 52) write that the money performers earn for *writing* songs that appear on a record is reduced if the artist performs on the record. See also Biederman and Phillips (1980).

44. The highest royalty rate ever paid by the industry to a single artist was apparently established by Sony in 1991, when Michael Jackson reportedly commanded 22% of retail, or $1.90 an album, on 100% of units sold. Other top acts have only been able to receive royalty rates approaching this level on a standard 85% of unit sales. See *Rolling Stone*, May 4, 1991. However, the largest advance was reportedly the $10 million per album for six albums (*if* the albums sold over 5 million units each) on the deal that Prince signed with Warner Bros. Records in 1992. By comparison, Michael Jackson and Madonna are believed to have unconditionally received about $5 million per album, and the Rolling Stones $8 million. Also, in 2001, Mariah Carey reportedly signed a five-album deal with Virgin Records at $23.5 million per album, and Whitney Houston signed with Arista for $100 million. Carey's $7 million per album contract in 2002 with Universal was discussed in the *Wall Street Journal* of May 9, 2002. See also *The Hollywood Reporter*, September 4, 1992.

45. Mega-deals also often include establishment of star-affiliated labels and aspects related to movie and television production activities. In the face of plunging CD sales, promoters, labels, and advertisers are attempting to secure a larger share of an artist's overall revenues.

46. In a typical touring arrangement, the artist bears much of the risk by having to pay for tour producers who handle the physical details (i.e., transportation, backup musicians, hotels, etc.). But for established artists who have shown that they can fill arenas, concert promoters such as Live Nation Inc. might negotiate "net deals" in which artists earn a percentage of net income and the promoters cover costs.

For example, Madonna's 2007 package deal with concert promoter Live Nation Inc. reportedly included a general advance of $17.5 million, advance payments for three albums of $50 million to $60 million, and an additional payment of $50 million in cash and stock for the right to promote her tours. On such tours, major artists can typically command 90% of the gross, with the promoter receiving 10%. Kulash (2010) explains how changes in the music industry's structure have affected rock band profits and promotional opportunities. See articles by E. Smith in the *Wall Street Journal*, July 11, 2008 and October 11, 2007, Jurgensen (2010a, c), and Sisario (2013b).

Subsequently, popular group U2 also made a long-term agreement with concert promoter Live Nation and, as described in Leeds (2008), rapper Jay-Z left his longtime Universal Music Group label Def Jam for a $150 million package with Live Nation. Live Nation contributes $5 million a year in overhead for five years plus another $25 million to finance acquisitions or investments in a venture called Roc Nation. The Jay-Z package also includes an upfront payment of $25 million and a general advance of $25 million. Additional payments are then provided in exchange for certain publishing, licensing, and other rights. Also, in 2010, Sony's Columbia Epic Label Group made an estimated $250 million deal with the estate of Michael Jackson that extended Sony's rights to earlier recordings and included the release of ten projects in a combination of albums and DVDs over a ten-year period. See Goodman (2010, pp. 255–66), Plambeck (2010a), and Smith (2010b).

47. However, in contrast to pop music contracts, recording costs are not recouped against an advance, and the artist is paid on every record sold.

48. As the importance of singles has diminished, the RIAA has reduced the unit sales requirements for gold and platinum certification of singles by half since 1990. Also, in recognition of the importance of electronic downloads, *Billboard* and the RIAA now report digital tracks bought. The *Billboard* data include track-equivalent album (TEA) sales, using ten-track downloads as equivalent to one physical album sale. A Digital Gold award represents 100,000 downloads, and Digital Platinum 200,000 downloads. A *Billboard* study cited in the issue of June 4, 2010 calculated that between 1992 and 2009, the number of RIAA albums shipped averaged about 30% above Soundscan measures of albums sold (i.e., scanned).

49. Fortunately, one other complicating item, the allowance for breakage, which used to be used as a 10% of reduction of the sales base on which royalties are calculated, has mostly disappeared. This deduction was originally related to the breakage of fragile shellac records in the industry's early days.

50. See, for example, the *Los Angeles Times*, March 20, 2003.

51. Jurgensen (2007) indicates that a top producer can earn $50,000 to $100,000 per track, half of which is paid by the record label up front and the other half after the song is completed. These payments are viewed as an advance, which means that the label recoups the fee, only after which the production royalty ranges from 4% to 5% of the retail price.

52. The quotation is from Dannen (1990, p. 143). Wadhams (1990, p. 109) similarly says, "The record industry is the only one, even among the entertainment industries, in which the creative artist is ultimately charged for the entire cost of producing the work." In theory, artists should be able to trade off a lower advance for a higher royalty rate but, in practice, industry custom will normally favor higher advances and lower royalty rates.

53. Record companies will, in addition, typically profit from a hefty markup on actual touring and other such expenses, thereby making it difficult for artists' advances to be fully recouped and also making it advisable for artists to pay for some of these items directly. On concert tours, performers can often take home 35% of gate receipts and 50% of merchandise revenues without sharing any of it with the labels, but as noted by Leeds (2006) this may be changing. Amphitheaters normally take 65% of the gross receipts, but major acts can command much more, leaving promoters only with profits from parking and concessions.

Promoters profit from the difference between production and administrative costs and the gross, taking at least the first 10%. See also Kafka (2003).

54. Sisario (2013d) describes the Royalty Exchange, which enables artists to sell parts of their royalty stream rights to investors. Royalties taken as saleable assets ("Bowie bonds") first appeared in 1997, with artist David Bowie raising $55 million by selling a ten-year bond based on some of his royalties. See also Sisario (2013a, c).

55. In this example, note that the packaging fee of 20% applies to cassettes but that the industry standard is 25% for CDs and other new technologies (even when there isn't any packaging, as in Internet downloads!). With CDs, the royalty rate would most likely be 85% of the rate for analog cassettes. On a cents-per-unit basis, the artist nevertheless comes out about the same or perhaps better because the SRP is normally three or four dollars higher for a CD than for a cassette. However, artists might earn less from an album sold on Apple's iTunes than from a CD. Of a $9.99 retail price, 14% ($1.40) goes to the artist, 30% ($3.00) to iTunes, and 56% ($5.59) to the label. The following breakdown appeared in Byrne (2008).

In 2011, a lawsuit concerning artist Eminem against Universal Music turned on the issue, described in Sisario (2011b), of whether an individual song sold online should be considered a license or a sale. Eminem was entitled to receive 50% of royalty income for a license, but only 12% for sales. After the Supreme Court refused to hear an appeal, the lower court's decision that digital music should be treated as a license stands. Labels maintain that digital downloads are sales, from which sales-related expenses such as for packaging may be deducted from royalties even if there is no packaging in downloads. Musicians, however, claim that downloads are licenses. Each case hinges on the specific language of the contract and if a song was created as a work made for hire, as specified in the 1976 Copyright Act. Labels consider many songs to have been created as works made for hire under the auspices of employment, whereas artists do not. If a work is not made for hire, artists and composers can reclaim the rights. The uncertainty and confusion surrounding these issues make valuation of music-related assets unusually difficult and risky.

Litigation in *James v. UMG Recordings* in 2013 involved similar issues in setting precedents on whether downloads should be classified as "sales" or "licenses." Labels pay from 10% to 20% in royalties for sales, but as much as 50% with music licensed, such as for use in films or ads. Labels want to continue classifying downloads as sales, even though legacy costs of packaging and transportation have mostly disappeared. Musicians obviously prefer classification as more lucrative licenses. See Hunter-Tilney (2013).

56. Philips (2002) and Holloway (2002) describe BMG's intent to eliminate typical deductions off retail price for packaging, new technology, and free goods; increase royalty rates for digital downloads; and cut the duration of contracts in exchange for a share of artists' commercial sponsorship and film-deal revenues. Companies are now more inclined to alter royalty formulas for online music by eliminating certain fees that had been fixed regardless of actual costs. Other experiments with new business models include EMI's taking a stake in almost every dollar that the band *Korn* earns worldwide over at least five years. As reported in the *Los Angeles Times* of September 12, 2005, EMI would pay the band an estimated $15 million up front in return for more than 25% of the band's publishing, merchandising, and touring revenues as well as album profits.

57. It would, in fact, be usual for a major-label company to do more than breakeven on a "gold" album selling 500,000 units (though a large cost-conscious "independent" label might be profitable after selling only 100,000 copies).

58. For a typical CD priced to retail in the United States for at least $16, a major record company's distribution arm sells new releases of mainstream artists for around $12, a markup of $2.40, or 25%, from the price paid to the label. But because the label is normally also wholly or partially owned by the major, this distribution markup should usually be added to the gross profit of the company when estimating the total gross profit per unit (i.e., *before* deduction of its overhead, salaries, and financing costs). See also Avalon (2002, p. 90).

59. During the late 1970s, when return privileges were still almost unlimited and the rate of returns accelerated, some distributor companies found their reserves inadequate; losses, instead of profits, began to appear.

60. Multiples of sales over the last 20 years have averaged around 1.75 times, and multiples of EBITDA around 17.1 times, but it isn't unusual to see transactions done at multiples far above or below these means.

61. From the mid-1980s, the multiple of NPS rose from the area of five or six times to around ten times in the 1989 SBK/EMI deal. However, Rondor was acquired in 2000 by Vivendi Universal for approximately 20 times NPS, which was believed at the time to be at the high end of the estimated going range of 12 to 20 times. In cases in which a song still generates earnings, the amortization period for the copyright might be up to 20 years, but regular impairment reviews might require that the speed of amortization be substantially accelerated.

In many situations, song publisher catalogs seem to have been transferred at a going rate of around $1,000 per title. For example, Thorn EMI bought the rights to 90,000 titles held by independent British music publisher Filmtrax Copyright Holdings for $115 million in August 1990. Filmtrax, formed in 1984 to acquire the music assets of Columbia Pictures Entertainment, owned rights to songs such as "Stormy Weather" and "Ain't Misbehavin'." In July 1999, EMI Group bought 40,000 song copyrights from a unit of Japan's Fujipacific Music Inc. for $200 million ($5,000 a title). In 2007, Sony/ATV purchased the Famous Players publishing business (125,000 titles for $370 million) from Viacom's Paramount unit. And in 2011, Warner Music Group's publishing business was estimated to be worth $2.4 billion based on a multiple of ten times NPS. See also Gubernick (1989a), *Variety*, August 15, 1990, Krasilovsky and Shemel (1994, Chapter 12), and Wixen (2014).

Smith (2004a) writes that on ringtones publishers typically earn 10% of the sale price or 10 cents, whichever is higher. However, recording companies want a larger royalty share by making the payment the same as on CDs (which was 8.5 cents in 2004).

62. Creswell (2009b) writes that Sony/ATV publishing earns between $100 million and $130 million on revenues of around $500 million. In 2011, bidding for Warner Music's Chappell publishing arm was around $1.5 billion, and for the entire company, including recorded music, around $2.8 billion. Karp (2013b) explains that publishers are taking a broader and more active role in early artist development.

63. Shemel and Krasilovsky (1985, p. 362) note that, in terms of tax treatment, "the costs incurred in preparing master recordings, used for substantially more than one year to produce records for sale, are required to be depreciated over the period that the master recordings are utilized for that purpose."

Prior to the 1976 tax-code revisions, recording costs could be treated as totally current expenses deductible from current income, or they could be capitalized and subject to regular depreciation deductions. As of the 1976 revisions, however, for noncorporate producers, the costs attributable to the production of a sound recording, film, or book are deductible (on a "flow-of-income" basis) pro rata over the period in which the property generates income. This "flow-of-income" method of cost amortization for noncorporate producers also applies to record master costs and uses the same approach as in the film business, where estimates as to the total amount of income to be received over the economic life of the asset must also be made. But corporate producers may have the option to treat recording costs as current expenses deductible in the year incurred.

Producers must therefore capitalize costs incurred in the production of record masters and then deduct the costs over time using the income-forecast method of depreciation. However, costs incurred to produce demo records are not capitalized or recovered through depreciation deductions. Producers may instead elect to treat such demo costs as research and development expenses to be amortized over a period of 60 or more months. See also *Billboard*, April 9, 1994.

64. Rohter (2011a, b) notes that the major record companies – Universal, BMG, and Warner – instead believe that master recordings belong to them in perpetuity rather than to the artists who wrote and recorded the songs. This is, the companies argue, because the recordings are "works for hire" created by musicians who are employees, not independent performers. Artists must file termination notices at least two years in advance of when they want to reclaim rights. Rohter (2012) indicates that the Federal District Court in Los Angeles in 2012 upheld the rights of recording artists and songwriters to exercise their "termination rights" so as to be able to acquire and administer their work themselves after 35 years.

65. Although an estimated 40 million Americans play musical instruments, aggregate industry sales have not grown in real terms since the early 1970s – when unfavorable demographic, economic, and social trends first appeared. The percentage of personal-consumption expenditures going to this segment has diminished as interest in learning to play and availability of equipment and instruction in schools has declined. In 2010, the global musical instruments and accessories industry generated around $15.8 billion in retail sales, of which $6.4 billion was in the United States. According to data in the 2012 Fender Guitar IPO documents, fretted instruments accounted for 18.8% of total U.S. sales, with percussion 7.5% and pianos/keyboards 11.5%.

Since the 1980s, shrinking school enrollments and municipal and state funding problems have had the greatest effects in retarding sales growth. But young people's fascination with video games and computers has also diverted spending that might otherwise have been directed to this area.

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