19 Key Essays on
How Internet Is
Changing Our Lives

CHANGE

Patrik Wikström

The Music Industry in an Age
of Digital Distribution
The Music Industry in an Age of Digital Distribution

Patrik Wikström
Principal Research Fellow at the ARC Centre of Excellence of Creative Industries and Innovation, Queensland University of Technology
Patrik Wikström is Principal Research Fellow at the ARC Centre of Excellence of Creative Industries and Innovation, Queensland University of Technology, Australia. Dr. Wikström’s research is primarily focused on innovation and learning in the creative industries. He is the author of *The Music Industry: Music in the Cloud* (Polity Press, 2009) and has published his research in journals such as *Technovation*, *International Journal of Media Management*, *Journal of Media Business Studies*, *Journal of Music Business Studies*, and *Popular Music and Society*. Dr. Wikström has served as a faculty member at Northeastern University in Boston and at Jönköping International Business School and Karlstad University in Sweden. Dr. Wikström received his PhD in Media and Communication Studies from Karlstad University and he is a graduate from Chalmers University of Technology, Gothenburg, where he received a master’s degree from the School of Technology Management and Economics. Before his academic career, Dr. Wikström worked in the European media and telecom industry where he held positions as business development manager and strategy consultant.

**Sites and services that have changed my life**
- wikipedia.org
- amazon.com
- google.com
- coursera.org
- napster.com
The Music Industry in an Age of Digital Distribution

In 1999 the global recorded music industry had experienced a period of growth that had lasted for almost a quarter of a century. Approximately one billion records were sold worldwide in 1974, and by the end of the century, the number of records sold was more than three times as high. At the end of the nineties, spirits among record label executives were high and few music industry executives at this time expected that a team of teenage Internet hackers, led by Shawn Fanning (at the time a student at Northeastern University in Boston) would ignite the turbulent process that eventually would undermine the foundations of the industry.

Shawn Fanning created and launched a file sharing service called Napster that allowed users to download and share music without compensating the recognized rights holders. Napster was fairly quickly sued by the music industry establishment and was eventually forced to shut down the service. However, a string of other, increasingly sophisticated services immediately followed suit. Even though the traditional music industry used very aggressive methods, both legal and technical, to stop the explosion of online-piracy services such as Napster, Kazaa, Limewire, Grokster, DC++, and The Pirate Bay, it was to no avail. As soon as one file sharing service was brought to justice and required to cease its operations, new services emerged and took its place. By the end of 2013, the sales of physically distributed recorded music (e.g., cassettes, CD, vinyl) measured in unit sales, were back at the same relatively low levels of the early 1970s.

During the 15 years that has passed since Napster was launched, the music industry has been completely transformed and the model that ruled the industry during most of the past century has been largely abandoned.

This rapid transformation of the music industry is a classic example of how an innovation is able to disrupt an entire industry and make existing
industry competencies obsolete. The power and influence of the pre-Internet music industry was largely based on the ability to control physical distribution. Internet makes physical music distribution increasingly irrelevant and the incumbent major music companies have been required to redefine themselves in order to survive. This chapter will examine the impact of the Internet on the music industry and present the state of the music industry in an age of digital distribution.

Three Music Industries

In order to understand the dynamics of the music industry, it is first of all necessary to recognize that the music industry is not one, but a number of different industries that are all closely related but which at the same time are based on different logics and structures. The overall music industry is based on the creation and exploitation of music-based intellectual properties. Composers and songwriters create songs, lyrics, and arrangements that are performed live on stage; recorded and distributed to consumers; or licensed for some other kind of use, for instance sheet music or as background music for other media (advertising, television, etc.). This basic structure has given rise to three core music industries: the recorded music industry—focused on recording and distribution of music to consumers; the music licensing industry—primarily licensing compositions and arrangements to businesses; and live music—focused on producing and promoting live entertainment, such as concerts, tours, etc. There are other companies that sometimes are recognized as members of the music industrial family, such as makers of music instruments, software, stage equipment, music merchandise, etc. However, while these are important industry sectors they are traditionally not considered to be integral parts of the industry’s core.

In the pre-Internet music industry, recorded music was the biggest of the three and the one that generated the most revenues. Most aspiring artists and bands in the traditional music industry dreamed about being able to sign a contract with a record label. A contract meant that the record label bankrolled a professional studio recording and allowed the artist entry into the record labels’ international distribution system, something which
otherwise was beyond reach of most unsigned bands. The second music industry sector—music licensing—was much smaller and more mundane than the recorded music industry sector. Music publishers, who were operating in this business, were largely a business-to-business industry without any direct interaction with the audience. Their main responsibility was to ensure that license fees were collected when a song was used in whatever context and that these fees subsequently were fairly distributed among the composers and lyricists. The third music industry sector—live music—generated its revenues from sales of concert tickets. Although live music has a long and proud history, it came to play second fiddle to the recording industry during the twentieth century. Record sales was undoubtedly the most important revenue stream and record labels generally considered concert tours as a way to promote a studio album, and were not really concerned whether the tour was profitable or not. Sometimes the record label even paid tour support, which would enable bands to go on tour and promote the album even though the actual tour was running with a loss.

This music industry structure, including the relationships between the three industries, was developed during the mid-twentieth century and was deeply cemented when the Internet emerged to challenge the entire system. The short-term impact of the Internet on the music industries primarily concerned the distribution of recorded music to consumers. This means that while the recorded music industry was severely affected by the loss of distribution control and rampant online piracy, the other two music industry sectors were initially left more or less unaffected. As a matter of fact, while the recorded music industry has suffered during the past 15 years, the other two industries have gained in strength and prominence. There are several reasons why this shift in balance has happened.

One of the primarily reasons is simply that as one revenue stream is diminishing, the music industry is required to reevaluate its other businesses and try to compensate for the lost revenues from recorded music by increasing revenues from music licensing and live music.

For instance, revenues from music licensing have more than doubled during the past 15 years due to new and more active licensing practices, but also due to the fact that the media industries have changed in a similar way as the music industry. There are now considerably more television channels,
radio channels, videogames, Internet websites, and other outlets than only two decades ago, and most of these outlets need music as their primary or secondary content. Music publishers have also in general been more nimble than the record labels to address the demand from new media outlets. A clear example of how music publishers changed their business practices is how they strive to establish themselves as a one-stop shop for musical intellectual properties, where media outlets can clear all their music licenses with a single contract. That may sound like an obvious service, but in the traditional music industry it was not always the case. Rather, there was one legal entity holding the rights to the composition and another legal entity controlling the rights of the recording of the musical work (the master). Music publishers in the age of digital distribution increasingly control both the master and the composition, which makes the licensing process more efficient. The music licensing industry has during the past 15 years evolved into the most profitable music industry sector and is often also considered as the most innovative and agile sector of the three.

While music licensing is the most profitable music industry sector, live music has developed into the largest music sector. There is a fairly straightforward explanation why live music has experienced a surge during the past 15 years. Live music is simply easier to control than recorded music. A musical band that is in demand can grow their revenues from live music by increasing the number of concerts and raising the ticket prices. Even though the financial crisis of 2007–08 put a dent in the growth of the live music industry, it has nevertheless surpassed the recorded music industry in size. During most of the second half of the previous century, the largest music company was a record company, but after the Internet transformation of the music industry the world’s largest music company is Live Nation, a U.S.-based live music company spun off from Clear Channel in 2005. This is a further marker of the changing power relationships in the music industry. It should be noted, though, that the boundaries between the three industries are not as clear as they were during the pre-Internet era. Music companies, including Live Nation, serve as a general business partner to artists and composers and support their activities regardless of whether they concern live concerts, merchandise, licensing, or distribution and promotion of recorded music to consumers. This means that it is no longer entirely easy to categorize a music company into one of the three industries, but, nevertheless, in the case of
Live Nation its revenues are still mainly generated via live concerts, which still makes it relevant to refer to them as primarily a live music company.

This section has presented how the three main music industry sectors have been affected by the introduction of the Internet and how the size, strength, routines, and relationships between the industry sectors have been transformed. The next section will turn its attention specifically to recorded music and examine how new business models for music distribution may be able to lead the recorded music industry on a path toward recovery.

**A Growing Digital Music Market**

The music industry went to great lengths at the beginning of the century to put a stop to online piracy; however, they were not equally ambitious and innovative in developing new models for legal online distribution. Certainly, there were a few feeble attempts from the major record labels at the time, but the most important criterion in the development of these services seemed to be that they should not in any way threaten the existing revenue streams but should only add additional revenue to the companies. The majors did succeed with one of their goals, which is that the new services should not compete with the existing physical sales. However, unfortunately the services could not compete with anything, especially not with online piracy.

The first company that was able to create a successful online service for legal sales and distribution of music was not a music industry player at all—it was Apple Computer (as it was called at the time). In 2003, Apple was able to convince the major labels that music consumers would buy music legally if they were offered an extremely simple service that allowed them to buy and download music for less than a dollar per track. The service was called iTunes Music Store. In one sense,

iTunes was a radical change for the music industry. It was the first online retailer that was able to offer the music catalogs from all the major music companies, it used an entirely novel
pricing model, and it allowed consumers to de-bundle the music album and only buy the tracks that they actually liked.

On the other hand, iTunes can also be considered as a very careful and incremental innovation, as the major labels’ positions and power structures remained largely unscathed. The rights holders still controlled their properties and the structures that guided the royalties paid per every track that was sold was predictable and transparent. Apple were correct in their prediction of consumer behavior and the iTunes Music Store can not be considered as anything but an enormous success. In 2013, iTunes Music Store is the world’s largest music retailer (offline and online) and it has sold more than 25 billion songs since its launch in 2003. The service has evolved substantially during its decade-long existence, and a

![Fig. 1](Recorded_Music_Volume_1973_2012.png)

*Fig. 1. Recorded Music Volume, 1973–2012.*

Note: Digital includes full-length albums and singles split by 4. Vinyl includes LPs and EPs split by 4. Music DVDs are not included.

Source: IFPI 2013
number of competitors using more or less the same business model have entered the digital download music market. Even though the competition has increased, iTunes remains on top with a market share of more than 50 percent of the global digital music market. Figure 1 indicates how the global recorded music market has evolved since 1973, and shows that while the digital music market has been able to partially compensate for the decline of physical sales, the total recorded music market still has lost more than 50 percent of its sales since the peak in 1999.

While digital download services, such as iTunes Music Store, introduce a gradual change to the music business logic, there are other legal music services that are far more radical and thereby also far more controversial. These services do not offer individual tracks for purchase at a set price—they rather offer the users access to a large music library that they are able to listen to at their leisure. The users normally pay a monthly subscription fee that allows them to listen to as many songs in the library as they want, how often as they want.

This may sound like an appealing proposition, but these legal access-based music services have struggled both to convince record labels to license their catalogs to the services as well as to convince users that it is possible to enjoy music without actually buying and owning a copy of the track or album.

There is a considerable entrepreneurial activity in this segment of the music business, and services go live and bust on a weekly basis. Many service providers are still desperately looking for the business model that can attract music listeners and satisfy rights holders. The challenges are certainly considerable but the music service that so far has received the most attention of the international music industry and the one that could possibly have found the right path is a service called Spotify. Spotify is a useful vehicle for explaining the logic of the music industry in the age of digital distribution, and this section will present how service drives the music industrial transformation forward. Even if it eventually turns out that Spotify is unable to create a business model that is sustainable in the long term, it has already been able to transform the mindsets of both users and rights holders and will most likely be a music technological milestone on the magnitude of the Walkman, the Compact Disc, and Apple iTunes.
The Emergence of Access-Based Music Services

Spotify was founded in 2006 by Daniel Ek and Martin Lorentzon with the ambition to create a legal ad-supported music service that was free for the music listener but that generated licensing revenues to copyright holders.

Spotify was by no means the first attempt to create a legal service that could compete with illegal file sharing. Most predecessors had for various reasons failed miserably with their projects, which may be one reasonable explanation why the rights holders that Spotify was negotiating with were not particularly enthusiastic about engaging in another risky online music project. Despite all their initial skepticism, on October 7, 2008, the company announced that after two years of discussions and negotiations, they had signed agreements with the music industry’s leading rights holders to distribute their music to audiences in a handful of European countries. In order to succeed where many others had failed, Spotify had been forced to make a number of concessions. In addition to offering the major rights holders shares in the company, they were also required to implement a fundamental change in their business model. Instead of offering a service that was solely funded by ads, they also developed a more advanced version of the service, which was funded by subscription fees.

Spotify’s model with two or more different service versions where the most basic version is free and the more advanced versions are offered on a subscription basis is usually called freemium—a play on the words free and premium. Often, the profit margin for the free version is very low, or even negative, and it is expected that it is the subscription fees that will generate enough revenues to make the service profitable. The logic behind a freemium service model is that users shall be willing to use the service for free and that they while using the service gradually will make behavioral and emotional investments in the service that will increase the costs and efforts to switch to another service. The goal is to make as many of the users of the free version to convert to the subscription version. In order to achieve that goal, the free version has to have a number of increasingly annoying features (such as advertising) or lack a few key features (such as the ability to use the service on certain devices) that are removed/available on the premium versions of the service. The challenge for Spotify and other freemium services is to balance the different versions in a way
that stimulates the right customer behavior and entices users to become paying subscribers. To date, few music services manage this feat. Either the free version has been too good to motivate customers to upgrade their service or it has been too deprived of features to attract customers at all. In Spotify’s case they have achieved a conversion rate of approximately 20 percent, which means that 20 percent of the total user base is using the premium version and pay a monthly subscription fee.

Spotify has received a considerable amount of attention from the music industry across the world, but some of this attention has been largely based on suspicion and criticism toward their business model and methods. The criticism has to some extent focused on whether the freemium model presented above is long-term sustainable or not, but even stronger criticism has been focused on how the revenues have been shared with rights holders on different levels in the value chain. There are at least two reasons why this criticism has emerged. First of all, music companies have since decades back been used to a royalty model where a licensee pays a fixed amount per song sold, played, or used in whatever way. That model is very difficult to apply to an access-based service since the revenues that are generated by the service is not based on songs sold, played, or used, but based on the number of users of the service. Providers of access-based music services—regardless if the services are funded by subscriptions or advertising—have argued that rather than paying a fixed amount per track that is listened to, they should simply share whatever revenues are generated with the rights holders. Without getting too deep into the accounting detail, such a scheme is very beneficial to the service provider but transfer a considerable part of the business risk to rights holders.

Rights holders argue that their revenues should not depend on the skills of the service’s advertising sales team, but they should simply get paid for the music distributed to customers. In the past, a number of access-based service providers have been required to sign contracts that have generated fixed royalties per track to rights holders. However, such agreements make it very difficult to get an access-based music service off the ground, and several pioneers in the access-based music service market have not been able to survive for very long. One of the reasons why Spotify is considered as a milestone in the shaping of the new music economy is that the company seems to have successfully convinced the major music companies in
certain markets that they should indeed share Spotify's business risk and instead of taking a fixed license fee per track, they should take a share of Spotify's revenue, regardless of how high or low it is. Spotify succeeded by making a number of concessions in their negotiations, for instance by offering the major music companies the opportunity to buy a minority share of Spotify's shares.

Spotify has reported that 70 percent of their revenues from ads and subscriptions has been paid in royalties to rights holders. At the end of 2013, the company has generated more than a billion dollars for rights holders around the world, which according to Spotify is proof that their model does work.

However, even though it seems possible to generate revenues from access-based music services, the new contract structure is a radical change in the music business attitude toward distributors, and it is by no means uncontroversial. Some of the criticisms expressed by artists and composers are caused by the fact that the royalties are primarily paid by the service providers to music companies and not directly to the composers, musicians, or artists. The creatives argue that they are not given a fair share of the revenues and some of them even actively choose not to license their music to the services such as Spotify because the revenues that end up in their pockets is almost ridiculously low and that they do not want to support a corrupt and unsustainable system.

One reason why this problem has occurred is a debate about the classification of the royalties generated by access-based music services. Music companies (i.e., in this case the old record companies) claim that the royalties shall be considered as unit-based music sales, which in that case would mean that the musicians receive between 10 and 20 percent of the royalties paid by Spotify to the music companies. The musicians claim on the other hand that Spotify cannot be compared to traditional record sales at all but should rather be categorized as a performance, which in that case would mean that the musicians are entitled to 50 percent of the revenues rather than 20. The conflict concerns to a great extent the interpretation of agreements between record companies and artists that were established before Spotify and even the Internet existed. The debate about what type of royalty a particular Internet-based music service should
generate may seem like a legal issue with minor real-world implication, but it is an absolutely crucial question that will determine the structure of the future of the music industry. Much is at stake and it is unlikely that the music industry players will easily agree on a model that is perceived as fair to all parties.

This section has discussed the emergence of access-based music services and the challenges they have encountered as they try to enter the digital music economy. The next section takes this discussion one step forward by reflecting on how these services change the audiences’ relationships with music. The section argues that access-based music is merely a transitional phase in the evolution of a new music economy and points at indications of how the industry increases its reliance on so-called context-based features and services.

The Real-Time Listening Experience

While revenues from recorded music have fallen dramatically during the past 15 years, people across the world do not listen less to music—rather they listen to more recorded music than ever before.

Recorded music permeates every aspect of our daily lives and legal access-based music services combined with illegal online file sharing services means that more or less every song is available everywhere, all the time. This access explosion transforms the way people use and relate to recorded music.

For instance, in the pre-Internet days recorded music was expensive and scarce. Music listeners chose what record to buy with care and the growing record collection in their living room cabinets served as a diary of their lives told via a number of record purchases. Music listeners owned their physical records in the same way as they had a strong sense of ownership about other physical objects, such as books, souvenirs, or furniture, and these objects served as tools for both identity formation and communication.
Institutions, such as collection and ownership, become increasingly irrelevant in the age of digital distribution and ubiquitous access to music. In the light of this observation, a relevant question is what the new role of recorded music as an identity marker in the age of digital distribution may be. The retrospective record collection served as such an identity marker in the pre-Internet age, but as music listeners abandon their physical collections they are required to search for new ways to use recorded music as a tool for communication of their identities to their friends and the world. The scenes that are increasingly used for that purpose are online-based social networks such as Facebook, Twitter, etc. Access-based music services are commonly interconnected with such social network services, and thereby allow music listeners to constantly announce to the world what track they are currently listening to. This stream of information is primarily of interest to advertising platforms and their clients since it allows them to profile the audience based on their listening habits and send them advertising messages that are adapted to their demographics and interests.

The shift from the retrospective collection to the real-time listening experience is a radical shift in music listeners’ relationship to music. It diminishes the significance of the memory of past music experiences and moves the focus to the here and the now. It is interesting to note the kind of structures and behaviors that emerge as music consumption shifts from ownership to access and from the collection to the now playing. Amaral et al. (2009) have, for instance, shown that music listeners actively curate their music-listening feed in order to make sure that it does not reveal a track that does not fit with the image they want to exhibit. Some access-based music services have even created a “private-listening feature” in order to enable users to listen to music without sharing the experience with the world.

The access-based services are still in their early days and they still actively search for the optimal service and pricing structure that will allow them to compete and survive. Currently, the competition between the services is largely based on the size of their music catalogs, availability in different territories and different mobile platforms, etc. However, it is reasonable to assume that eventually all these services will asymptotically converge toward a similar music offering and will be available on all platforms and include more or less every song that has ever been recorded.
According to basic economic theory, the competition between similar services or products will be based on price, profit margins will eventually shrink, and a few large players will eventually survive and compete in an oligopolistic market. Access-based music services will in other words become a commodity market and behave in a similar way as the markets for sugar or oil.

When the market has reached this gloomy state and the room for innovation and differentiation based on the pure access model is more or less exhausted, online music service providers will most likely look for other ways to differentiate their services and to keep up their profitability. One way of doing this is to go beyond the pure access model and to create services and features that provide a context to the songs in their catalog. The context may for instance enable music listeners a way to search and easily find the song they are looking for at a particular moment, it may allow users to share their music experiences with their friends, to organize their favorite music experiences in convenient ways, etc. Such context-based services provide a less deterministic and far more expansive space for innovation than those services that are based on a pure access model. While innovation within the access-model framework leads toward the same ultimate goal (universal access to all songs ever recorded), innovation within the context-model framework lacks such a knowable outcome. A provider of a context-based music service has a greater possibility to create a competitive advantage based on unique, innovative features than what is possible within the access-model framework.

Today the number of context-based services grows alongside access-based music services and most often a music service offers both access to music as well as a range of features that allow users to do things with music. The customer problem that needs to be solved is not that the customer needs access to music but rather how to navigate and do things with that music. In other words, customer value is increasingly created by providing the audience with tools that allow them to do things with music rather than by providing the audience with basic access to music. This shift from providing access to music to providing services and features that are based on the assumption that access to music is already provided is part of a similar general transformation of the music industry. The discussion has up until now been focused on the distribution of music, but the shift from
content to context can be also observed in other segments of the music industry value chain.

A number of artists and composers have during recent years implemented the context-focused model in the creative production of their musical works. Rather than only making polished recordings for the audience to experience and enjoy, they have created services and practices that involve the audience in the creative process and allow the fans to do things with music. The British singer-songwriter Imogen Heap is one example of this trend. Heap actively encouraged her fans to upload sounds, images, and videos during the production of her latest album. She used this material in her work both as inspiration and as actual building blocks to her songs. As a consequence, Heap's fans felt they were collaborating with their idol and were part of a communal, creative experience. Billy Bragg is also a singer-songwriter from Britain, but from a different generation and in a different genre than Heap. Bragg has also established a context-oriented experience for his fans, albeit perhaps primarily driven by his fans than by Bragg himself. Bragg reflects on his relationship with his fans and explains that he provides a “social framework” for his fans and that some of his fans don’t even like his music but they enjoy being part of a social community (Baym 2012).

Other musical artists and producers go way beyond the traditional format of the song and create mobile applications that allow the users to play with music in different ways. London-based RjDj and San Francisco-based Smule are two examples of organizations that have developed such applications that challenge the boundaries between music and interactive videogames. These tendencies raise fundamental questions about the definitions of the music industry and music organizations. Will tools and software for playing with music become recognized as a vital part of the music industry and a fourth core sector of the industry, next to live music, music licensing, and recorded music? If so, what will this mean for established music companies, artists, and composers? When live music and music publishing became increasingly important industry sectors in the first years of this millennium, traditional record labels reinvented themselves, built new capabilities that allowed them to serve as record labels, music publishers, management companies, live music companies, etc. They turned into 360-degree music companies, which placed equal emphasis on
all three music industry segments. If context-based services and software will continue to grow in importance, music companies will need to add yet another new competency and perhaps new business areas to their organizations that will enable them to capture the increasing value created by context-based music services.

The Music Industrial Transformation Continues

The recorded music industry has been radically transformed during the past 15 years, but much remains before the industry takes the definitive step and leaves the physical world behind. This chapter has discussed some aspects of how this transformation continues, and how access-based music services play a substantial role in this process. The chapter has also touched upon how the recorded music becomes increasingly marginalized as a revenue source and how other industry segments such as live music and music licensing become increasingly significant. Finally, it has also presented how the audiences’ relationships with music change as a part of this transformation and how services and features that allow users to play with music rather than merely to play music move into center stage of the music industry in the digital age.
References


