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Understanding and interpreting the digital market

Executive Summary

- The annual IFPI Recording Industry in Numbers report publishes the trade and estimated retail value of the recorded music digital market sector in over 40 countries. This article will enable the reader to interpret what these statistics mean for publishers and writers, and enable a more meaningful comparison across countries.

- The digital supply chain is different from that of physical in that most collecting societies license digital retailers, such as iTunes, directly on behalf of the publisher and writer. So, if the IFPI state that the UK digital market is worth £109m in 2006, one cannot simply assume that eight percent thereof goes back to the publishers and writers, via the societies.

- Importantly, a series of adjustments needs to take place to derive what is happening with mechanical and performing rights. These will involve a series of 'add-ins' and 'take-outs' of revenues specific to different rights holders. Similarly, an understanding of what the adjustments are, and how they must be handled, improves our understanding and interpretation of the fast evolving digital market.

- For example, the estimated retail value of the UK digital market in 2006 can be expressed in common currency, less VAT, as £90m. Yet the MCPS-PRS Alliance, which represents both performing and mechanical rights for authors and publishers, collected £13m, (inclusive of all ringtones), or 14 percent of the estimated retail value, notably above what a simplistic 'eight percent rule' would have delivered.

- The relative aspects of these adjusted values are then explored. As the digital market is still emerging we seek to explain how the territories are performing in a strict 'per capita' type context. This evidence is charted against the societies' penetration, relative to the estimated value of the retail market, with some striking results.

- Going forward, we offer an economic projection of the digital market for the five largest EU countries, by referring to a recently published Jupiter Research forecast. The forecast shows the growth of the estimated digital retail market net of VAT and incorporates the societies' share of that growth in terms of gross collections.

- To conclude, we consider some of the caveats that exist. For example, not only is this fledgling market more heterogeneous in terms of formats, but also in revenues too.

A Primer on IFPI Statistics

The annual IFPI *Recording Industry in Numbers* (RIN) report publishes the trade and retail value of the physical and digital recorded music market sectors in over 40 countries. Trade, or wholesale, value refers to the record companies' revenue net of discounts and taxes. Promotional goods and non-music related sales (e.g. comedy content) or non-recording artist related products are not included in IFPI's trade revenues. All IFPI analysis, growth and trends, are based on trade values.

Retail value refers to the estimated final value paid by the consumer for the purchase of a music product, inclusive of relevant sales taxes and retailer mark-up. Retail values presented by IFPI are estimates only - IFPI does not collect sales directly from retailers in the physical or digital markets. Retail values are particularly difficult to establish with accuracy in the mobile environment.

IFPI measures digital sales incorporating online, mobile and subscription revenues. This is termed the 'digital' market. Online sales include single and album download, music video downloads and streams. Mobile sales exclude mono/polyphonic ringtones, but capture mastertones, single tracks to mobile, streams to mobile, music videos and ringback tones. Finally subscription-defined revenue includes all online and mobile subscriptions.

IFPI's physical and digital sales reflect transaction-based music sales and therefore exclude licensing or fee-based income, such as PPL revenues in the UK. While it is acknowledged that this does not provide a full picture of the recording industry, it should be noted that the physical and digital revenues covered within IFPI account for the majority of revenues in the recording industry.

In the forthcoming RIN report 2008 (to be published in May/June), IFPI will for the first time publish recording industry revenues from licensing and performance rights, providing a more comprehensive outlook on the recording industry's revenue streams. Under licensing IFPI will track licensing income such as ad-funded revenues, income from ISPs for the use of music and video-on-demand services. Licensing will also include revenues from new business streams (often termed '360 degree' deals), midi file income (mono/polyphonic ringtones), synchronisation revenues, digital premiums, covermounts (when the deal involves a fee - if treated as transactional income revenues are reported under physical sales) and un-earned advances and fees.

Under performance rights income, IFPI tracks collections via the collecting societies for broadcasting, public performance, internet and private copying - for both record companies and performers. IFPI also tracks the distribution of these monies to the record companies.

Interpreting the Digital Market, from a Collecting Society perspective

Whilst the IFPI's recording industry statistics are a valuable source of information, they are not on their own sufficient for a full understanding of the market for publishers, writers and collecting societies. This is because in many territories outside of the US, the societies license both the mechanical and performing rights directly to digital retailers such as iTunes, whereas in an offline world the mechanical right would be compensated 'further up the supply chain' via the record company.

There are structural asymmetries in the construction of the digital supply chain, not only to the actual rights licensing structure, but also to our understanding and interpretation of the digital market, especially the distinction between retail and wholesale statistics. Whilst this may be intuitively obvious to some, it has been ignored by many others when commenting and advising upon the fledgling revenue online streams. Yet, given the importance of this sector, both in its potential to add new revenues and the need for it to replace old, this article aims to improve our awareness and understanding of the true value of the digital market for the different rights-holders.

In 2006, the Alliance collected nearly £13m on behalf of both mechanical and performing rights holders for services in the UK. This includes online, mobile and ringtone revenues. As with IFPI digital statistics, there's usually a lag between the time of collection and the time the activity actually took place. Digital-specific distortions like delayed invoicing, audit revenues, treatment of advances, tariff disputes and the diseconomies involved in matching the long tail will smooth out over time, but are well worth bearing in mind when trying to gauge the relative performance and likely path of the market.

Importantly, to understand the asymmetry that exists between the IFPI market and that of the collecting society, a series of adjustments needs to take place to derive what is happening with mechanical and performing rights. These will involve 'add-ins' and 'take-outs' of revenues specific to different rights holders. For example, the Alliance licenses all ringtones, (not just master tones), at the (then) rate of 15 percent. For 2006, mono and polyphonic ringtones constituted around 40 percent of total ringtone revenues, yet these are currently excluded from IFPI statistics. In addition, audit revenues, which claw back money from previous years, were also significant for this specific period. Similarly, it is worth bearing in mind that there may be instances of lop-sided growth in the digital market. This is where one of the two licensing parties generates new digital revenues, such as litigation settlements by record companies (which do not form part of the collecting society's market) or the recent deal with the Alliance and YouTube, where these new digital revenues will not (yet) be mirrored in the annual reports by the IFPI.

The table overleaf helps take us through how the recording industry's digital market sector is made up, and then helps bridge the gap between that of the collecting societies' published revenues, working with IFPI estimates and Alliance statistics. We begin with an IFPI estimated recorded music digital retail value of £109m, of which £16m has to be netted off as nominal VAT (17.5%), leaving £93m as the adjusted value of the market, and the licence base for which mechanical and performing rights are derived. Given that IFPI also publishes the trade values, we can estimate the retailers' margin is around £26m, leaving £67m for the record companies.

The UK Digital Market 2006:
From Retailer to Song Writer - A Worked Example
(Figures in £ millions)

2006 Estimated Digital Retail Value (IFPI)		£109
Estimated VAT based at 17.5% [1]	(£16)	
Adjusted 2006 Digital Retail Value - Net of VAT		£93
Estimated Retail Gross Margin (Pre Society)	(£26)	
2006 Trade Value of the Digital Market (IFPI)		£67
Then, to be extracted from the Retail Gross Margin[2]:		
2006 MCPS-PRS Alliance Digital Collections		£13
Average Commission of 12 Percent	(£1.6)	
2006 MCPS-PRS Alliance Net Distribution		£11.4
Of Which: Mechanical Rights		£6.8
Of Which: Performing Rights		£4.6

[1] VAT is applied on all UK sales @ 17.5% as VAT is determined by the point of sale and not the territory of residence of the DSP. All of this value is paid to HMRC at some point in the value chain. There is no element of profit in this number.

[2] The asymmetry between the record company's digital market and that of the collecting society can be highlighted here. Using three published estimates, (retail, VAT and trade) we can calculate the estimated retailers' margin. Whilst this is confined to the record company market, this will be close to the actual retail margin that the collecting society will extract its £13m from, hence reducing the margin down further, to £10m, of which additional costs and overheads will need to be netted off.

Sources: IFPI (estimated retail and trade values) and MCPS-PRS Alliance. Figures may not add up due to rounding.

This 2006 trade value of £67m should not be confused with net realised profits for UK record companies, as several further adjustments would need to take place. For example, costs need to be netted off, artists would be paid out of this revenue pool and revenues would need to be repatriated to the companies' international headquarters. Similarly, digital aggregators who work predominantly in the independent label sector would charge commission, which can range from 5 percent in the case of Royalty Share to as much as 30 percent for the Orchard. Consequently, one should not view this figure as being the value to the record companies per se, but rather the revenues which support their own internal supply chain.

For the songwriters and publishers, the licence base will be the gross retail less VAT, of which £12.9m was collected by the society, thus reducing the retail gross margin further. In terms of 'market penetration', this represents 14 percent of the estimated retail value less VAT. The average commission taken by the Alliance is approximately 12 percent, which allows £11.4m to flow through to publishers and writers. Under the Alliance's own Joint Online Licence (JOL), the 2006 distribution resulted in a 40:60 spread in favour of mechanical rights, of which the Apple iTunes is dominant. Most EU territories operate on a 25:75 (performing:mechanical) split for downloads, whereas there are some exceptions, such as Spain, who operate a 50:50 split. This can create important asymmetries within a reciprocal network due to the way in which the royalties flow within and across the EU's internal borders.

Interpreting the Digital Market

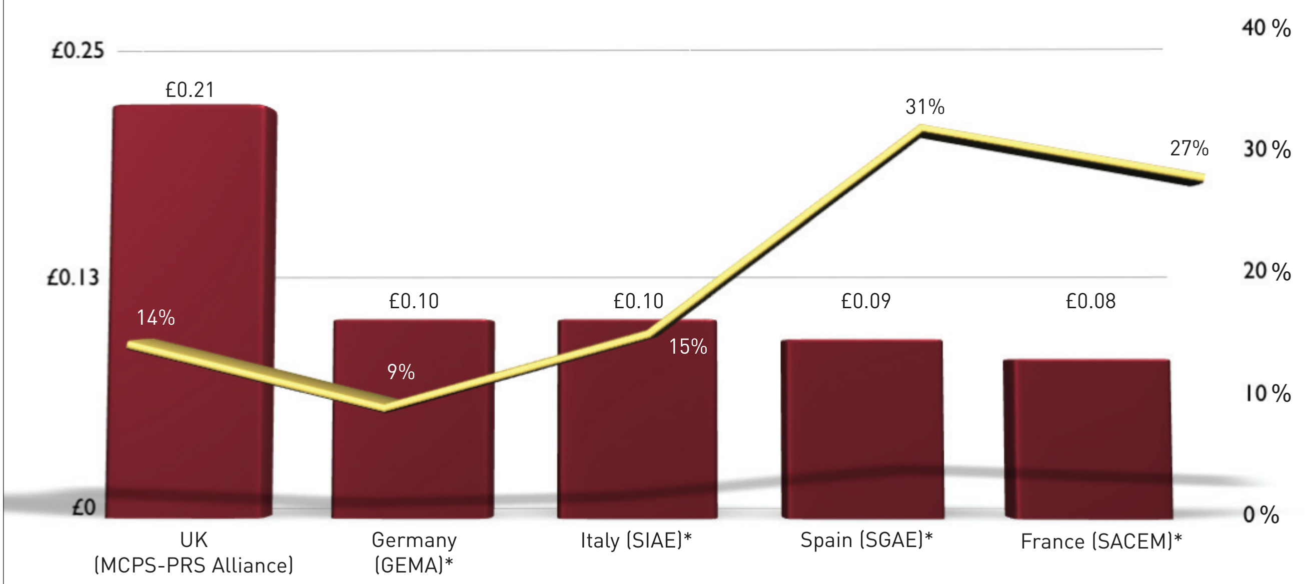
We can refer back to IFPI recording industry's statistics to understand how the UK market compares with other countries, in a relative context. The table overleaf isolates the top eleven digital markets, (in order to capture the five largest EU countries), and lists them in order of retail value. Using population data, the per capita values are calculated and then inter-ranked accordingly. Whilst the relative rankings are broadly in line with absolute market values, there are a few exceptions. Australia can be seen to be outperforming Germany and Canada, whilst China is a natural outlier. Interestingly, the UK ranks third, with a per capita retail value of $3.3, notably higher than its four European neighbours.

IFPI 2006 Top Eleven Digital Market Retail Values Per Capita

Country	Estimated Retail Value US $m	Population (millions)	Per Capita Retail Value $	Inter - Relative Ranking
US	$1,849	301.1	$6.1	1
Japan	$778	127.4	$6.1	2
UK	$201	60.8	$3.3	3
South Korea	$151	49.9	$3.0	4
France	$128	63.7	$2.0	5
Germany	$117	82.4	$1.4	8
Canada	$51	33.4	$1.5	7
China	$50	1322.0	$0.0	11
Italy	$41	58.1	$0.7	10
Australia	$37	20.8	$1.8	6
Spain	$32	44.4	$0.7	9

We can conduct a similar 'relative' exercise for mechanical and performing right revenues, collected via the societies. Rather than work with the top eleven countries, this analysis will be restricted to the top five EU countries, due to structural differences in the way these revenues flow through in other parts of the world, and the basic similarities in terms of each of the five EU countries collective rights management structures. The chart below presents the combined digital gross collections for performing and mechanical rights in per capita form in maroon bar charts against the left hand axis; highlighting that the UK's MCPS-PRS Alliance is shown to collect more than twice that of Germany, Italy, Spain and France, per head of population in 2006. Against the right hand axis, plotted in the yellow line, is the relative penetration of that society, given the estimated retail value of the digital market for that country.

Gross collections per head of population (LHS) and penetration relative to estimated retail value less VAT (RHS)



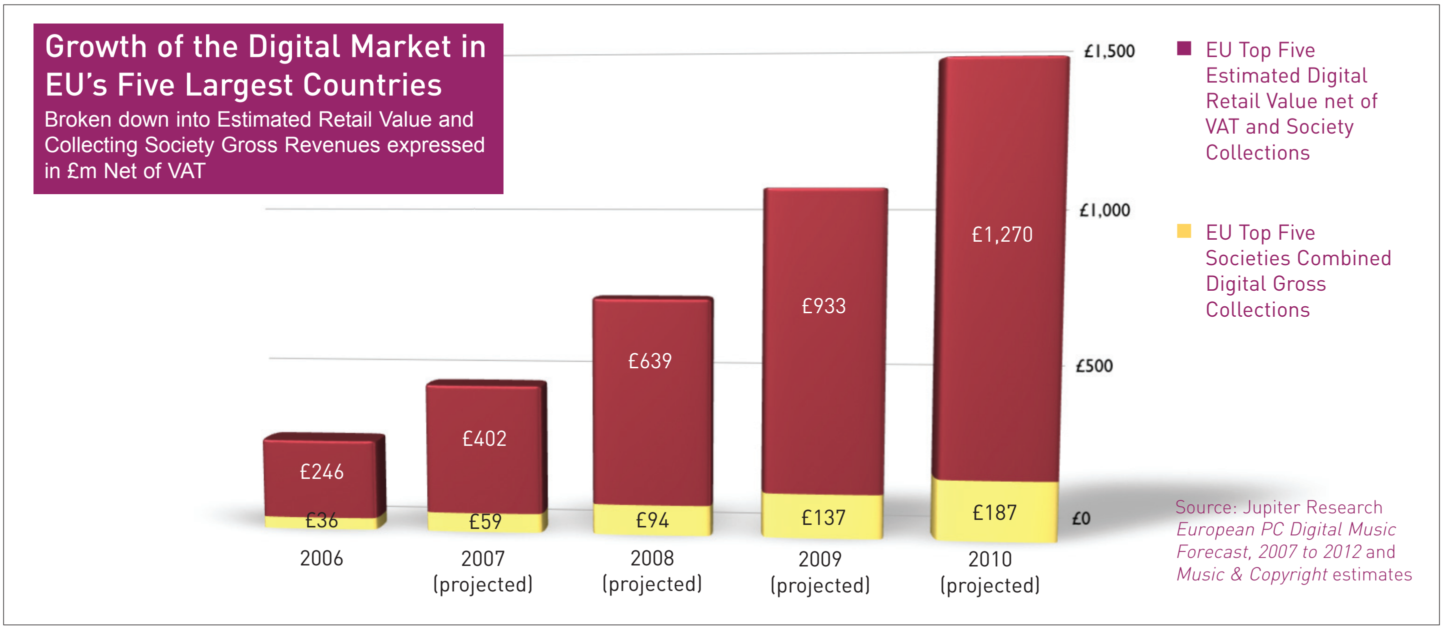
Figures from *Music & Copyright*

Interpreting the left hand axis of this chart throws up more questions than it does answers. For example, both Germany and the UK have had to go through lengthy (and costly) tribunal disputes in order to develop their digital licensing schemes. This will not only hinder the ability to develop their respective markets, but also distort the statistics for that time period. For example, Music & Copyright (May, 2007) reported that in 2006 GEMA deposited €6.3m (£4.3m) in escrow accounts for ringtone melodies and €2.5m (£1.7m) for music-on-demand. Whilst we've factored this into the calculation, it is not clear which time period these revenues would represent. More importantly, it flags up how societies have reacted differently to developing licensing schemes for this nascent market. In the UK, for example, the JOL was launched as far back as 2002, which meant that it was particularly well placed to become an 'early adopter' of digital licensing. Similarly, the UK might benefit from its position as being: (i) a relatively large market and a net-exporter of its repertoire and (ii) English speaking, hence a benefactor of developments in the USA.

Interpreting the right hand axis of the chart reemphasises that one cannot compare like-with-like, (or IFPI stats with society revenues), due to who is licensing, what is being licensed and how it is collected. However, the variances of society penetration relative to the estimated retail market are striking. Whilst, the UK's gross collections are 14 percent relative to estimated retail net of VAT, Italy and Spain's gross collections are calculated to be around 30 percent. This raises questions about the ability of both record company and collecting society to develop monetise and grow their respective digital markets. Spain for example, (according to research by Jupiter), has the highest level of online piracy within the major European markets. This is a major barrier in the ability of record companies to develop a legitimate online market in Spain. Whilst this will inevitably dampen revenues for the collecting society, (captured in its low collections per capita figure), this might be off-set by the benefits of collective rights management being able to exploit 'licensing-specific' markets - which are excluded from the IFPI retail estimates.

Interpreting the Digital Market

We can present an outlook for the digital market, and what it means for collecting societies, by referring to the recently published 'European PC Digital Music Forecast, 2007 to 2012' by Jupiter Research. The forecast commences with the five EU countries having a total retail digital value of £282m in 2006, of which £36m or 13 percent is estimated to have gone to the five collecting societies. Going forward, Jupiter views the market growing at 63 percent in 2007, slowing down to 36 percent year-on-year growth by 2010, by which point the estimated retail value of the digital market will be worth £1.4 billion net of VAT, of which the five societies will collect £187m in royalties.



Conclusion

This article has helped us understand the asymmetries that exist within the fast evolving digital market(s), as well as create awareness of some of the many caveats which relate to how it needs to be interpreted. For instance, not only is the digital market increasing in its heterogeneity of formats, but of revenues too - especially as litigation, advances, spill over effects from online broadcasting and equity become more prevalent.

Similarly the need for increased levels of transparency, especially at the licensing and reporting level, can only improve the ability for the various stakeholders to understand developments in their own market(s). For example, when new forms of digital revenues are generated, increased transparency will allow the various stakeholders to understand who benefits most from the new monies, and who loses out as a result - especially if it is merely displacing old revenue streams.