

Selling Music Online

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The legal distribution of music files via Internet has the potential to become one of the largest, most lucrative of all online consumer markets. Exploiting this opportunity will be a very complex challenge for the recorded music industry.

Distributing music files has quickly become one of the Internet's largest and busiest consumer markets, as Napster's community of 38 million users will proudly attest. And why not? Bertelsmann CEO Thomas Middelhoff was right when he said that music – more than any other media content – is predestined for sale over the Internet.

The operative words in Middelhoff's comment, however, are "for sale".

Files may change hands frequently thanks to Napster, but money rarely does - at least not with the record companies and artists who have a justifiable claim to it. Napster, MP3.com, Gnutella and other as-yet-unknown services are spreading like deserts which are swallowing up the fertile land the record companies currently harvest for around \$40 billion every year. The rapid growth of these file-swapping methods has left music executives with two unsettling choices:

- turn this large and busy market into a legitimate and lucrative one, or
- watch a large chunk of their revenues evaporate into the file-swapping wasteland.

Prior to the recent deal between Napster and German media giant Bertelsmann, the music industry showed unity by taking a rather short-term approach to the demand that Napster has unearthed. It filed lawsuits. Dogged by allegations of copyright infringe-

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ment, Napster is on the verge of being shut down by US federal court. Potential Napster users are now on notice: when you download your favorite song, you may be breaking the law.

But if Napster disappears, how will millions of consumers satisfy their demand? How will the record companies prevent enterprising and renegade software developers from following the footsteps of Shawn Fanning, Napster's 19-year-old founder?

The Napster-Bertelsmann deal demonstrates an acute interest in solving the problem outside the courtroom. But acute interest won't be enough. Everyone who owns a CD player knows what is really at stake: the industry needs a new business model. And it needs one fast.

The lack of an appropriate business model is so painfully clear that even the US technical journal *Scientific American* felt obligated to mention it in a recent article on copy protection technology for digital media. The upshot is that all record companies will need to do plenty of homework and look beyond the obvious in order to make online music sales work in such a way that consumers, artists, and record companies all benefit.

Pricing will play a make-or-break role. If the record industry seizes the initiative and anchors the prices for online music sales at acceptable, sustainable, and profitable levels, it will strike a knock-out blow against the renegade systems and drive them to the margins. After all, studies by the record companies themselves and by independent sources such as *Webnoize* revealed that as many as three out of four Napster-type users would be willing to pay for a download offer in exchange for the assurance that they were not violating any laws. If the music industry fails to act or sets those anchors too low, prices will degenerate and gut the industry's profitability and stability. Pricing is a dangerous lever, and the industry has little room for mistakes.

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The potential market for selling music online already exists and is waiting to be served properly. It is now up to the music industry to deliver. Here are the areas the industry needs to address systematically.

The customers: target segments must be re-defined

Before you can create a sound offer, you need to understand the target segments and customize the benefits of Internet music. Niche segments can be better cultivated and economically served than currently possible, because the potential for customization opens possibilities for a finer segmentation based on customers' needs.

A hardcore Bon Jovi fan will take advantage of the opportunity to download not only the latest Bon Jovi song, but also seek to download all upcoming new versions (unplugged, live) of the same song. Previously unreleased content or newly released versions of songs from the band's earliest days - which may have too small an audience to warrant pressing a CD in commercial quantities - can be made available to all comers at minimal marginal cost.

This desire among fans is nothing new, but it has remained largely outside the record companies' domains. Loyal fan communities of artists as diverse as Bruce Springsteen and the Grateful Dead have been swapping bootleg concert tapes on the black market for nearly three decades, and fans of house music artists for nearly two decades. But these fans would now have the opportunity to gain access to more and better quality versions - all of it legal!

The same applies to niche markets such as blues. While most blues artists remain outside the mainstream, they all have hardcore followings who feel poorly served

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by mainstream record stores and would be willing to take their money online. In terms of information content, the website of the leading blues label Alligator Records (www.alligator.com) is in many respects superior to what the majors such as Sony Music offer their customers.

Table 1 (as of October 2000)

| Company | BMG | Universal* | EMI | Sony | Time Warner |
|-----------------|---|---|---|--|---|
| Available offer | 100 albums and singles (goal:2500) | About 60 singles | About 160 albums and singles | About 150 singles | 100 albums and singles (goal:1000) |
| Price range | Albums: \$ 10-15 Singles: \$ 2-3.5 | Singles: \$ 2 | "Reflecting the offline price structure" | Singles: \$ 2 | Albums: \$ 15 Singles: \$ 1.2-2.5 |
| Website(s) | Various partner sites, including Lycos, Spray.net, www.music-download24.de | Various partner sites, including www.getmusic.com (in cooperation with BMG) | Various partner sites, including www.rollingstone.com | www.sonymusic.com and various partner sites, including www.music-choice.com (in cooperation with Time Warner and EMI) | Various partner sites, including www.tower-records.com (cooperation with AOL can be expected soon) |

* In October 2000, Universal started testing a streaming service (5 000 users in North America) with more than 20 000 songs available

Casual fans do not need such an extensive service. They will be more satisfied with a helping hand that guides them to certain songs and to other bands of the same genre. Casual fans may also include those who want to find an out-of-print nugget but lack the time to search used record stores, cut-out bins, or flea markets.

The net benefit in all of these cases is nearly identical - someone gets a desired song - but the differences in perceived value are enormous. This raises two urgent questions: how to define the actual product, and how to price all those benefits?

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The product: Quality is a must, but services make the real difference

The existing offers of the five major record companies (see table 1 on previous page) do not do justice to the capability for selling music online. By simply pasting a bricks-and-mortar business model onto the online world, they lack attractive product offers and do not exploit possibilities for customer segmentation, pricing strategy, and channel management.

Legal technicalities must, of course, be overcome. But they represent only one step. Assuming that the record companies set up an adequate copy protection scheme and DRM (Digital Rights Management), they will still face a greater risk and a much stiffer challenge, namely, to develop offers which will attract and hold paying customers.

First things first: the online product has to provide high quality downloads to distinguish itself from today's Napster and its future followers. Napster may offer a wide range of files, but the sound quality and the completeness of the songs is highly unpredictable. Users only know the true quality of the desired track after they have downloaded it and tested it. This is entirely unacceptable for a premium commercial offer from a reputable record company.

Furthermore, the network must have enough capacity so that customers will be able to log in at anytime, and be robust enough so that customers can download files without disruptions or lost connections. Broadband connections will alleviate this problem to some degree.

But the real question concerns the "product" itself. Will all songs be available separately, or will some be available only on complete albums? Does this make the whole concept of the traditional pop album – which is really just a few singles and lots of filler – obsolete? That concept resulted from the technical constraint of old long-playing (LP) vinyl records, which could reasonably hold around 45 minutes of music. Despite the

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increased capacity, flexibility, and quality of the CD format, the bundle of songs we refer to as an "album" has remained largely unchanged. It also continues to form the basis of payment for most recording artists.

In the Internet world, the only meaningful constraints are the capacity of the users' hard drives, the quality of their connections, and their ability to produce their own tapes or CD's. Finally freed from the constraints of vinyl and its successors, record companies can bundle music as they see fit in order to exploit customers' desires. Redefining these bundles attractively will be at the heart of any successful strategy for the online sale of music, because the possibilities - in terms of unit size, artists, genres, etc. - is nearly limitless.

Without the bundles, we have the extreme situation in which every song is available as a separate unit. This creates a higher benefit for customers, for it allows them to fully customize their purchases. But it also effectively turns every song into a "single" which needs to survive on its own. What happens if just a tiny fraction of the songs account for the bulk of sales? The record companies have to weigh the outcomes here: higher costs for new releases on one hand, and higher benefits for customers on the other.

The possibility for additional services and product enhancements is nearly unlimited compared to CD's or old vinyl records. These range from cover art files, interviews (recorded and print), featured lyrics, previews of new songs, up-to-date notifications of tour dates, excerpts from tour magazines, opportunities to buy concert tickets and merchandise (posters, t-shirts, etc.), to interactive opportunities such as artist chats and review posting. Companies could also make special bonus tracks available only to online subscribers, or offer special subscriptions under which the user receives all songs in a particular series automatically at a certain interval, say, once per month.

The ability to use other media as the basis of a product offer is an unexplored but potentially profitable terri-

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tory for the record companies. From a technological standpoint, we are not all that far away from having listeners be able to hear a song on the radio, call their online music sales company on their Internet-compatible mobile phones, and order the song from wherever they are. This can happen spontaneously, or be promoted by through sponsorship or cross-promotion. When third generation mobile phone systems are launched, the carriers will be scrambling for high-traffic content. Working with them to promote online music sales could help both sides build their businesses.

The constraints are gone. The record companies' thinking and actions must begin to reflect that.

The pricing structure: Forget obvious solutions like simple subscriptions

No one seriously doubts that record companies will have to charge money for digital downloads in order to compensate artists and publishers. But how are users supposed to pay for their downloads?

The record companies cannot answer this question accurately without knowing what pricing elements matter most in the perception of the customer. Where will the customer's eye be drawn when he or she examines the offer? Would they pay more attention to one-off charges, a monthly fee, or a price per download, or some other element? Those elements which are in the customers' focus warrant attractive prices, while those outside the customers' main focus can be held at higher, less attractive levels. The colorful mix of pricing elements in mobile telephony - which range from one-off installation charges to monthly fees to per minute charges (peak, off-peak, weekend) to billing intervals (full minutes, 10 seconds), etc. - shows how many degrees of freedom such a complex pricing challenge can present.

Is this fine-tuning or nit-picking? Not if you look at the bottom line of companies which take this kind of

Pricing approaches can include bundling, multi-step discounts, price customization, stretch discounts, or bulk bundles, among many others.

approach to pricing. Optimal pricing can add 20-30% to a company's bottom line, while sub-optimal pricing decisions can reduce it to an equal degree.

What comes to mind first for pricing elements for the record companies is a straightforward pay-per-download system. But that may hinder the companies in their efforts to gain a loyal user community and collect some valid data about it. Buyers who make separate purchases leave only a limited data trail. This makes Dell Computer an apt analogy for the record companies. One of the competitive advantages in Dell's business model is its unrivalled customer database gained through years of direct selling both on- and off-line. Pay-per-download makes such a relationship difficult to build.

The other idea which springs quickly to mind is a flat subscription fee. This might be more suitable, because it guarantees the record companies a stream of customer information. But watch out: Experience with pricing for Internet access shows that flat rates tend to attract heavy users who make up a small percentage of all customers, but block a large part of the available capacity. In the U.S., some 4% of the AT&T's flat-rate users block 50% of the network resources, according to a company source.

Neither per-download nor subscription - the two most obvious pricing structures - is ideal on its own. A more intelligent pricing structure is required. Both components - subscription fee and pay-per-download - could be combined into a multi-dimensional tariff to avoid uneconomical usage while strengthening the relationship with the customer. Other pricing alternatives include:

- **Bundling**, which fosters sales of products that might not seem too attractive when sold separately. Example: You can download Metallica's "S&M" at \$14, or you can download "S&M" and another, older album together for \$19.95. Or you buy the latest U2 single "Beautiful Day" and receive future

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versions – live, unplugged, or maxi – automatically via e-mail free of charge.

- **Multi-step discounts**, which encourage higher usage. Example: you can purchase your first 10 blues singles at \$3 apiece, the next 10 singles at \$2, and so on.
- **Price customization**, which is a useful tool to approach different segments in different ways. Example: To attract new users, a tariff with a low subscription and high per-download component makes sense; while heavy users are better served by a high subscription fee and low per-download fees. Once their usage surpasses a certain point, they are better off. The fencing between the segments, however, has to be supported by the product structure.
- **Stretch discounts**, which are designed to encourage a user to buy a marginal number of additional units in order to receive a certain bonus or discount. For example, if usage patterns reveal that someone buys 7-8 albums per month on a regular basis, they could be enticed to "stretch" to 10 albums, by being offered albums 11 and 12 for free.
- **Bulk bundles**, which means that the basic monthly subscription fee includes the right to receive a certain number of songs or units automatically. The user then pays only for the songs or albums purchased beyond that basic amount. This model is common in mobile telephony in Europe, where a subscriber receives a fixed block of minutes per month for a regular fee, then pays only for minutes used beyond the fixed block.

The price levels: How to find the magic numbers

No matter *how* the record companies plan to get their money from customers, the big question still remains: *how much* will they be able to get? Good ques-

What are the customers willing to pay for the new products and services? This has no easy answer and raises many additional questions of perception.

tion. The main battleground for determining this answer is not the board room or some meeting room in the record companies' marketing department, but in the field with the customers themselves. What are they willing to pay for these new products and services? This has no easy answer and raises many additional questions of perception.

We would like to emphasize a point we made in our introduction: If the music industry fails to act or sets the price anchors too low, prices will degenerate and gut the industry's profitability and stability. Pricing is a dangerous lever, and the industry has little room for mistakes.

Is music on the Internet just typical Internet content? If yes, then the willingness-to-pay for music on the web will be low and limited anyway. It is sad but true that Internet users are accustomed to have free access to almost any kind of content (e.g. financial information, sports). Exceptions are rare. Wall Street Journal online (*wsj.com*) is one of the very few content providers in the financial sector that manages to charge a fee and still generate a user community by the sheer quality of its service.

Is music a bona fide product rather than pure content? If yes, then the willingness-to-pay will be more substantial and should be tapped. People buy airline tickets and concert tickets over the Internet all the time. The prices for these products can easily come under pressure, but they have certainly not plummeted to near zero.

The willingness-to-pay is of course closely linked to the benefits generated by the product. Herein lies the success of *wsj.com* as well as the success of a potential offer for downloading music. State-of-the-art research tools like conjoint measurement can measure those benefits and transform them into the underlying willingness-to-pay.

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The record companies should also not lose sight of the total cost from the consumer side. While customers may not always consider the travel, time, and research costs when they drive to the mall and spend \$14.99 on a CD, they may be more sensitive to the additional – and transparent – costs incurred for downloading music. These include Internet access fees, hardware storage costs, on-line time, and so on, and not just the average cost per download.

The distribution: Exploit the Old Economy channels

One of the biggest mistakes the record companies could make is to view the online distribution of music as a pure all-or-nothing decision. Much like bookstores in the amazon era, the Old Economy distribution channels still have inherent advantages and an important role to play. This must be considered in any pricing decision.

If the music industry prices its digital offerings too low, it will kill off most of its existing distribution chain. This would be a mistake, at least in the medium-term. The distribution of music as physical goods (i.e. CDs) should still be an important part of the industry's revenue streams for a long time. Some customer segments will always prefer to buy CDs or tapes in a store rather than via download. Others will still enjoy the pure experience of going to a record store, assuming that these stores can steal a page from bookstores and enhance the customers' shopping experience with amenities such as coffee shops, listening or sampling booths, improved selections, special events, and customer clubs and cards.

It is also conceivable that a customer can order a CD from a terminal in a store and have the CD produced on-site. The same concept is already feasible for the in-store printing and binding of books, and stores hope that this can reduce their inventory costs while at the same time expanding their selection.

The Internet will force companies to cooperate in order to generate enough content to attract large user communities.

The music industry must avoid doing anything that neglects or antagonizes its established distribution. Companies will have to find ways to manage their channels effectively, that is, to adjust them to target segments. While youngsters will tend to download their files, most of the older consumers can be expected to still buy CDs. In order to strengthen the appeal of a channel to its target segment, some pieces of music may even be reserved exclusively to either one of the channels.

This is where exclusive bonus tracks could play an important role. A company could, for example, offer a special CD of Beethoven's Ninth Symphony played at the Vienna Festival only in certain channels such as specialty record shops or general retailers.

What the companies need to do now

No matter what the solutions to product development, pricing, and channel management look like in detail, the deal between Bertelsmann and Napster will be a crucial step for online music distribution. But it is only a starting point. The Internet will force companies to cooperate in order to generate enough content to attract large user communities. Bertelsmann seems to have recognized the need for cooperation by not restricting the Napster deal to its own stable of artists at BMG. Other companies will have to move fast to join the alliance.

Otherwise, the next Napster will hit the market. File-sharing software like Gnutella does not need a centralized server. It doesn't even need a "company" between the users. In other words: there will be no one to take to court this time. The measures that helped to stop MP3.com will prove useless here. Once a software like Gnutella gets a grip on the mass market, it will be virtually unstoppable for the industry, turning the record companies online dream into a headache at best, a nightmare at worst.

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That's why the companies had better rush to get their act together. To succeed, they need to:

1. **Know their markets.** Online customers will differ from their offline relatives but just speculating about the future customer is not enough. Valid data will be crucial. Sophisticated research with state-of-the-art multivariate methods will provide indispensable insights that can be turned into a long lasting strategic advantage.
2. **Focus on premium quality offers.** Value for money. It's as simple as that. Premium products are an absolute must for the new services, because reliable, first class quality is the one thing file-sharing pirates will never be able to deliver consistently.
3. **Look beyond the obvious!** The sale of music online is nearly constraint-free. It forces the music industry to think beyond its established borders and look for new products and services (bundles, additional services) as well as new partners (ISP's, mobile phone companies).
4. **Work out sound business models.** We're talking about a multi-billion dollar market at stake. This calls for a little more sophistication than a mere subscription fee. A huge part of the potential profits will be generated by utilizing advanced pricing tools like stretch discounts. Neglecting those tools means sacrificing those profits.
5. **Start with the most promising segments.** Not every customer segment has to be served from the start. In order to get on the fast track to profitability, companies need to focus on the very few segments that hold a large enough potential to reach the critical mass that justifies large investments.
6. **Protect existing channels.** No matter how bright the online future looks: today's rent is paid with the money made in the good old CD stores. It's going to remain that way for quite a while. Companies have to keep an eye on their established distribution channels. Savvy companies will integrate online and offline distribution, thereby turning a threat into a win-win situation.

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