

IFPI:07 Digital music report



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Digital Music In 2007 – A Brave New World



John Kennedy, Chairman & CEO, IFPI

The record industry today has evolved into a digital thinking, digitally literate business.

In 2006, we saw internet advertising revenues increase to the stage where they will shortly overtake radio advertising revenues. We saw newspaper headlines talking about the four lap-top home. In 2006, we learned that some of the online business will be about micro transactions where a million dollars of revenue can be the result of 57 million transactions! And, most of all, we learned that this is a market that is evolving not only on a daily basis but with regular revolution in the market to add spice to the evolution. Frequent surprises in the market are also matched by an air of expectation, and in 2007 that has borne fruit with the iPhone, which should herald a shake up of the mobile music market. This is a market where the learning curve changes direction on a regular basis!

The pace of transformation in our industry is breathtaking, but at the moment the holy grail is evading us. I would like to be announcing that a fall in CD sales is being compensated for by an equal or greater increase in online and mobile revenues. But that is not yet happening on a global basis.

The digital music business continues to grow. Trade revenues in 2006 doubled to about US\$2 billion – around 10 per cent of our sales. By 2010 we expect at least one quarter of all music sales worldwide to be digital.

Some commentators have expressed concern about the pace of annual growth. Yet we never claimed it would double every year and the rate of growth that we are seeing today would be considered wonderful for many businesses.

However, there is correctly a certain amount of nervousness around. This is sensible; there is certainly no room for complacency. We are all troubled by the research that suggests the number of new tracks purchased per MP3 player is low, and yet at the same time digital music is hitting new milestones. It has helped the singles business to its best year ever, revived genres like classical and is regenerating formats like music video. It is spreading internationally. New markets like China, that have been historically closed to legitimate business by ruinous levels of piracy, are offering the prospect of a “leap to digital”.

The chief winners in the rise of digital music are consumers. They have effectively been given access to 24-hour music stores and services with unlimited shelf space. They can buy or consume music in new ways and formats – an iTunes download, a video on YouTube, a ringtone or a subscription library. To cap it all, *Time* magazine crowned the internet user as their person of 2006.

We are still in a period of innovation and experimentation. Some believe the subscription model won't work and others believe it is the industry's brightest hope for the future. However, the subscription model cannot be properly tested whilst there are interoperability issues to resolve.

The market remains a challenge. Other industries are struggling with the same problems we have had to live with. The film industry is increasingly suffering from online piracy, and the newspaper industry is facing a slump in sales triggered at least partly by behaviour on the internet.

As an industry, we enforce our rights decisively, and this will continue. In 2006, we had significant legal victories, led by a US\$115 million settlement against Kazaa. We were told we could never track down such offenders on the internet. We were told they would hide in places where we could not find them!

We have taken some 30,000 actions against illegal file-sharers globally and, as the research in this report shows, these actions clearly work. Illegal file-sharing in Europe was contained last year against a 30 per cent increase in broadband household penetration.

However, actions against individual uploaders are onerous and expensive and we shouldn't have to be taking them. That job should not be ours – it should be done by the gatekeepers of the web, the Internet Service Providers (ISPs), who unquestionably have the technical means to deal with copyright infringement, if only they would take responsibility for doing so.

At one time you were considered a new media philistine if you wanted to regulate the internet. But then Google promised the Chinese government that censorship was possible. Then Google blacklisted BMW in the internet world for anti-social behaviour. It seems policing is acceptable for all sorts of things but not intellectual property!

With cooperation from ISPs, we could make huge strides in tackling content piracy globally. Disconnection of service for serious infringers should become the speeding fine or the parking ticket of ISP networks. We need government help to make it clear that ISPs must face up to their responsibilities and cut off copyright infringing users. To be fair, at the end of 2006 the UK government signalled that it may be prepared to play a facilitating role in this and set a deadline of December 2007 for tangible progress.

What does John Kennedy wish for 2007? He hopes politicians who talk about the importance of the Knowledge Economy come up with actions to match their words. For an internet lifetime we have heard that the Knowledge Economy is the future. With manufacturing economies lost to many governments, there is an acknowledgement that in the future we are going to be more reliant on the creative industries for employment, tax revenues, overseas earnings and general economic growth. The rhetoric is wonderful but is simply not matched by deeds. Let's hope that will change in 2007. The music industry is still an exciting, innovative and vibrant industry, but there are no easy wins and everyone involved knows that in 2007 we must all strive even harder for that holy grail that I referred to earlier.

To end on a high note however. Doug Morris, as CEO of Universal Music, the largest recording company, has announced that he expects 2007 to be Universal's most successful financial year ever. That's an encouraging signal to send to the gloom merchants and a motivational message for his employees and his competitors!

Consumers Shape The Future Of Recorded Music



Consumers are changing the ways they discover, access and listen; copyright remains key to the digital music business.

New digital delivery channels are driving music consumption to its highest-ever levels as consumers demand access to music in more ways than ever.

Digital music has empowered the music fan. The popularity of single track buying, the growth of mobile music and the rising demand for music video on the internet exemplify this. The past year has also seen a surge in user-generated content on social networking sites such as MySpace, Bebo and YouTube – a new way for record companies to legitimately bring their music to the public if they can successfully control widespread copyright infringement, and a great opportunity for independent labels to showcase their talent.

Digital music is still in an early phase of development. In 2006 record companies explored new and different revenue streams. Examples of these included advertising-supported online services and shared revenues from the sale of portable digital devices. Record companies are continuing to focus on what they do best – discovering, marketing and licensing great music – using all the digital tools at their disposal to help them compete for a share of the market. Digital is also opening up potential in countries blighted by physical piracy. International teams at record companies are extending digital operations into China, India, Russia and Eastern Europe.

However, digital music has not yet achieved its holy grail: growth has not offset the fall in CD sales. The recording industry's single



greatest challenge is the widespread unauthorised availability of its product for free. Digital piracy and the devaluation of music content is a real threat to the emerging digital music business.

This report outlines the ways in which the recording industry is responding to the consumer and building a digital business. It also identifies the problems faced and where the music sector needs action by government and by industry partners to tackle piracy and prevent the undermining of its intellectual property rights.

Highlights Of 2006

Record companies' digital music sales are estimated to have nearly doubled in value in 2006, reaching a trade value of approximately US\$2 billion. The split between online and mobile remains fairly equal, but varies substantially across markets. Digital sales are estimated to have grown from 5.5 per cent in 2005 to around 10 per cent of industry sales for the full year 2006.

Single track downloads are estimated to have totaled 795 million in 2006, up 89 per cent on 2005. Single track downloads

and masterfiles remain the main digital music formats, but other formats, such as mobile downloads, digital albums, music videos and ringback tones all saw healthy growth.

The number of tracks available online doubled to reach over four million on leading services in the last year.

There are 498 online music services available in over 40 countries, offering consumers a wide variety of choice and great value.

Portable music players are helping drive digital music consumption.

Portable player sales totalled around 120 million in 2006, an increase of 43 per cent on the previous year (Understanding and Solutions). Portable player owners are more likely to buy music legally than general internet users; but the amount of purchased music stored on devices is still low.

New revenue streams and business models emerge. Social networking

sites exploded in popularity while advertising-supported models such as video licensing on Yahoo! Music and MSN emerged as a potentially exciting revenue stream for record companies.

Law suits are having an impact.

Recent research from analysts Jupiter shows that illegal file-sharing in Europe has been contained in the last year, in the context of a 30 per cent increase in broadband household penetration.

Global Digital Music Market In Figures (millions)

	2005	2006	Change
Broadband lines	209	280	34%
Song catalogue online	2	4	100%
Single tracks downloaded	420	795	89%
Subscription service users	2.8	3.5	25%
Mobile subscriptions	1,817	2,017	11%
3G mobile subscriptions	90	137	52%
Portable player sales	84	120	43%

Sources: IFPI, PWC, M:Metrics, Understanding & Solutions

"As we continue our transformation from a 'songs-and-records' company into one that delivers a wide variety of rich, music-based content on multiple platforms, our experience has shown that the key to harnessing the vast digital opportunity is ensuring innovation remains our guiding principle. We always work towards establishing strategic partnerships, pioneering new products and exciting user experiences within a framework that recognises the needs of consumers alongside the rights of copyright holders, and we believe that is the best way to ensure that legitimate music services are first-choice for fans."

Patrick Vien, Chairman and CEO, Warner Music International

Digital Market Overview In 2006



The digital music sector is expanding internationally, but individual markets are developing in different ways.

Digital music sales are estimated to have almost doubled in value worldwide in 2006, reaching an estimated trade value of around US\$2 billion. Digital channels accounted for an estimated ten per cent of music sales for the full year 2006, up from 5.5 per cent in 2005. The global split between online and mobile sales remained fairly equal worldwide, but varies substantially across markets.

Key Year For Mobile Music In The US

Single track downloads in the US totalled 582 million in 2006, up 65 per cent compared to 2005 (Nielsen SoundScan). Digital albums now account for six per cent of all album sales in the US and grew faster than single tracks in 2006, although from a small base.

iTunes, the leader in online downloads, has sold over two billion tracks since its launch in April 2003 and more than one billion in 2006 alone. In November 2006 it expanded its operations in the US to include a mini-store dedicated to Latin music and entertainment including music, videos, television shows, audiobooks and podcasts.

2006 was a key year for mobile music in the US and this continued in 2007 with the much-anticipated Apple's iPhone. Sprint launched the first full track download-to-mobile service at the end of 2005 and has sold over ten million tracks in since. Verizon followed suit, launching a service in the beginning of 2006. Mastertones are still the main mobile music format in the US, but ringback tones and single track sales are growing.

Cingular announced its mobile music strategy in November 2006 and became the first US operator to provide a mobile platform to online music services such as Napster, eMusic and Yahoo! Music. It will also be the operator carrying the iPhone when it goes live in June 2007 in the US.

Digital Diversity In Europe

European markets account for around 20 per cent of global digital sales. Despite strong growth in most countries, digital sales in Europe remain concentrated in the top markets – UK, France, Germany, Italy and Spain. Overall, digital channels accounted for six per cent of total music sales in Europe in the first half of 2006, lower than the estimated global average.

Less developed promotion and marketing of digital music services and lower broadband penetration in the smaller markets are factors in the slower development of the online music market in some parts of Europe. However markets such as the UK have seen strong growth.

The mobile music market in Europe is developing steadily. The cost of data-transfers is high compared to Asia and third generation '3G' technology is not widespread across the region. This is contributing to the slower development of advanced mobile music services in some European markets.

Europe is, however, very well provided with online digital services, with a more diverse mix of retailers than in the US. According to IFPI's tracker, there are currently 320 online music services in Europe and 20 available in more than one market.

There were 53 million single track downloads in the **UK** in 2006, double the number in 2005. Digital album sales have reached 2.2 million since the Official Chart Company (OCC) started tracking the figure in April 2006. The UK has also the highest proportion of regular online buyers in Europe, currently at eight per cent of internet users, up from four per cent in 2005 (Jupiter Research).

Mobile operator '3' leads the mobile music market in the UK, with a 70 per cent share of 3G subscriptions and 75 per cent of all mobile music sales ('3'). '3' makes up about 25 per cent of all chart-eligible download sales in the UK. The company upgraded its MusicStore in October 2006 to include faster searches and over 500,000 tracks available to download to PCs or mobile phones. 3MusicStore is powered by Groove Mobile and 24/7 MusicShop.

The **German** digital market is estimated to have seen modest growth in 2006. Single track downloads are believed to have reached 24 million, up from 19 million in 2005. Widespread availability of unauthorised music in the form of P2P file-sharing, stream ripping and CD burning are clear obstacles to growth of legitimate music services. Consumer reluctance to make online payments via credit card and the lack of interoperability are also having an impact.

US Digital Music Market (millions)

	2005	2006	Change
Broadband lines	43	57	31%
Single tracks downloaded	353	582	65%
Album downloads	16	33	101%
Mobile subscriptions	174	194	11%
3G mobile subscriptions	3	15	448%

Sources: IFPI, Nielsen SoundScan, PWC, M:Metrics

European Digital Music Market (millions)

	2005	2006	Change
Broadband lines	68	94	39%
Single tracks downloaded	62	111	80%
Mobile subscriptions	622	656	5%
3G mobile subscriptions	6	27	440%

Sources: IFPI, Nielsen SoundScan International, PWC, M:Metrics



In **France**, iTunes is the leading online service, followed by Virgin Mega and Fnac, although mobile sales dominate the market. New launches of subscription music services took place in 2006. eMusic launched in September and Fnac extended its service in November to include a subscription option (FnacMusic Illimité), offering a catalogue of one million tracks costing €9.99 per month at the end of the year.

In the mobile music sector, in December 2006 Musiwave and French mobile operator SFR announced quicker download times for over-the-air downloads, as well as enhanced dual-delivery options, a simpler purchasing interface, better streaming and previewing. Full-track prices also dropped to €0.99 from €1.99. SFR reported sales volumes of 300,000 tracks per month at the end of 2006, a number the company hopes to boost to one million.

Mobile music also accounts for the majority of digital sales in **Italy** and **Spain**. Advanced music handsets are noticeably more popular in Italy than in the rest of Europe. Italy is the third biggest mobile music market in Europe after the UK and France, but has the biggest single track download market in Europe, due to higher 3G penetration, operator marketing and Italian consumers' enthusiasm for entertainment on mobile phones. Rampant piracy in Spain has limited the growth of the digital business there.

Asia Leads In Mobile Music

Consumers in Asia have taken to mobile music in their millions in 2006, supported by the ongoing roll out of 3G networks and rich media content such as full audio and video tracks delivered wirelessly to handsets. Asia accounts for 25 per cent of global digital sales, led by Japan, South Korea, China and Indonesia.

Mobile music accounts for an overwhelming 90 per cent of **Japan's** digital sales and growth in the sector remained strong in 2006, pointing to a mature but not yet saturated market. Japan has an advanced 'mobile culture' with high penetration of advanced phones and 3G.

Mastertones are still the most popular mobile music format in Japan, but record companies are creating new multimedia packages for consumers. Full track downloads grew strongly in 2006 and already represent over a third of mobile music revenues (RIAJ). NTT DoCoMo, the biggest mobile operator in Japan, began selling full track downloads to mobile in June 2006, following KDDI and Sofbank. Full length video downloads to mobile also showed potential in 2006, with sales predicted to rise further in 2007 as device capabilities continue to improve.

Online music sales in Japan more than doubled to an estimated 22 million in 2006, after iTunes Japan launched in August 2005. Other key players include LabelGate-backed services Mora, HMV, Listen and Napster – the first online subscription service to launch in Japan (October 2006).

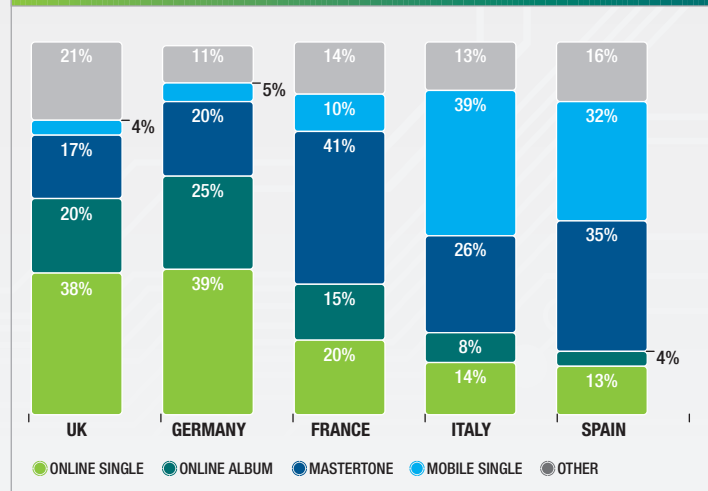
Spotlight: Korea's MelOn

South Korean SK Telecom's MelOn was one of the first services to embrace the concept of ubiquitous music use, offering over 800,000 tracks any time and anywhere for consumers to enjoy on the PC, mobile phone or MP3 player. For a monthly flat rate of around US\$5 SK Telecom customers can stream and download music online or via mobile, as well as reproduce their songs without limitations, as long as the monthly subscription is maintained. All tracks are protected by digital rights management.

SK Telecom has over 20 million subscribers and music has become its biggest grossing data service. As of early June 2006, MelOn had nearly 4.5 million users, with 15 per cent of those on a flat-rate subscription. According to SK Telecom, the site ranked first among South Korean paid music sites in terms of revenue.

Mobile music has also attracted fans in **India**, which is one of the fastest growing wireless services market in the world. Some 55 million handsets were sold in 2006, up 71 per cent from 2005 (Consumer Electronics Association). Soundbuzz launched India's first full song and video mobile download service in May 2006. The Indian industry has grown since then to 10,000 over-the-air full song downloads per day across all mobile carriers, according to Soundbuzz.

Digital Sales Value By Format



Source: IFPI, first half 2006

“We are encouraged by the growth of online and mobile music sales, as well as by our success in developing a variety of new business models, including ad supported video distribution on the internet. As our physical revenues continue to decline, we need to proactively continue to build digital growth and identify new digital opportunities that further extend the reach of our artists.”

Thomas Hesse, President, Global Digital Business, SONY BMG Music Entertainment



“2006 was an enormous year for Universal Music internationally and, therefore, the industry. We saw huge growth in all our digital businesses, spurred by a wide range of partnerships. Universal Music will also continue to deliver when it comes to signing and breaking the best artists. Just as importantly, don’t forget the consumers. Ignore them at your peril, as the future of music lies in their hands!”

**Lucian Grainge, Chairman and Chief Executive,
Universal Music Group International**

South Korea stands out as an extraordinary digital music market, the second largest in Asia and the only one where digital sales have overtaken physical sales of music. Digital music represented 57 per cent of South Korea’s music market in the first half of 2006.

South Korea has seen exploding demand for advanced mobile handsets. Mobile carriers estimate sales of ten million music player-equipped phones in 2006. Streaming is the most popular digital music format in South Korea, closely followed by full track downloads.

Mobile operators are the key to the digital market in South Korea, offering integrated online and mobile services such as MelOn (SK Telecom), Dosirak (KT Freetel) and MusicOn (LG Telecom). In May 2006 Warner Music Korea announced a new joint venture with mobile operator SK Telecom, an example of the growing importance of mobile phones for buying, storing and listening to music.

There are also constraining factors in South Korea. For example, the proprietary digital

rights management systems used by mobile operators are limiting consumers’ ability to transfer music.

Australia saw strong growth in digital sales in 2006, although from a small base, following the launch of iTunes in August 2005. Online and mobile sales are equally split in Australia. iTunes also launched its 22nd Music Store in **New Zealand** in December 2006 with two million tracks including a range of local acts.

Latin America Shows Promise

The Latin American digital market is still in its infancy, limited by low broadband penetration, resistance to online credit card use and high levels of piracy. However, several markets are showing promising progress. Broadband and mobile penetration is rising fast in Brazil, Argentina and Mexico and marketing of legal online services has intensified alongside a campaign for combating digital piracy.

In **Mexico**, online downloads topped nine million units up to the third quarter of 2006 – 15 times the volume registered during the same period in 2005. In spite of this growth, digital sales remain concentrated in mastertones and pre-loaded music to mobiles – growing revenue streams for record companies in the absence of fast 3G networks or high penetration of MP3 capable phones.

In **Brazil**, two major legal sites were launched in mid-2006 (Terra and UOL) adding on to the more established iMusica. There are now 20 websites offering legal downloads in the country. More than 90 per cent of all digital sales are made as mobile downloads, the majority of them mastertones.

Argentina is also showing a steady growth in digital sales, which quadrupled in the year to July 2006. Some 80 per cent of all digital sales are currently made as mobile downloads.

China: The Leap To Digital?

China has a small digital music business but, with over 430 million mobile subscribers, fast-growing broadband and potentially massive consumer demand, the country has the potential to throw off historically ruinous levels of physical music piracy and make the “leap to digital”.

Whether China does succeed in harnessing digital channels for a new vibrant legitimate music market very much depends on how seriously a commitment the country and its key operators will make to protecting and enforcing intellectual property rights. The recording industry supports the US Government’s moves to raise the pressure on China, if necessary via the WTO, to ensure effective enforcement of intellectual property rights.

In late 2006, the legitimate online music sector in China suffered a setback when a Beijing court failed to rule against the biggest unlicensed free music service, Baidu – which is also China’s biggest internet search engine. IFPI is appealing against that judgment, which is out of step with court rulings against similar so-called “deep link” music sites in China and across the world.

Record companies in China say Baidu has been the biggest stumbling block to persuading consumers to pay for licensed music downloads.

In South Korea and Taiwan, the closure of infringing peer-to-peer services Soribada, Kuro and Ezpeer by court judgments or settlements has benefited the legitimate market.

Despite the setback, record companies are working hard to develop a digital business in China, partly modelled on digital success in South Korea. There is clear evidence that Chinese consumers are prepared to pay for music via digital channels, particularly via mobile platforms.

The CEO of China Mobile, the country’s dominant mobile operator, said that a single song was downloaded 15 million times on his network over six months, a rate 15 times higher than a typical best-selling CD.

A handful of online music sites are licensed by major and independent record companies, including QQ, Top100.cn and Aigomusic.com.

Digital Diversifies Consumer Buying Habits



Music fans have embraced digital singles and videos.

Single Track Downloads Move Ahead

Many consumers have discovered the benefits of the digitally unbundled album. This has taken global singles sales volumes to an expected all-time high in 2006. Overall single sales in physical and digital formats reached over 900 million units in 2006 – with digital accounting for over 80 per cent of that figure (IFPI). In the US, Canada and South Korea digital sales completely replaced the physical singles market.

Popularity Of Music Video Grows

Although DVD music video sales peaked in 2004, the format is now beginning to see the positive impact of digital delivery. Music video accounted for three per cent of total digital revenues in the first half of 2006. From January 2007 video downloads will count towards the singles charts in the UK – an indication of the commercial impact music video now has. Music video is also helping fuel the growth of advertising-supported business models.

Music video has taken off in particular as value-added content on platforms such as Yahoo!, YouTube and MTV. For example, Yahoo! shares its advertising revenues with some record companies on a per-stream basis.

YouTube, a largely unknown start-up in late 2005, became the largest video sharing site on the web by mid-2006. YouTube receives



OK Go – Here It Goes Again

some 65,000 new video uploads per day from individual users to add to an existing catalogue of well over ten million. Each day some 100 million videos are streamed to over six million viewers – nearly half of all the videos streamed on the web.

With music video at the forefront of YouTube's service, first Warner and then other record companies have embarked on a series of licensing deals with the service, although there are still some concerns over copyright issues.

Music Videos: New Channels Encourage Innovation

Music video looks set to thrive over the next few years – something that is driving a creative resurgence in the format.

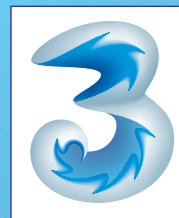
● **Beck** personally shot a video for every one of the 15 tracks on his latest album 'The Information' and describes the video collection as "a visual version of the album for the internet".

● **Good Charlotte** plan to film two sets of videos to coincide with their 2007 album release: one for TV and a set of "underground" shorts for mobiles and web-based services like YouTube.

● Rock band '**OK Go**' scored the biggest hit of their career with the video 'Here It Goes Again'. The video was viewed by over one million people on YouTube in the first six days. As of November 2006 the video had been viewed nine million times, becoming the eighth most viewed video on YouTube.

● **Hard-Fi** cut an exclusive made-for-mobile edit of their video for the single 'Cash Machine' for UK mobile music store '3'.

Music Video – A Digital Hit



UK mobile operator '3' first launched its music video jukebox service in 2004, offering consumers a selection of the latest music videos to enjoy on the move. '3' has

sold over 25 million music videos to date, making up almost half of its total music revenues. Combined audio and video sales on the '3' network now surpass one million units per month. The company claims second place in the UK digital music market, behind iTunes, with a 20 per cent share.

Buyer behaviour reported by '3' on its network offers some insights into how mobile music creates new opportunities for record companies. Music sales peak at around 10 p.m. and many customers buy tracks while travelling on public transport. This represents a brand new sales window for music. One in three of '3's sales are from customers between the ages of 18 and 24, demonstrating that young people will buy music, if it is presented to them in the right way.

"In this internet age, the consumer is using music content more than ever before – whether that's playlisting, podcasting, personalising, sharing, downloading or just simply enjoying it. The digital revolution has caused a complete change to the culture, operations and attitude of music companies everywhere. It hasn't been easy, and we must certainly continue to fight piracy in all its forms. But there can be no doubt that with even greater commitment to innovation, and a true focus on the consumer, digital distribution is becoming the best thing that ever happened to the music business and the music fan."

Eric Nicoli, CEO EMI Group

Music On Mobile Grows In Popularity

Mobile music is helped by impulse buying and a well-established payment infrastructure.

High Demand For Music On The Move

Ringtones were the first mass market mobile music product to offer phone personalisation to music fans. Consumers are now moving away from traditional ringtones to mastertones/real or true tones – ringtones that feature the original sound recording – and full track downloads to mobile.

Research carried out by UK mobile operator '3' in September 2006 shows that consumers want to own music on the spot. Some 76 per cent of respondents aged between 16 and 24 said that when they heard a track they liked they wanted to own it straight away.

Mobile music benefits from the fact that mobile music services have payments integrated with consumers' mobile bills. This helps particularly among the younger demographic, where credit card ownership is limited.

Music Phones Catching On

The handset revolution has played an important role in developing the mobile music market, with audio/video-supported handsets becoming the norm. Leading handset manufacturer, Nokia, sold 80 million music phones in 2006, double the number in 2005. Meanwhile, Sony Ericsson is reportedly selling over one million Walkman phones per month.

Urban Music Popular on Mobile

Fans of urban music in particular appear to be driving mastertone sales in the US. Almost half of US rapper T-Pain's 'Rapper Ternt Singa' sales came through mastertones, as did 38 per cent of Cassidy's 'I'm a Hustla' and 31 per cent of Bow Wow's 'Wanted' revenues. Rock and pop acts, by contrast, seem to generate more digital sales through online channels.

For all the popularity of music-capable mobile phones, the digital market is a long way from a single all-function portable device. New research from IFPI/M-Lab⁽¹⁾ in November 2006 shows that less than 10 per cent of portable player owners in Europe use their mobile phones as their main portable music player.

The move to convergence was boosted in early 2007 as Apple announced the launch of the much anticipated iPhone. It will be available exclusively through the operator Cingular in the US by June 2007, and then rolled out to Europe and Asia

In October 2006, Nokia launched its dedicated music brand XpressMusic featuring the new Nokia 5300. The handset can store 1,500 tracks, supports all major music formats (MP3, AAC and WMA), and has dedicated music buttons and FM radio. Nokia will launch a music store to tie-in with its massive global handset distribution, aiming to be the market leader in digital music distribution 'within five years'.

Sony Ericsson also expanded its Walkman music phone line, launching the W830i with a storage capacity of up to 1,000 songs, an advanced Walkman 2.0 music player, music recognition function, FM radio and enhanced audio quality.

1 Sample 2,249 portable player owners in the UK (iPod owners only), Germany and France.

3G Sees Limited Growth

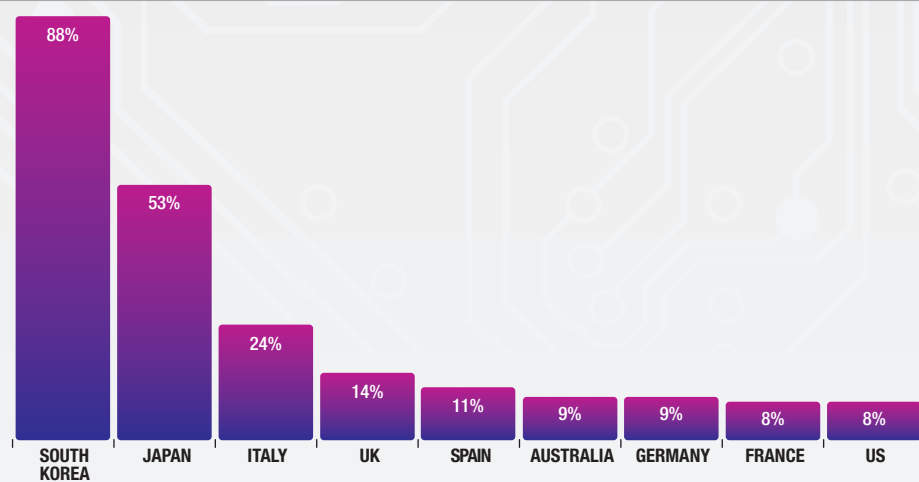
Third generation mobile technology (3G) is crucial for the development of advanced music-to-mobile services such as full track and video download services. It allows for fast downloads of full tracks to mobile as well as video services and streaming. While penetration in Asia is already high, levels in Europe and in the US are lagging behind.

Establishing New Music Formats: Ringback Tones

Ringback tones exemplify the varied new uses of music via digital channels. Ringback tones are songs a caller hears while waiting for their call to be picked up. They have proved very successful, now accounting for approximately three per cent of global digital sales. This share rises to a much higher level in markets like China. Consumers in Europe have not adopted the format as readily, but sales in the US are growing strongly.

Ringback tones are also promoting new music in a new way. Universal's new signing 'Samsons', for example, has become the biggest act in Indonesia following sales of over two million ringback tones.

3G Penetration (% mobile subscribers)



Sources: M:Metrics, IFPI (Korea, Japan, Australia)



Most popular music phones in 2006.



France	Italy	Spain	UK & Germany	US
Samsung D500	Nokia 6630	Motorola V360	Nokia 6230i	Motorola RAZR V3
<ul style="list-style-type: none"> ● MP3 player – stores up to 20 songs ● Video player – stores up to one hour of footage ● 1.3 Megapixel camera – stores up to 1,000 photos ● Bluetooth ● E-mail ● 96MB internal memory 	<ul style="list-style-type: none"> ● 3G ● Realplayer – download and play music & video files ● MP3 player – plays MP3 & AAC files ● Video capture & playback – up to one hour per clip ● 1.3 Megapixel camera ● Bluetooth ● E-mail ● 10MB internal memory plus removable 63MB Multi Media Card 	<ul style="list-style-type: none"> ● MP3 player – plays MP3, AAC & WAV files ● Video capture & playback ● VGA Camera ● Bluetooth ● E-mail ● 5MB internal memory plus up to 512MB removable memory slot 	<ul style="list-style-type: none"> ● MP3 player – plays MP3, AAC & M4A files ● Video capture & playback ● 1.3 Megapixel camera ● Bluetooth ● E-mail ● 32MB internal memory plus up to 512MB Multi Media Card 	<ul style="list-style-type: none"> ● MP3 ringtones ● Video capture & playback ● VGA Camera ● Bluetooth ● E-mail ● 5MB internal memory

Source: M:Metrics



“We see the trend in the player market moving away from single purpose devices towards multipurpose, and more importantly, connected devices. This trend will enable hundreds of millions of people to have their music collections with them, as well as to download and enjoy digital music on their mobile device. Nokia’s leadership in this area means we can offer a compelling mobile music experience combining devices, content and connectivity.”
Ed Averdieck, Managing Director, Nokia Music Service

Emerging Business Models

2006 saw the development of a competitive digital music market with a mixture of different business models.

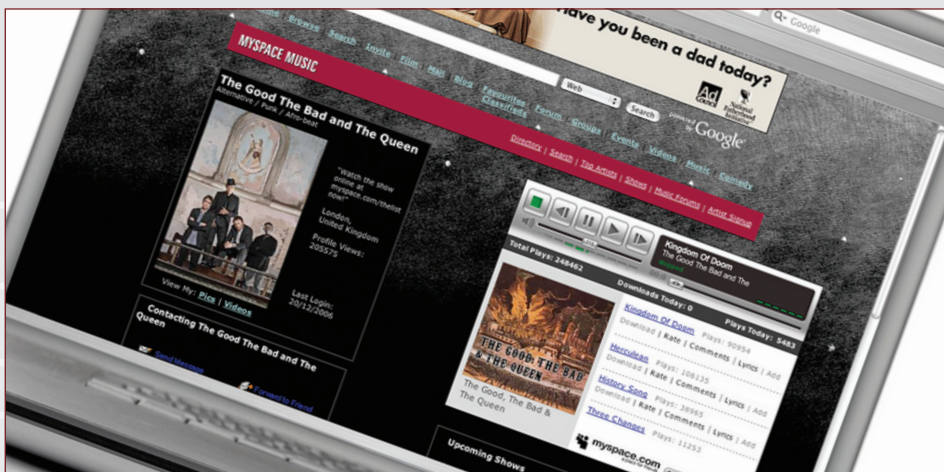
Social Networks: Licensing And Partnerships Develop

Social networks and user generated content made a major impact on digital entertainment in 2006 and represent an opportunity despite copyright concerns. Social networks have been around for several years, but really came to worldwide attention with the growth of MySpace, famously acquired by News Corporation.

User generated content is booming through networks such as MySpace, Bebo and YouTube. The latter has declared an ambition to host every single music video ever made on its site and was acquired by Google in late 2006. Other social networks have exploded in particular markets – Orkut in Brazil and India, QQ in China, muvee in Singapore, Mixi in Japan and Cyworld in South Korea. MySpace launched a Japanese version in partnership with telecoms group SoftBank in November 2006.

Social networking sites are potentially a great opportunity for the music industry. These sites reach a huge community of music fans, offer new ways of marketing music and selling tracks, albums and videos. They also can help the industry discover new artists. Some bands have even begun holding 'virtual only' concerts; Ben Folds launched his album 'supersunnyspeedgraphic, the LP!' by throwing a virtual launch party on 3D virtual world "Second Life" in October 2006, while Damon Albarn's new project "The Good, The Bad and The Queen" threw an exclusive MySpace gig in December 2006.

Several record companies have licensed YouTube on the basis of identifying copyrighted works posted by users as well as providing content. Yet at the same time social networking sites raise important copyright concerns. Their technological innovations should never become an excuse for them to practice massive copyright infringement. These networks must respect copyrighted content and ensure there are filtering tools in place for that. Record companies are looking to embrace social networking sites, but this should not be at the expense of compromising their copyright and that of artists and songwriters.



Advertising-Supported Services Set To Make An Impact In 2007

Advertising-supported services created a buzz in 2006 and became a new revenue stream for record companies, as advertisers continue to divert their budgets from conventional TV, radio and print to the internet. The internet accounted for six per cent of global advertising spend in 2006 (Zenith Optimedia). Internet advertising is forecast by Forrester Research to overtake traditional radio advertising in 2010. Music is playing a key role in this change.

In the US, Napster's ad-supported service 'Napster Free Player' allows users to stream songs from its catalogue of two million tracks for free up to three times, before being directed to a purchase or asked to subscribe to a Napster paying service. Yahoo! Music partnered with EMI in December 2006 and offers an ad-supported music video service to European customers. The service allows for free access to videos while supported by targeted advertising.

In the UK, Yahoo! Music offers over 6,500 free videos.

Other services offering ad-supported legal downloads of audio and video content are expected in 2007. One of the most high-profile, Spiralfrog, signed deals with Universal Music Group, KOCH Records and EMI Music Publishing.

Another ad-supported service, Qtrax, is set to launch in 2007 and offers 'tethered downloads' in the proprietary 'mpq' format that can only be played a limited number of times. Qtrax offers click-to-buy purchasing or a flat monthly fee to upgrade to a premium subscription service that provides unlimited downloads in the Windows Media format.

Ad-supported services are also expanding via mobile platforms. In April 2006, EMI partnered with Rhythm New Media, a US mobile advertising company, to trial an ad-supported mobile video service in the US. The service offers free mobile video with TV-style ads embedded in a highly targeted fashion.

“We need to legitimise consumer behaviour without asking them to change their usage habits. Advertising funded services offer such a solution. But to succeed they need support from content owners, advertisers and the financial community, as well as a critical mass of users. SpiralFrog was set up from the start to address these criteria.”

Robin Kent, CEO, SpiralFrog



Record Company 'Direct-To-Consumer' Channels Emerge

Record companies have also rolled out their own video and music-streaming services to consumers. Sony BMG announced Musicbox Video, featuring free content from its roster of artists. Visitors can view full length videos, share streams with friends or embed content in their own websites. Universal partnered with video delivery platform WWEBNET to launch MusiVidz, offering a broadcast network featuring videos from a wide range of Universal artists.

Both services will ultimately offer artist interviews, live performances and 'behind-the-scenes' footage. The launches indicate early developments in direct-to-consumer initiatives by music companies.

Subscription Services Wait For Wireless And Interoperability

Music subscription services such as Rhapsody, Napster and eMusic now reach 3.5 million consumers worldwide, growing by 25 per cent in the last year, with the majority of subscribers located in the US. Music subscription services accounted for seven per cent of digital revenues in the first half of 2006.

Subscriptions offer enormous customer value and work exceptionally well with wireless home entertainment systems such as the Sonos Zone Player – a wireless system that allows music to be played in every room of the house regardless of where the music collection is stored.

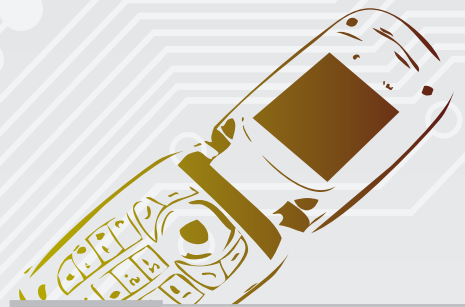
"Music subscription services have experienced tremendous growth, but are constrained by closed hardware and the absence of a healthy compatible device market. Over the next few years, subscription services will go from a very small market in portable devices to having the ability to attach to hundreds of millions of cell phones. 2007 will mark the beginning of this transformation."
Chris Gorog, CEO, Napster

Some services are expanding their offers to mobile platforms as well. Napster partnered with Japanese mobile operator NTT DoCoMo and plans to expand its mobile offer in Europe in partnership with O2.

Subscription services are seeing modest market growth. Portable or 'To Go' versions of subscriptions have suffered significantly from lack of compatibility with the dominant portable music player, the iPod.

Subscription services also appear not yet to have met consumers' demand to 'own' their music, with most services offering unlimited music only as long as the subscription is live.

Launched in Europe in September 2006, eMusic is a subscription based service that seeks to address this by allowing an allocation of permanent downloads in an unprotected iPod compatible format for €9.99 per month. Its catalogue is composed of over two million songs from independent record companies. eMusic announced that it had achieved some 20,000 subscriptions during its first two months in Europe and has reported a global user base of 220,000.



"The success of eMusic in Europe and around the world shows that consumers are eager for a digital music service that focuses on music beyond the commercial mainstream. By offering customers well-priced, expertly curated adventurous music that they can own in the universally compatible MP3 format, we've shown you can sell a lot of it. This combination has helped eMusic become the world's number two digital music service and sell more than 100 million downloads in three years."
David Pakman, President and CEO, eMusic

Social Networking – A New Tool For A&R?



Social networking sites are impacting on record company artist and repertoire (A&R) work and marketing but are not a panacea. Rather they are being used by record companies in conjunction with more traditional practices like promotion, public relations and plugging.

Darcus Beese, A&R executive at Island Records, says social networking sites are impacting the way he does his job, but that they sit alongside rather than replace traditional ways of discovering and marketing artists. Artists like Arctic Monkeys and Lily Allen have gained popularity through social networking sites, albeit as part of marketing campaigns that also involve mainstream media.

He argues that social networking sites are also "just another tool" to be used to bring new acts to the public, asserting that someone with the talent and charisma of Lily Allen would have come to prominence whether MySpace had existed or not.

Beese adds that he has seen promising acts on social networking sites, but when he follows this up by going to their gigs they often fall short of what their internet clips promise: "That's the sleight of hand that is MySpace. It can be a barometer or a red herring."

"The main benefit of these sites is the immediacy with which they let consumers discover music. Someone just has to mention an artist's name and you can type it into your computer and go straight to the music. You don't have to wait for the gig or go down to the shops to get the CD."

Portable Players Drive Music Demand



The increasing popularity of portable digital music players is driving interest in music services.

The global portable digital player market grew sharply to an estimated 120 million units sold in 2006 with a 75:25 split between flash-based and hard drive players (Understanding & Solutions). This has had a mixed impact on digital music sales. Portable player owners are more likely to buy music legally than general internet users; but the amount of purchased music stored on devices is still low.

New research by IFPI/M-Lab carried out in November 2006 in the UK, Germany and France¹ shows that portability is a key driver of growing demand for recorded music:

- Two in five (39%) European portable player owners have bought music online at least once – in the UK that figure is 58 per cent.
- About half (47%) of those portable player owners who bought music online said they now buy music only, or mostly, in digital format.
- One in seven (14%) portable player owners use paid music downloads as their main source of music – roughly in proportion to those who use P2P networks and free websites (13%). However a greater volume of music on portable players is obtained from P2P and free sources than is purchased on legal sites and the frequency of purchase on legal sites is still low.

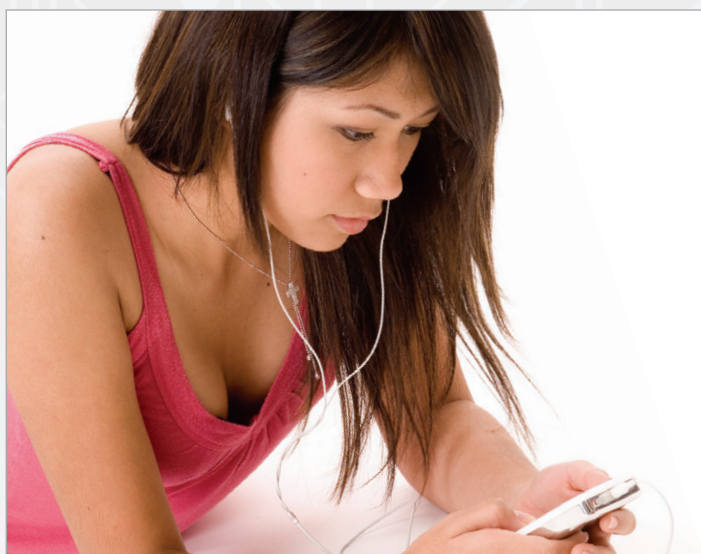
Separate research by Jupiter shows that iPod owners are three times more likely than general internet users to be regular paying music downloaders. Sixteen per cent of internet users that own an iPod in Europe download music legally on a monthly basis, compared to five per cent of internet users that don't own a portable player². This indicates that portable ownership is driving interest in legal music buying, although research suggests volumes of new tracks are low.

New Players Launch In 2006

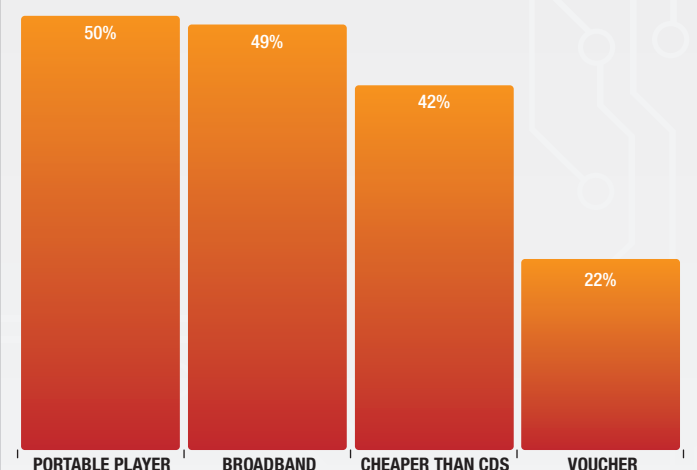
A number of new music players launched in 2006, notably Microsoft's portable music device, Zune, in the US in November. Zune is a hard drive player with a built-in FM tuner and Wi-Fi networking. The Wi-Fi feature allows limited sharing of songs, recordings, playlists and pictures. Tracks received from another person's Zune can be played for up to three days, or three plays. This is the first use of wireless music-sharing from a music portable device. Microsoft expects to sell one million units of the Zune by the end of June 2007. Universal Music struck a revenue share deal with Microsoft whereby Universal receives a fee for every Zune sold.

- 1 Sample 2,249 portable player owners in the UK (iPod owners only), Germany and France.
- 2 Jupiter Research, September 2006. UK, Germany, France, Italy, Sweden, Spain.

“Zune is delivering innovative ways for consumers to discover new music and connect with others through social experiences enabled by its wireless sharing capabilities. Innovation is key – whether it's how we work with artists, new technology features or giving consumers the all-you-can-eat ZunePass subscription, we are focused on changing the game.”
Bryan Lee, Corporate Vice President of Entertainment Business, Microsoft



Drivers to Online Music Buying



Source: IFPI/M-Lab Survey, Nov 2006. “What made you start buying music online?” Base: all who buy online.

Record Companies Boost Consumer Choice



Record companies are digitising catalogues and offering music in a variety of formats and channels.

Unlike traditional music outlets, digital music stores offer 24-hour shopping and unlimited shelf space. The number of tracks available in the largest digital stores doubled from two million in 2005 to four million in 2006. This compares to a maximum of 150,000 CD titles physically available in the largest specialist music stores and far fewer in non-traditional stores such as supermarkets.

The importance of greater choice for consumers is borne out by research. A Nielsen/Net Ratings UK survey of internet music users revealed that consumers rate the best attributes of digital music as being able to "find the music they wanted" and "variety of choice" – way above other attributes.

The 'Long Tail'

The 'Long Tail', a term coined by Chris Anderson, *Wired Magazine* editor-in-chief, argues that products with a low sales volume can collectively make up a market share that rivals or exceeds that of the bestsellers and blockbusters – if the store or distribution channel is large enough. The 'Long Tail' illustrates the opportunities the internet has created in distribution and sales.

Record Companies Invest In Digitising Catalogues

Record companies have made good progress extending digital catalogues well beyond what is available in the physical world. This is critical as consumers rate 'more choice available' as a major reason for increasing their purchase of music through digital channels in the future (IFPI/M-Lab Research, November 2006).

Universal Music, for example, announced in February 2006 the first step in its plan to make 10,000 older, out of print European albums available for download over the next few years, with the release of 300 albums. By October, online music fans had downloaded more than 250,000 tracks from this selection. The second phase of the initiative was rolled out in November, adding a further 700 albums.

In another catalogue push Universal announced wholesale price reductions on 1,500 digitally-delivered titles in Europe, dropping album retail prices from £7.99 to £5.49. The company says this should encourage greater album sales and more price differentiation – although iTunes has still

insisted on keeping single tracks at a uniform price point. Meanwhile other major record companies and the majority of independent labels are undertaking similar initiatives.

Olivier Robert-Murphy, VP Strategic Marketing, Universal Music Group International said: "It's easy for our consumers online to find and download current artists and current hits, but through this deep catalogue reissue programme we are now able to respond to and quantify the appetite for more eclectic, diverse recordings from the past. It is clear that this is a 'tail' worth chasing."

Digital-Only Album Releases Increase

Digital-only releases are rising sharply, contributing to a larger share of all releases. In the US there were over 13,000 new digital-only album releases in the first half of 2006, accounting for as much as 36 per cent of all new album releases in the period. This compares with 16,580 new digital-only releases in the entire year of 2005 (Nielsen SoundScan).

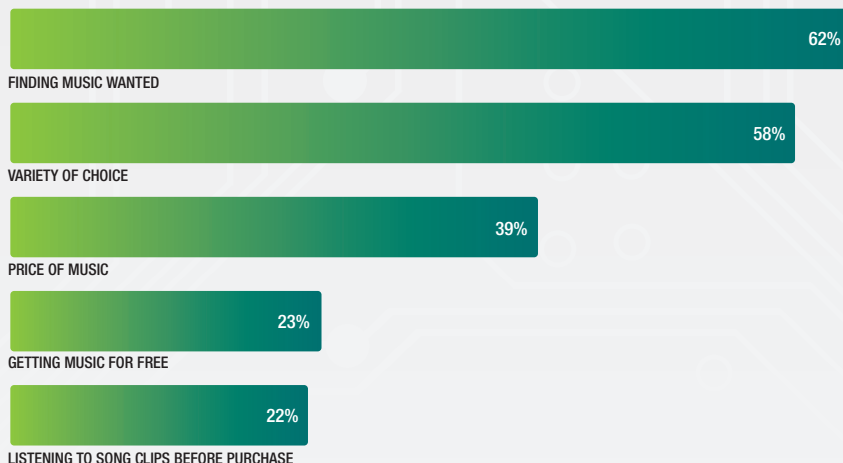
In the UK, the industry released over 37,000 albums in 2006 (BPI), 30 per cent of these releases were digital bundles, underlining the power of digital delivery to expand the output of music.

Record Companies Transform As Consumers Ask For More

High profile album releases are now often accompanied by hundreds of digital formats and products including the album itself, digital singles, exclusive digital tracks, digital 'bundles', artwork, videos and a whole range of music products created for mobile phones.

While music products diversify, the business of getting it to the consumer is becoming more holistic, with digital marketing and distribution strategies developed right from the start of a campaign. It is not unusual for a record company to offer an artist's fan base wireless full song and video downloads to go with personalisation tools such as ringtones and wallpapers.

Top Five Attributes of Internet



Source: Nielsen/NetRatings Music 2006: Online vs Offline Consumption



New information and accounting systems have been introduced by record companies to effectively market these products. Each of the major record companies currently partners with 400 to 500 separate businesses in the digital space. This has been an enormously complex and costly undertaking, with the required digital business and operational infrastructure costing many millions of dollars in investment in new technology, skills, and product digitisation. Fulfilment, account management and IT infrastructure are all affected. In nearly every aspect of their operations, from business development to royalties, record companies have evolved from the traditional business of distributing and marketing physical products.

“It’s hard enough for artists and labels to handle traditional distribution without support. Add more than 10 times the content online, hundreds of digital music services, a dozen different business models, complex accounting systems, new ways of marketing and promotion and you realise quickly that you need more sophisticated and skilled partners on your team.”

Scott Cohen, Founder, The Orchard

Digital Format Boosts Classical Genre

The success of classical in the digital music space has taken many by surprise. The unlimited availability of titles that online stores provide has created renewed consumer interest and new market development opportunities for classical music.

New Ways Of Filtering Music To Consumers

2006 saw the evolution of new services that promote and filter music for consumers in a far more flexible way. Many of them are experimental, and it is too early to say which ones will thrive in the long term.

Tastemaker Services

Fmagazine, Pitchfork, Playluder, Drowned in Sound, NME.com: these are e-magazines, strong on editorial such as news, features, interviews and reviews. They provide links to download stores and increasingly feature preview content, free sampler downloads and other editorial.

Recommendation Services

Last fm, Pandora, The Filter: these services offer personalised recommendations to users – often based on combining preferences and ratings of users with similar music tastes. For example, Last fm uses recommendation tool ‘Audio

Scrobbler’ which notes what the music users have listened to in their computer (via iTunes or Windows Media, for example) and builds playlists based on similar tracks. Pandora’s Tuneglu recommendation tool is based on the ‘Music Genome Project’ – a rating of each music track in the catalogue based on up to 400 distinct musical attributes.

Platform Specific

Nokia has launched its Music Recommenders service for use with its range of music phones. The service focuses on indie music across 12 genres with music experts generating recommended playlists each month. Other mobile providers offer similar features. SonyEricsson has launched M-Buzz and is also building music recognition software into its handsets.

Classical was the fastest-growing music genre in the US, growing by 23 per cent in 2006 (Nielsen SoundScan). There have been exceptional digital sales on particular titles. Universal Classics artist, violinist Janine Jansen’s recording of The Four Seasons received 75 per cent of its US sales through downloads. Also from Universal, a downloadable album of the New York Philharmonic’s performance of a Mozart concert secured top 40 chart positions on iTunes in the US and the UK.

In April 2006, Warner became the first major record label to launch a classical online music store (Warnerclassics.com). Warner intends to make its entire classical catalogue of 25,000 titles available on the service. Universal launched classicsandjazz.co.uk in

January 2007. These two services join established online stores such as Classical.com and Chandos.net both of which offer classical downloads as iPod compatible MP3s.

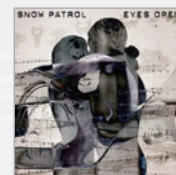
Record companies are also reaching out for jazz fans in a new way. In July 2006, Blue Note Records began releasing jazz masterpieces with recordings by Chet Baker and Art Blakey amongst others.



Some Of The Innovative Digital Releases In 2006 Included:



Madonna’s latest album was released digitally with three price points in three bundles, reaching numbers one, two and four in the iTunes chart, with the most expensive bundle coming first.



Digital bundles – British band Snow Patrol achieved a sizable proportion of sales of its latest album ‘Eye Wide Open’ via digital channels.

The album was released on iTunes as a ‘deluxe’ digital package featuring a bonus digital booklet, an exclusive ‘Making of...’ video and a video of the first single from the album.



Did Lily Allen Send You A Note To Tell You It Was Her Birthday?

Did you get an e-mail about Razorlight's concert in your home town? Has Robbie Williams just made you one of his MySpace friends?

The way record labels and artists communicate with fans is fast-changing, according to UK label EMI Records' marketing expert John Leahy.

"Every EMI artist has a MySpace page. We use social networking sites to allow fans to post news and swap stories. We might get a fan that filmed Corinne Bailey Rae on his mobile while she was doing an in-store signing in Leeds put his footage on a site for fellow fans to share."

Leahy says that the rise of digital technology also means that record companies have to provide more content themselves for fans. He explains "we film artists in rehearsal, we film them playing acoustically and we film them doing radio interviews" to generate content for their official websites and the social networks.

EMI's official artist websites allow fans to buy music, videos, concert tickets and merchandise. Leahy believes that EMI's deal



with Robbie Williams through which they share revenue from such sales "is the future of marketing artists."

Thanks to the rise of "long tail" sales, it is important for labels to keep websites replenished even when an artist doesn't have a new release to plug. For example, when Ed Harcourt played a gig in a bar in London recently EMI created some film and photographs to post on his website and e-mail to all his fans on their database.

Leahy adds that the growth of digital has affected all aspects of music marketing. The increased popularity of mobile music could

make video directors think about how their images will play when downloaded to a handset, though he cautions against "letting a two inch screen dominate our thinking."

He also notes that labels now have online pluggers who work with the likes of AOL and MSN, in the same way that companies traditionally employed people to promote songs to radio stations.

A combination of new technology and effective database management is making marketing much more targeted. Leahy says that "if a band like Kraftwerk were to play a concert in Scotland EMI could target all their fans with Scottish postcodes".

New systems enable labels to alert fans about artist tours, TV performances and new material. Leahy cautions that "we are sensitive about who we target, and careful to limit commercial messages."

Managing the relationship between an artist and fans through online technology is an increasingly key role for record labels. Consumers have a rapacious appetite for information and companies have to meet that demand. It is another reason why the role of labels is set to grow in the digital era.

"The past year has seen iTunes forge strong marketing partnerships with major brands, such as Starbucks in the US and Coke in the UK and Germany, and with the addition of blockbuster movies and TV shows, Apple is continuing to raise the profile of legal downloading and the value proposition of the iTunes Store worldwide."

Eddy Cue, Apple's vice-president of iTunes



Mobile packages –

In July 2006, Sony Ericsson began offering exclusive Robbie Williams content in their line of Walkman®-branded handsets in Latin

America, giving Robbie's global fan base exclusive access to tour performances, new music releases and features that include a memory stick loaded with the chart topping album Intensive Care, exclusive live recordings and video clips, exclusive wallpapers and pictures.



USB single –

Island Records released a single from UK act Keane on memory stick format in October 2006. The ultra thin limited edition 512Mb USB

stick was sold in HMV stores for £3.99. In addition, the USB holds the track's video and a number of screensavers and web links.



Grammy-winning

R&B artist John Legend teamed up with US mobile operator Verizon Wireless to promote his album 'Once Again' with two 30

second clips of his songs provided to subscribers who then voted on which should be released as his next single.



Protecting intellectual property is key to growing the digital business.

Internet piracy and the ubiquity of unlicensed music have caused enormous problems for the recording industry as it evolves into the digital age. The music industry was the first of the modern creative, intellectual property-based industries to feel the impact of the mass availability of its core product for free. Today the film, TV and news media industries are all grappling with the same dilemma of how to monetise their business in an environment where the main competitor is free.

Record companies' sales and investment in music has been severely hit by internet piracy in recent years. Global CD sales fell by 23 per cent in value between 2000 and 2005. Experience suggests the problem can be contained by a range of different strategies, but will not be eliminated. In 2006 despite key successes against unauthorised peer-to-peer operators, networks like Limewire and BitTorrent continued to be massive carriers of copyright theft.

In 2007, the recording industry will be sustaining and expanding its programme of legal actions against file-sharing while increasingly focusing on the "gatekeepers" closest to the source of the problem.

Legal Actions Have An Impact

IFPI and affiliate recording industry bodies continued the global campaign against

illegal file-sharing in 2006, bringing legal actions against more than 10,000 individuals in 18 countries, including Brazil, Mexico, Poland and Portugal for the first time. The principal aims of the campaign are education and deterrence.

Surveys on levels of illegal file-sharing across different countries show that legal actions are having a clear effect. Studies also show that fear of legal action is an important factor driving consumers away from unauthorised P2P. In the US lawsuits were the most cited reason among internet households for changing from unauthorised P2P to legal downloading (NPD Group, June 2006).

Actions have been taken against uploaders who use all the main unauthorised P2P services, including BitTorrent, DirectConnect, eDonkey, Gnutella, Limewire, SoulSeek and WinMX. The average legal settlement in these cases is now €2,420 and people from all walks of life are affected. In Argentina, one mother made her son sell off his car to pay her back the settlement fee.

A recent study in Hong Kong shows that the industry's advice to parents about checking their children's use of the family computer for is also having an impact. Researchers at Lingnan University found that more than a third of parents (36%) have advised their children to refrain from illegal downloading in the last year.

Research Shows Legal Actions Are Helping Contain Illegal File-sharing

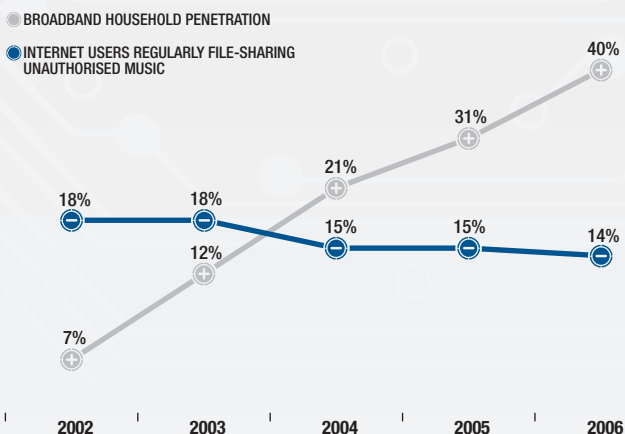
Recent findings from Jupiter Research in key European markets (UK, Germany, France, Italy, Spain and Sweden) suggest that IFPI's legal campaign against large-scale uploaders is having an impact. While broadband household penetration is rapidly rising, the percentage of internet users engaged in frequent unauthorised P2P usage is actually falling.

In Germany, for example, the proportion of internet users frequently file-sharing copyrighted music fell back from 13 per cent in 2004 to just eight per cent by 2006. In the UK, 11 per cent of internet users frequently engaged in file-sharing in 2004 and this remained constant in 2006 following a drop in 2005.

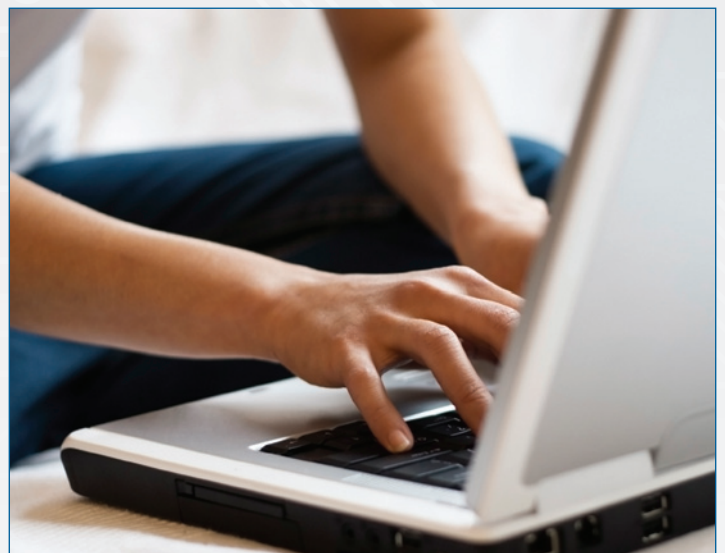
When the industry in France announced impending action against illegal file-sharers in 2004, the percentage of internet users engaging in frequent unauthorised P2P activity fell from 24 per cent to 14 per cent. In 2006, following a gap between legal actions, the percentage of frequent unauthorised P2P usage crept back up to 21 per cent.

Following on from the highly publicised launch in Stockholm of an international wave of actions, the number of Swedish internet users regularly infringing music copyright fell from 24 per cent in 2004 to 14 per cent in 2006.

P2P Usage vs Broadband In Europe



Source: Jupiter Research, Sep 2006: UK, France, Germany, Italy, Spain, Sweden.



Internet Piracy – The Call To ISPs



“Gatekeeper” ISPs hold the key to the problem.

The recording industry accepts that mass-scale legal action against uploaders is the second best solution for containing internet piracy. The best answer lies in tackling the problem closer to its source.

Internet Service Providers (ISPs) are the gatekeepers to the internet. They have it within their power to limit access to copyright infringing material and therefore hold the key to substantially reducing online piracy.

Technology similar to that used to block access to child pornography could be used to block access to websites that facilitate infringing file-sharing of copyrighted music.

Disconnection of serious copyright offenders by ISPs is the easiest and most practical response to illegal file-sharing. ISPs have been very slow to help the music industry crack down on internet P2P piracy. To a significant extent their incentive to do so is limited by so-called ‘safe harbours’ in many countries’ laws, including the US and the EU, that were drawn up some years ago to encourage the development of the

online industry. However, they should recognise their responsibility to assist in enabling control of piracy and the development of a legitimate online market.

Most ISPs’ terms of service prohibit using the service to infringe copyright, and reserve the right to terminate service to those who do so. ISPs should enforce this condition and terminate their service to people using their networks to steal and distribute music without permission. IFPI has asked ISPs to come to the table and address these issues voluntarily. Many of them initially made promising noises, but the discussions have so far gone nowhere and ISPs have generally refused to take effective action.

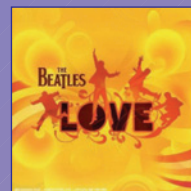
Governments have a vital role to play in requiring ISPs to engage in the fight against piracy. In the UK, the government-commissioned Gowers Intellectual Property Review recommended in December 2006 that ISPs should either come to a voluntary agreement with the industry for a procedure to remove users who engage in piracy, or face government intervention.



“If we in the EU are going to turn Europe into the leading knowledge-based economy and society, then we have to ensure that our young people are both technologically savvy and aware of the basic tenets of intellectual property which protects creative content.”

Erika Mann, MEP and Chair of the European Internet Foundation

Tackling Pre-release Piracy



Pre-release ‘leaks’ of pirated material, which is often uploaded to P2P networks with the potential to reach mass distribution

within hours, can have a serious impact on an album launch and have a damaging effect on legal sales.

Several new albums were available illegally online weeks before launch in 2006 – including high-profile releases by Placebo, Franz Ferdinand, The Strokes, The Flaming Lips and The Red Hot Chili Peppers. In response, pre-release security has tightened enormously.

Record companies now use encryption and watermarking technologies to try to ensure promotional copies can only be listened to by a select few. Often pre-release security involves a more complex strategy. An intense operation was mounted by teams at IFPI and EMI to protect the first new Beatles album for over 30 years, “Love”.

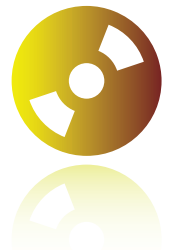
On the underground music piracy scene, obtaining a copy of the album to distribute illegally on the internet was a high priority.

Promotion of the album and its release to journalists and reviewers before release was achieved under unprecedented security. The internet was also closely monitored for potential leaks prior to release.

The operation was successful. The first leaks of the album were found only some 36 hours prior to the first official release date and just few hours away from the UK radio embargo time.

Post-release investigators tracked down the original content uploaders and removed a high volume of infringing content.

Progress Against Pirate Operations



Courts create new legal landscape for digital music.

The last year has seen a string of court rulings against illegal services. At the same time, services that have been hosting copyright infringing material have signed agreements with record companies to clean up their content.

● **Kazaa**

Kazaa was the biggest international brand name in music piracy until July 2006, when the service signed an agreement with record companies ending its infringing activity and paving the way for the development of a legal service. This followed the landmark ruling in the Australian Federal Court that found the Kazaa operators liable for widespread copyright infringement. Kazaa paid US\$115 million in compensation to the record companies that took legal action to stop copyright infringement on its network. Kazaa also agreed to introduce filtering technologies that would prevent its users from distributing copyright-infringing files.

● **allofmp3.com**

Russian-based allofmp3.com has offered music for sale around the world without the licenses to do so, in contravention of Russian law and international copyright treaties. In

October 2006, a Danish court came to a significant judgment that the internet service provider Tele2 should block users' access to the infringing website. This ruling was not appealed by Tele2 and led to other Danish ISPs voluntarily blocking users' access to the site. This is a significant development in enlisting the support of ISPs in tackling copyright infringement, but the site still offers unfair competition to legitimate digital services in many countries.

● **Illegal FTP Servers in Denmark**

The Danish Supreme Court ruled in February 2006 that internet service providers can be obliged to prevent their customers from using their services to infringe copyright by terminating the user's accounts. The ruling was based on European Union (EU) copyright laws and has implications across the EU. ISPs in Denmark can now face injunctions if they do not co-operate with rights holders in identifying people engaged in unauthorised P2P activities and terminating their accounts.

● **Zoekmp3**

A Dutch court gave a landmark judgment against Zoekmp3, a major "deep links" site, in the Netherlands in June 2006. The ruling

clarified that making available a searchable website of deep links to unlicensed mp3 files for download is illegal in the Netherlands. It followed a judgment in Australia against mp3s4free.net.

● **Bearshare**

In May 2006 the American operators of the BearShare service agreed to cease to operate any music or film download services and sold its assets to iMesh, a legal file-sharing service.

● **Kuro**

In September 2006 Kuro, Taiwan's best-known unauthorised P2P file-sharing service, settled with the recording industry. Kuro's operator, Fashion Now Co Ltd, also agreed to stop distributing its P2P software and end all support for the copyright-infringing service.

● **Mp3s4free**

In December 2006 the Full Federal Court of Australia rejected the appeal of Stephen Cooper, the operator of the the mp3s4free website and his ISP who had earlier been found guilty of copyright infringement. The website provided access to illegal music files.

A Growing Form of Piracy – Digital Stream Ripping

The audience for digital radio has grown dramatically. Digital radio offers a superior quality of sound, a wider selection of stations, information on tracks as they play, sleek design and interference-free reception. Over 500 million people around the world can now receive nearly 1,000 different Digital Audio Broadcasts (DAB) services and in the UK alone, digital-only radio stations are now attracting up to nine million listeners.

While the technology behind DAB has provided the consumer with yet another way to discover and listen to music, it is also vulnerable to "digital stream ripping" – the process by which someone can automatically identify and separate individual tracks from digital transmissions and store them for future playback in any order.

This is not like time-shifting a favourite radio show for later enjoyment. The problem with digital stream ripping is that once



recorded, a transmission licensed for one-time listening can in effect be turned into a library of permanent, free, high quality downloads, each labelled with artist and track information.

Stream ripping undermines the growing market for legal, paid-for download services. It means that DAB becomes an "on-demand" service and turns a digital radio service into something that is not radio at all.

The threat of stream ripping is potentially even greater where unprotected digital streams are transmitted over the internet. In addition to providing guidelines for digital broadcasters to protect against stream ripping, the recording industry is helping to develop technologies that webcasters and other streaming providers can use to protect streams against a variety of stream rippers.

Rights holders and streaming providers cannot deliver solutions alone. Governments should as minimum ensure that copyright law does not inadvertently legitimise stream ripping services. Time shifting or private copying exemptions adopted before the advent of stream ripping may, in effect, leave rights holders without protection. Exemptions that would inadvertently cover the activity of stream ripping need to be limited, or else stream ripping services have to be explicitly prohibited.

Copyright, Music And The Education Challenge



A Leading Role For Government

Digital technology has made education about copyright and the value of creative content a critical priority for creative and intellectual property based industries like music. Intellectual property is the fuel of a media and entertainment sector estimated at over US\$1 trillion (PWC), and which is a major employer in the knowledge economy. Yet schools are providing insufficient education on the issues which the health of that sector, and the jobs in it, will depend.

Copyright education must become a higher priority for governments. IFPI is calling for educational programmes on copyright, intellectual property and the value of creativity to be incorporated into the core curriculum of all primary and secondary schools.

Digital File Check Helps Users To Stay Safe And Legal

A publicly-available software programme, Digital File Check, helps to remove or block any of the file-sharing programmes commonly used to distribute copyrighted files illegally. It also allows the user to delete copyrighted music and video files from the "shared folders" of the computer from where they are commonly swapped illegally on the internet. The system is available in Belgium, Denmark, Finland, Germany, Greece, Ireland, Italy, the Netherlands, Poland, Portugal, Sweden and the UK at www.pro-music.org



Awareness Grows On Virus And Spyware Risks

In 2006, the FBI ran courses on security risks of P2P networks. At the same time surveys show growing concerns over P2P network safety among internet users.

In the UK research by Entertainment Media Research in September 2006 found that six out of ten people who plan to cut back or stop file-sharing say they will do so because of fear of computer viruses and spyware. In Japan, 46 per cent of internet users who have stopped using P2P networks cited viruses as a major reason for doing so according to research by the Recording Industry of Japan (RIAJ) in July 2006.

IFPI, with partners in the film and software sectors, are directly addressing companies, public offices and colleges to raise awareness of those security risks. A 'Copyright and Security Guide' for universities and

Dutch Kitemark Helps True Fans Download Legally



In 2006 the Dutch recording industry launched a kitemark for legitimate services – "Truefan" to help users distinguish between legal and illegal online music services. The project is backed by the Dutch Online Shop organisation, which is supported by the Dutch Consumers Association. The project was undertaken after research showed that men in their early 30s who were willing to pay for online music claimed not to be know where to find online music they could purchase legally. The Truefan mark acts as a road sign on the digital highway.

schools, produced jointly by the music, film and video industries, will be launched in early 2007. This guide has been designed to help university and school administrations take responsibility for cleaning their computer networks and communicate to their staff and pupils about the dangers of copyright infringement.

Lesson Plans, Film Shorts and Guides Support Parents and Teachers

IFPI and its national groups have launched a series of educational projects in the last three years, providing audio-visual and lesson aids to teachers. These include:

● **The information guide for parents** and teachers produced with children's welfare charity Childnet International, "Young People, Music and the Internet" which has been distributed in schools, shops and libraries in 23 countries. It is available at www.pro-music.org and www.childnet-int.org.

● **'National Music Week' for schools** in the UK was launched in October 2006. Schools involved in the project were provided with lesson plans looking at the importance of copyright, and the business side of the music industry as well as music appreciation lessons. Tokens to be redeemed against one of ten songs at leading retailers where offered to every child, forming a "schools top ten" of new bands.

● **Programmes for young people** from third grade to university have been run in the United States to educate as to what is legal and illegal when it comes to obtaining music on the internet.

● **The film '1001 Jobs in Music'** has been shown in France at FNAC music stores across the country to introduce public debates for young people on the value of music. In Finland, schools have been issued with comic books aimed at 12–15 year olds about a hopeful young band thwarting the efforts of music pirates to steal their music before it was released.

● **Other initiatives** include the Value of Music pack in Austria, the film 'Everything Begins With A Song' in Argentina, 'Listen Up 2' in Canada and 'Copy or Love' in Italy. These are all cutting-edge audio-visual and educational tools made available for free to teachers.

More information on all of the initiatives above is available upon request at press-office@ifpi.org

DRM Promotes Consumer Flexibility And Protects Content

DRM is the enabler of flexible music offerings.

Digital Rights Management (DRM) has played a key role in the progress of the digital music business to date. The vast majority of consumers acquiring music via digital delivery are doing so via channels that use DRM, which enables a range of flexible options for consumers to enjoy music. Rights management technologies are needed for a wide range of music services just as they are for cable and satellite TV as well as software, movies and games. The most obvious example of DRM working in the market is iTunes and the successful iPod. DRM is also deployed in over half a billion mobile handsets.

Today, the industry – in particular major labels – remain strongly committed to DRM. Yet at the same time many recognise that there are serious impediments to further progress which must be resolved.

DRM has attracted some heated debate and much misplaced criticism. A key concern has been the limited opportunities for consumers to transfer their purchased music between services and devices. However, this is not a problem caused by DRM itself, but by the deployment by some technology companies of non-interoperable proprietary DRM systems.

Record companies strongly favour interoperability, which can only be achieved through the agreement of these technology companies.

In general, governments have sought to take a cautious and balanced line and to allow the issues to work themselves out in the market. Market mechanisms remain the best means to achieve a balanced outcome and the record industry prefers this solution.



“What reassures me for the future is to see the strength, calm and determination with which the labels and record companies are dealing with the issues they’re facing. New economic models are developed, contracts are adapted, while commercial and marketing operations are transformed. What energy!”

Gilles Bressand, CEO, XIII Bis Records



www.ifpi.org
www.pro-music.org



representing the
recording industry
worldwide



MUSIC. A LANGUAGE, A LIVELIHOOD, AN INDUSTRY.

IFPI represents the recording industry worldwide with some 1400 members in over 70 countries and affiliated industry associations in 48 countries.

IFPI Mission:

- Promote the value of recorded music
- Safeguard the rights of record producers
- Expand the commercial uses of recorded music

IFPI Services:

- Market Research
- New Technology
- Internet Anti-Piracy Unit
- Industry Representation to National Governments and European Union
- Communications and Events
- Legal Policy
- Litigation & Regulatory Affairs
- Physical Anti-Piracy Enforcement

Members are invited to get in touch for:

- Key statistics on the digital and physical music markets worldwide
- Advice on digital distribution and technology
- Help with pre-release security and anti-piracy
- Research proposals that would benefit the industry
- Questions about copyright laws and treaties at a national or international level
- Grass-roots ideas to promote the value of music to their consumers
- Information about the international IFPI GRID and ISRC identification systems
- Information on IFPI membership, publications and resources

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