THE COSTS OF LICENSING FOR ONLINE MUSIC SERVICES: AN EXPLORATORY ANALYSIS FOR EUROPEAN SERVICES

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ABSTRACT

Since the late 90s, the music industry has seen its global turnover declining rapidly and has not been compensated yet by the growth of incomes generated by online music services. Actually, such services face a number of transaction costs (TC) concerning licensing music rights, notably in Europe where markets are still organized at a national level. This article analyzes the problems faced by these services in Europe with a focus on the complex licensing process. In particular, this article analyzes the TC related to licensing rights for online music services. The now established TC theory has rarely been applied for the analysis of digital content markets. The emphasis is put on the TC faced by Creative Upstarts in the fragmented European Union (EU) market.

INTRODUCTION

Numerous online music services have emerged over the past years[1] and the online offer of titles steadily increased.[2] As a result, digital channels accounted for 32% of record companies' revenues in 2011.[3]

However, the growth of online music services does not compensate for the decrease of revenues, which stemmed from the decline of the compact disc.[4] Worse, the European online music market remains fragmented with few pan-European services. One result is that the European market still lags behind the U.S., whereas the EU accounts for more Internet users.[5]

What are the reasons for this European development? What could be the consequences for the Creative Upstarts? To answer, this article focuses on

1. MICHAEL MASNICK & MICHAEL HO, FLOOR 64, THE SKY IS RISING: A DETAILED LOOK AT THE STATE OF THE ENTERTAINMENT INDUSTRY 28 (2012), *available at* http://www.techdirt.com/skyisrising/.

2. Thirteen million tracks were licensed at the global level in 2010. INT'L FED'N OF THE PHONOGRAPHIC INDUSTRY (IFPI), IFPI DIGITAL MUSIC REPORT 2011: MUSIC AT THE TOUCH OF A BUTTON 5 (2011) [hereinafter IFPI 2011a], *available at* http://www.ifpi.org/content/library/DMR2011.pdf.

3. INT'L FED'N OF THE PHONOGRAPHIC INDUSTRY (IFPI), IFPI DIGITAL MUSIC REPORT 2012: EXPANDING CHOICE. GOING GLOBAL 6 (2012), [hereinafter IFPI 2012], *available at* http://www.ifpi.org/content/library/DMR2012.pdf.

4. However the global trade value of the recorded music industry grew by[ ]0.3% in 2012. INT'L FED'N OF THE PHONOGRAPHIC INDUSTRY (IFPI), IFPI DIGITAL MUSIC REPORT 2013: ENGINE OF A DIGITAL WORLD 6 (2013) [hereinafter IFPI 2013], *available at* http://www.ifpi.org/content/library/DMR2013.pdf.

5. KEA EUR. AFF. & VRIJE UNIVERSITEIT BRUSSEL, LICENSING MUSIC WORKS AND TRANSACTION COSTS IN EUROPE: FINAL STUDY 17 (2012), [hereinafter KEA & VUB], *available at* http://www.keanet.eu/docs/music%20licensing%20and%20transaction%20costs%20-%20full.pdf.

the Transaction Costs (TC) faced by online music services in the complex licensing process.

This article is, to our knowledge, the first attempt to quantify the TC within the online music rights licensing process, from the service providers' point of view. Extensive bibliographical research and interviews with 25 relevant stakeholders in the music licensing field[6] yielded information on market trends, on the legal framework, and on current commercial practices.

Mainly, a survey was disseminated to 41 services providers operating in the UK, Spain, Czech Republic, and on a pan-European/global level, which provides the basis for estimates on TC. With a global response rate of 22%, the survey provided a sufficient amount of information on market developments and licensing practices, although most responses came from small services. There were, however, important differences in response rates per country. With only two services responding in the UK and in Spain, it was not possible to develop a global analysis concerning the quantification of TC in the national markets. Also, the small size of the database makes any attempt to generalize results tenuous. In general, the quantification of transaction costs resulting from the ongoing survey provides insights and puts forward illustrative examples rather than a complete and accurate picture of the online music market in the three markets.

Section two describes the current state of the online music market, including the opportunities it faces and some problems encountered. Section three provides a legal analysis of the licensing process for online music services in the EU. Section four analyzes and quantifies the transaction costs faced by online music services. Section five concludes with a focus on the Creative Upstarts.

I. A GROWING BUT NOT THRIVING ONLINE MUSIC MARKET

A. The Online Music Market: Expanding Fast . . .

The digital music market is taking off. There are numerous music startups aiming to provide digital services around music[7]. Online music services such as iTunes, Spotify and Deezer are expanding their offers into new markets and increasing the number of titles available to consumers.[8] At the beginning of 2012, the largest international online music services were available in 58 countries against 23 one year before.[9] Similarly, the online offer of titles is steadily increasing with 13 million tracks licensed at the

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6. For a complete list, *see* KEA & VUB, *supra* note 5, at 67.
7. MASNICK & HO, *supra* note 1, at 28.
8. IFPI 2013, *supra* note 4, at 5. According to the IFPI, 30 millions tracks were offered in 2012 (IFPI 2013, *supra* note 4 at 6) increasing from 20 millions tracks in 2011 (IFPI 2012, *supra* note 3, at 10).
9. IFPI 2012, *supra* note 3, at 4.

global level in 2010.[10] Digital channels account for 32% of record companies' revenues, which is more than any other content industry except for the video game industry.[11] The digital market is particularly developed in the U.S., Japan, and the UK.[12]

A variety of Creative Upstarts have emerged experimenting with the different possibilities that digital technologies offer for online music services.[13] In the frame of this paper, the Upstarts sometimes propose more innovative business models, which include advertising-based, free streaming services and subscription services with a freemium model. Such freemium services provide users on the one hand access to music content that is free but limited in time, choice, and on demand and/or contains advertising; and on the other hand paying unlimited (or less limited) access for subscribers.[14]

More generally, digital distribution has affected existing business models of the music industry. Subscription services, which allow their subscribers to download or stream music, are developing rapidly. For example, users subscribing to Spotify's paid service total around 4 million across 13 countries in July 2012[15] against 1 million in 2010,[16] while around 7 million used the free streaming service. In 2012, Deezer has 20 million users and 1.3 million paying subscribers.[17] Other online music services include video sharing platforms (e.g. YouTube, Dailymotion), mobile services, and music in the cloud offers, e.g. Apple's iCloud that provides users access via Internet to their files. Such services exemplify how digital distribution has altered consumer behaviour, as consumers today increasingly want to access music at any time on any device, rather than owning music physically in forms of CDs or even mp3s.[18]

B. . . . But Still Fragile

Still, the growth of the online market does not compensate for the decrease of revenues related to the decline of the compact-disc. Since the emergence of the Internet, the recording industry has seen its global

10. IFPI 2011a, *supra* note 2, at 5.
11. IFPI 2012, *supra* note 3, at 6.
12. IFPI, RECORDING INDUSTRY IN NUMBERS 2011 7 (2011) [hereinafter IFPI 2011b].
13. MASNICK & HO, *supra* note 1, at 28.
14. CHRIS ANDERSON, FREE: THE FUTURE OF A RADICAL PRICE (Hyperion, 1st ed. 2009).
15. *Spotify Payout Q2 2012*, SPOTIDJ (Sept. 03, 2012), http://www.spotidj.com/blog/spotify-payout-q2-2012/.
16. IFPI 2011b, *supra* note 12.
17. DEEZER, http://www.deezer.com/en/legal/about.php (last visited June 6, 2012).
18. *See generally* PATRIK WIKSTRÖM, THE MUSIC INDUSTRY: MUSIC IN THE CLOUD (2010).

turnover declining very fast, due to a rapid decrease in physical sales, in particular CDs.[19]

Online music offers may not be as thriving and innovative as it seems. Among the 500 licensed online music services in the world counted by the International Federation of the Phonographic Industry (IFPI),[20] many services replicate the physical recording store, by essentially offering download-to-own services, thus following iTunes's way. More worrying, there does not seem to be profitable, stand-alone online music services. Even though figures are difficult to obtain, it seems that even Apple gains more revenue with the sales of iPods than through iTunes.[21] It can also be argued that the success of iPods has favoured the adoption of the Mac ecosystem by consumers. Indeed, Deezer recently announced that it has been profitable in France since 2011.[22] But Spotify, while growing rapidly, has seen losses grow: Spotify grew in 2011 by 160 % to €190 million, but registered losses from €28 to €45 million.[23]

It might be related to that situation that the music industry remains largely concentrated among traditional music companies, with few or no room for Creative Upstarts in music production and distribution, although the industry value chain has been disturbed by the entrance of new players in the market. The market is now dominated by three major music companies (down from six in 1998), which have a worldwide share of 70 percent of the market for distribution: Universal Music Group, Sony Music Entertainment and Warner Music Group.[24] Next to the major music companies, the market consists of a large number of small and medium enterprises (SMEs), often Creative Upstarts, the independent labels.

The major music companies' control over the value chain is being undermined by the entrance of new actors in the industry where artists and independent labels can directly make deals.[25] These include hardware

19. IFPI 2011b, *supra* note 12, at 7. There was, however, a slight increase in revenues of the recorded music industry (by 0.3%) in 2012. *See* IFPI 2013, *supra* note 4, at 6. Additionally, in order to get a full picture, other revenues should be taken into account, which include live concerts, synchronization, and royalties collected by Collective Management Organizations. Such revenues have increased in the recent years. *See* KEA & VUB, *supra* note 5, at 12.

20. IFPI 2011a, *supra* note 2, at 28.

21. Brian Laung Aoaeh, *Apple's iPod + iTunes Business Model*, TEKEDIA (Dec. 12, 2011), http://tekedia.com/31377/apples-ipod-itunes-business-model/.

22. CMU Editorial, *Spotify's success is key to Deezer's, says CFO*, COMPLETE MUSIC UPDATE (June 13, 2012), http://www.thecmuwebsite.com/article/spotifys-success-is-key-to-deezers-says-cfo/.

23. Greg Anderson, *Spotify Revenue Numbers Lower Than Expected, Still Focused On Growth*, ARCTICSSTARTUP (Apr. 16, 2012), http://www.arcticstartup.com/2012/04/16/spotify-revenue-2012.

24. KEA & VUB, *supra* note 5, at 23.

25. ANDRA LEURDIJK & OTTILIE NIEUWENHUIS, STATISTICAL, ECOSYSTEMS AND COMPETITIVENESS ANALYSIS OF THE MEDIA AND CONTENT INDUSTRIES: THE MUSIC INDUSTRY 100 (Jean Paul Simon ed., 2011).

companies (e.g. Apple, Nokia), mobile and Internet service providers (e.g. Telefonica, Vodafone), off-line and online retailers (e.g. HMV, Amazon), and a variety of pure players, mostly operating online services (e.g. Spotify, Deezer, We7). The same is true for marketing with social networks and other recommendation tools, which to some extent substitute traditional ways of marketing records.

More generally, the value chains are becoming more complex and less linear.[26] As a response, the majors try to be more proactive at the level of online services – for instance by launching online music services themselves, entering joint ventures, taking over services or concluding preferential deals with some services.[27] Traditional players do still have important bargaining power, as they own the rights to the repertoire. However, some of the new market entrants act as important gatekeepers for making music accessible online.[28]

C. A Worse Situation in the EU

Taken as a whole, the European market still lags behind the U.S., although the EU accounts for more Internet users and therefore more potential consumers for digital music.[29] In 2010, digital music revenue amounted to $2 billion in the U.S. and $996 million in Europe.[30] In addition, almost half of all music revenues came from the digital sector in the U.S. in 2010 (52% in 2011), while physical sales still accounted for 73% of all music revenues in Europe.[31] Furthermore, the national markets in Europe have not developed similarly: in 2010, the digital share of recorded music sales varied from 2% in Hungary to 29% in Denmark.[32]

These imbalances are reflected in the expansion of international service providers. Apart from the two global services, Traxsource and Classics Online, which have been available worldwide since their creation, most EU-wide services were first launched in specific countries or groups of countries, before expanding to new territories (e.g. iTunes, Spotify, 7 Digital, Napster, Rara, Emusic). As a result there are fewer pan-European services than there could be. In 2010, there were 21 music service providers in the U.S.,[33] while in Europe there were only 14 services that were specifically targeting several European markets.

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26. *See generally* The "Content Flat-Rate": A Solution to Illegal File-Sharing?, PARL. EUR. DOC. PE 460.058 (2011), *available at* http://www.europarl.europa.eu/meetdocs/2009_2014/documents/cult/dv/esstudycontentflatrate/esstudycontentflatrateen.pdf.
27. KEA & VUB, *supra* note 5, at 24.
28. *Id.*
29. *Id.* at 16.
30. *Id.*
31. IFPI 2011b, *supra* note 12 at 8.
32. *Id.* at 43, 48.
33. IFPI 2011b, *supra* note 12, at 6.

Our more detailed analysis of the UK, Spain, and the Czech Republic shows first that the more developed a market, the bigger the variety of business models used by services and therefore more opportunities for the Creative Upstarts. Thus, in the UK, customers can choose from a wide range of 51 services, from the traditional download-to-own on a pay-as-you-go basis to innovative "all-included" services, which cover streaming, download-to-own, and even mobile services.[34] In contrast, in the Czech Republic the traditional download-to-own on a pay-as-you-go model prevails.[35]

Secondly, the more developed a market, the more varied the kinds of service providers. Thus in the UK and Spain, service providers include record labels, hardware producers, Internet service providers, mobile operators, and retailers.[36] The Czech market is essentially borne by record labels and (since autumn 2011) iTunes.[37] Thirdly, the more developed the market, the bigger the incentive for international (potential pan-European) services to enter first.

II. HOW DOES LICENSING WORK AND WHAT MAKES IT COMPLEX?

A. The Various Rights Holders and their Exclusive Rights

The multiplicity of right holders (authors, performers, record producers) and of rights to acquire (making-available and reproduction rights) makes licensing processes complex. Actually, all of these rights have to be cleared for all right holders. This corresponds to a fragmentation of rights, which generates multiple transactions in an uncertain context. All this increases TC.

First, every music track has several right holders. These include (i) the "authors" (composers and lyricists, who respectively write the music and the lyrics); (ii) the "performers" (singers and musicians, who interpret the music and the lyrics created by the authors); (iii) the record producer, who makes the financial investment to record the performance; (iv) the music publisher, who acts as manager of the author and is in charge of issuing licenses to users of the music, marketing and promotion of the music and collecting income from licenses.[38]

Authors, performers, and record producers have a set of legally recognized rights to control the exploitation of their works. In order to ensure better management of their rights, authors and performers usually assign, license, or entrust all or parts of their rights to a third party that will

34. KEA & VUB, *supra* note 5, at 18.

35. *Id.* at 20.

36. *Id.* at 18-20.

37. *Id.* at 20-21.

38. ANN HARRISON, MUSIC: THE BUSINESS: THE ESSENTIAL GUIDE TO THE LAW AND THE DEALS 112-117 (5th ed. 2011).

take care of exploiting or managing those rights. Such third parties are publishers for authors and record labels for performers.[39] Music publishers are not considered copyright owners by law, but usually become copyright holders by virtue of the transfer of rights from the author.[40]

In addition, one track usually does not only have multiple right holders; there are also several different rights granted to these persons by copyright law. Composers and lyricists have a recognized set of economic rights to their compositions and lyrics. Performers and record producers are also entitled to some economic rights (the so-called related or neighboring rights) respectively on the fixations of their performances and on the first fixation of the sound (recording).[41] For all of them, online music services need to clear the making available (or "performing") right and the reproduction (or "mechanical") right, as it is considered that copies of the work are made when downloading.

In the EU, these rights are granted to authors and holders of neighboring rights in the Directive 2001/29/EC.[42] This Directive transposes the World Intellectual Property Organization (WIPO) Internet Treaties, notably its recital 15.[43] More recent legislative developments in the European arena include the Directive 2011/77/EU.[44] In order to harmonize the rules governing the activities of Collective Management Organizations (CMOs), the European Commission introduced in 2012 a legislative proposal for a Directive on collective rights management and the multi-territorial licensing of rights in musical works for online uses.

As a consequence of EU's attempts to harmonies copyright legislation across the Union, few differences continue to exist between Member States, at least concerning the online distribution of music. However, business practices can vary greatly across the EU.

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39. KEA & VUB, *supra* note 5, at 27.

40. Violaine Dehin, *The Future of Legal Online Music Services in the European Union: A Review of the EU Commission's Recent Initiatives in Cross-Border Copyright Management*, 32 EUR. INTELL. PROP. REV. 220, 222 (2010).

41. KEA & VUB, *supra* note 5, at 26.

42. Directive 2001/29/EC, of the European Parliament and of the Council of 22 May 2001 on the Harmonisation of Certain Aspects of Copyright and Related Rights in the Information Society, 2001 O.J. (L 167) 10, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2001:167:0010:0019:EN:PDF.

43. It harmonizes national copyright and neighboring rights legislations to adapt to technological and commercial developments relating to the rise of digital technology.

44. Directive 2011/77/EU, of the European Parliament and of the Council of 27 September 2011 Amending Directive 2006/116/EC on the Term of Protection of Copyright and Certain Related Rights, 2011 O.J. (L 265) 1, 1, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:265:0001:0005:EN:PDF.

B. The Organization of Copyright

Right holders are free to choose whether they want to administer their rights for online uses themselves or through a CMO. Usually, authors choose to administer their rights through CMOs, hence each CMOs' repertoire encompasses a large catalogue of rights on musical works.[45] The CMOs' operations have been highly criticized because of opacity and their inability to respond to the needs of the online environment.[46]

One consequence is that there have been important changes in the past years regarding licenses for the multi-territorial use of musical works.[47] This change is linked to the European Commission's activity in the field of music licensing aimed at facilitating cross-border licensing.

Traditionally, CMOs were able to license for their own territory their national repertoires as well as the repertoires of CMOs of other countries due to a system of reciprocal agreements between these societies.[48] This system allows copyright users to obtain territorial "blanket licenses" for the world repertoire through the CMOs of their country of establishment. If CMOs wished to offer services in a number of territories, they had to negotiate with each CMO in each territory.

In 2005 the European Commission published a Recommendation "on collective cross-border management of copyright and related rights for legitimate online music services,"[49] advocating multi-territorial licensing for the online environment. It asked Member States to enable rights holders to assign the management of the right holders' online rights to any CMO on a territorial scope of their choice. In addition, it asked Member States and to give right holders the right to withdraw any of the online rights and transfer the multi-territorial management of such rights to another collecting society, regardless of the Member State of residence or the nationality of the CMO or of the rights holder.[50] The direct consequence of the actions undertaken by the Commission was the withdrawal of the major publishers' Anglo-American repertoire from traditional CMOs and the creation of new entities to manage their mechanical rights in relation to multi-territorial uses.[51]

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45. Dehin, *supra* note 40.

46. KEA, THE COLLECTIVE MANAGEMENT OF RIGHTS IN EUROPE-THE QUEST FOR EFFICIENCY, *study prepared for European Parliament* 14 and 46 (2006).

47. KEA & VUB, *supra* note 5, at 29.

48. LIONEL BENTLY & BRAD SHERMAN, INTELLECTUAL PROPERTY LAW 277 (3d ed. 2011).

49. Commission Recommendation 2005/737/EC, on Collective Cross-Border Management of Copyright and Related Rights for Legitimate Online Music Services, 2005 O.J. (L 276) 54, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:276:0054:0057:EN:PDF.

50. Commission Recommendation 2005/737/EC, *supra* note 49.

51. HELLENIC FOUND. FOR EUR. & FOREIGN POL'Y (ELIAMEP), COLLECTING SOCIETIES AND CULTURAL DIVERSITY IN THE MUSIC SECTOR 26-29 (2009), *available at*

These new licensing entities are managed and owned by several traditional CMOs such as CELAS for Electric and Musical Industries Ltd (EMI), managed and owned jointly by *Gesellschaft für musikalische Aufführungs- und mechanische Vervielfältigungsrechte* (GEMA) and PRS for music.[52]

Many independent publishers, following the example of major publishers, have also entrusted the PRS to manage their rights through a new licensing entity to facilitate multi-territorial rights management of Anglo-American repertoires (IMPEL).[53] Some collecting societies now issue multi-territorial licenses on their own repertoire and also on the repertoire of other collecting societies.[54]

This implies that today music repertoires are even more fragmented than they were before 2005. Rights to the entire music repertoire are managed by an increasing number of different management entities that cannot always accurately identify the rights they manage, due to the dispersed and fragmentary nature of both the rights and right holders.[55]

C. The Organization of Neighbouring Right

In general, while the management of authors' and publishers' online rights is entrusted to CMOs, the management of performers' and record producers' exclusive rights is done either directly or through commercial third parties, such as aggregators.[56] More precisely, the performer transfers all, or substantial parts, of their online rights to his/her record producer and receives royalties, i.e. a percentage of the revenues on the recording. Hence the record producer administers the performers' rights, as well as its own rights on the sound recording. While major and large independent record labels often handle the management of their own (and the performers') rights, smaller independent record labels often pass through aggregators to deliver their music works to online platforms.[57]

Interviews show that aggregators convert and encode music formats and deliver technical copies of the music, and act as distributors of music over the Internet, negotiating the deals directly or through an intermediary with online music services. Aggregators usually have exclusive contracts with the record labels they represent. At the national level, they negotiate deals directly with the online music service providers. Frequently, established music services use standard agreements. As a result, negotiations are quite

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http://www.eliamep.gr/en/category/european-integration/collecting-societies-and-cultural-diversity-in-the-music-sector/.

52. For a complete list of these entities see KEA & VUB, *supra* note 4, at 31.

53. *Id.* at 37.

54. PARL. EUR. DOC. PE 496.734, *supra* note 16, at 3.

55. KEA & VUB, *supra* note 5, at 30.

56. Aggregators (*e.g.*, The Orchard, PIAS UK, Zebralutions) should not be confused with the new licensing entities that deal with copyrights.

57. KEA & VUB, *supra* note 5, at 31.

rapid – as there is almost no negotiation – and Transaction Costs are reduced for service providers, in comparison to a situation where they would need to negotiate with every record producer.[58]

D. Licensing Process for Services in the EU

The following figures illustrate the complexity of acquiring licenses for online music services, in particular those active in several EU territories. They were designed based on interviews.[59] Services accessible in only one territory will usually have to acquire rights from the local CMOs for authors and publishers and from record labels.[60] In general, this scenario applies to smaller services operating only in the local territory. Larger services operating in the local territory will mostly have to negotiate the major publishers' repertoire directly and big European local repertoires with the national CMOs. The provider will have to deal with CMOs for authors' and publishers' rights. On the other hand, record labels administer their own rights together with the online rights of performers. Services providers negotiate directly with the record labels or with aggregators.

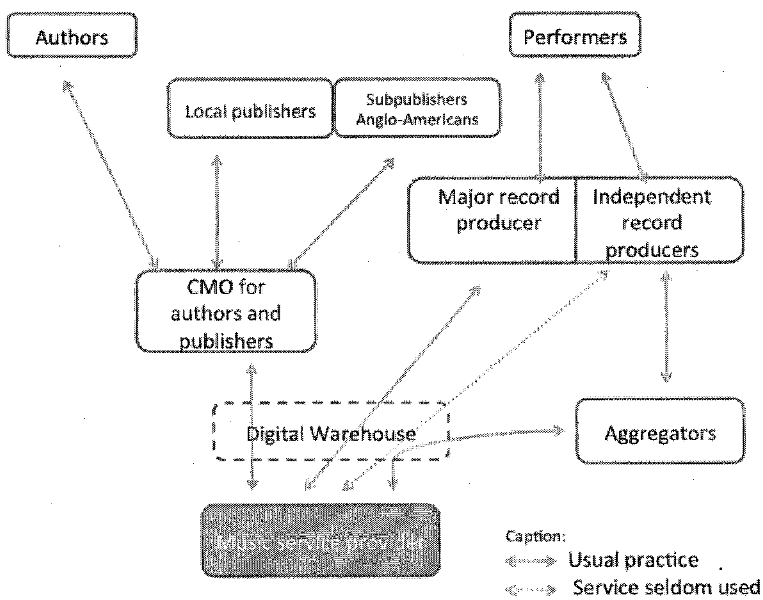

Figure 1: Licensing for small services accessible in one territory[61]

58. Aggregators themselves face additional transaction costs derived from the negotiation with the record producer they represent.

59. *See* KEA & VUB, *supra* note 5, at 32-37 (and at 64 for a complete list of interviewees).

60. KEA & VUB, *supra* note 5, at 31.

61. *Id.* at 35.

To operate in several territories, service providers have to negotiate with several different entities. The next figure illustrates the case when the online service provider wishes to offer a catalogue as large as possible. This would include the Anglo-American repertoire as well as local repertoires (from both majors and independents) from the various countries, in which the service is accessible. Consequently, service providers will have to negotiate with all the right holders and other entities involved.

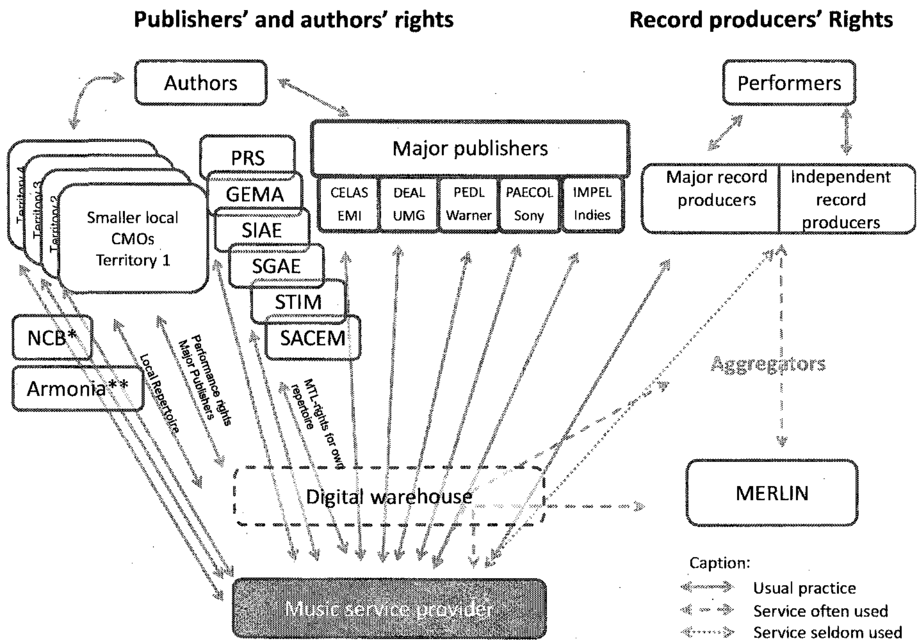

Figure 2: Licensing process for services accessible in several territories
* For Baltic and Nordic repertoires (making available and reproduction rights).
** For French, Italian and Spanish repertoires (making available and reproduction rights).

III. THE COSTS OF LICENSING FOR MUSIC SERVICES

A. Definition and Identification of Transaction Costs

Transaction Cost Economics (TCE) – a.k.a. neo-institutional economics – was developed notably by Oliver Williamson[62] and the use of TCE in the

62. MATTHIAS KLAES. TRANSACTION COSTS, HISTORY OF, *in* The New Palgrave Dictionary of Economics, 2nd Edition (2008), *available at http://www.dictionaryofeconomics.com/article?id=pde2008_T000239*; *see generally* OLIVER E. WILLIAMSON, *Chapter 3 Transaction Cost Economics*, *in* HANDBOOK OF INDUSTRIAL ORGANIZATION (Richard Schmalensee & Robert Willig eds., 1989) [hereinafter HANDBOOK OF INDUSTRIAL ORGANIZATION].

branch of the law and economics of copyright is now relatively commonplace.[63] TCE is focused on transactions, which can be defined as the transfer of property rights (here, intellectual property rights (IPR)), whereas property rights relate to the rights of the individuals to use, alter, generate income from and transfer resources.[64] TCE aims to analyze the conditions of a transaction and has been applied to various social situations – from the functioning of an industry to the relationships within a family.[65] Here the transactions concern the licensing of IPR to online music services.

This section focuses on *ex ante* Transaction Costs (TC). TC include all the costs incurred when a transaction takes place. Williamson compares TC to friction in physics:[66] without them transactions would be much easier; it is worth trying to reduce them but it is never possible to suppress them entirely. It is common to distinguish between *ex ante* and *ex post* TC. *Ex ante* costs are all the costs incurred before a transaction and *ex post* costs are all the costs incurred after a transaction.[67] The online music market is still young and there are many Creative Upstarts, therefore it is more relevant to focus on *ex ante* costs, which arise during the establishment of a service.[68]

Based on Hansen and Schmidt-Bischoffshausen[69] and Picot et al,[70] the typology of *ex ante* TC for rights for online distribution of music content includes: (i) identification costs, which correspond to all the costs incurred to identify and find the rights owners; (ii) negotiation costs, which correspond to all the costs incurred between identification and the actual agreement.

This article focuses on the TC supported by the online music services. This approach is rarely considered in research on TC in online content markets. Previous studies consider TC at a general level, without necessarily entering into the details of the TC faced by every partner.[71]

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63. Wendy J. Gordon & Robert G. Bone, *Copyright*, *in* ENCYCLOPEDIA OF LAW & ECONOMICS 192 (B. Bouckaert & G. Degeest eds., 2000).

64. Markus Anding & Thomas Hess, *Online Content Syndication - A Critical Analysis From the Perspective of Transaction Cost Theory*, ECIS 2002 PROC. 551, 553 (2002), *available at* http://aisel.aisnet.org/ecis2002/86.

65. WILLIAMSON, *supra* note 62.

66. *Id.* at 142.

67. KEA & VUB, *supra* 5, at 42.

68. However while it is analytically possible to distinguish between these costs, in reality there are strong links between both. Actually, *ex ante* costs are borne to try to prevent *ex post* abuses. In addition every agent tries to assess *ex ante* the reliability of the other party in order to determine the conditions/circumstances under which there could be a transaction.

69. Gerd Hansen & Albrecht Schmidt-Bischoffshausen, *Economic Functions of Collecting Societies - Collective Rights Management in the Light of Transaction Cost- and Information Economics*, 1 (Oct. 19, 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=998328.

70. *See generally* ARNOLD PICOT ET AL., DIE GRENZENLOSE UNTERNEHMUNG (4th ed. 2001).

71. *See, e.g.*, Hal Varian, *Transactions Costs and Copyright*, WIPO, (Sept. 15, 2010), http://www.wipo.int/edocs/mdocs/copyright/en/wipo_ip_econ_ge_4_10/wipo_ip_eco

When such previous studies focus on one partner, they often consider the role played by CMOs in reducing or increasing TC.[72]

B. What Causes Higher Transaction Costs? An Overview of the Literature

This section develops assumptions about the characteristics of transaction, which have an impact on TC in online music licensing. To do so, this section covers two kinds of literature: general literature on TC theory and literature on online music licensing. According to Williamson,[73] transactions differ along three dimensions, which have an impact on their related costs: asset specificity, uncertainty, and the frequency of transactions. Before analyzing each dimension, the impact of the number of transactions is considered.

1. The Number of Transactions

Every transaction incurs costs; hence the total TC of a firm increases with the number of transactions. Thus, from a general perspective digital technologies increase TC because they make more content available.[74] Online music service providers must identify and negotiate for every additional country where they will be present. Therefore, it is anticipated that online music services which are available in several countries face higher TC than those which are available in only one country. In other words, multi-territorial accessibility increases TC[75] unless an efficient and operative system of multi-territorial licensing (e.g. one-stop shop) is in place, so that service providers do not need to clear licenses in each territory.

Online music service providers must also identify and negotiate with a variety of right holders for the different repertoires they want to add to their catalogue, with each repertoire comprising anything from one to millions of titles. Therefore it is expected that online music services with bigger catalogues face higher TC than online music services with smaller catalogues. However, TC are not necessarily proportional to size, a transaction will in general cover more than one title, e.g. one major's

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n_ge_4_10_www_142277.pdf.

72. This is notably the case for Hansen & Schmidt-Bischoffshausen, *supra* note 44; *see* Roya Ghafele & Benjamin Gibert, *Counting the Costs of Collective Rights Management of Music Copyright in Europe*, MPRA 1, 7 (Oct. 17, 2011), http://mpra.ub.uni-muenchen.de/34646/1/MPRA_paper_34646.pdf.

73. *See generally*, OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS, A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION (1975).

74. Varian, *supra* note 71, at 2.

75. LEURDIJK & NIEUWENHUIS, *supra* note 25, at 75.

catalogue. Conversely, cases also arise where one or a few titles require several transactions.

2. *Dimension 1: Asset Specificity*

Assets include all economic resources owned or controlled by firms to produce value. Assets are said to be specific when their owner cannot redeploy them for alternative uses without a significant cost.[76] Business partners investing in specific assets face delicate negotiating positions because they need a transaction to take place, otherwise they will have lost money by investing in an asset that cannot be redeployed without a cost. However, the higher the specificity, the harder it is to find partners willing to invest in such assets.

From the service provider's point of view, the assets comprise all the resources acquired to set up the music service.[77] Most online music services (at least the more generalist ones) cannot avoid making deals with the right holders that own or manage rights for the most important parts of the repertoire. This is one reason why major publishers and major record producers are in a better position in negotiations. It is therefore expected that online music services will face higher negotiation costs when dealing with major publishers and major record producers.

The case is more ambiguous for CMOs. CMOs are unavoidable business partners since they provide both local blanket licenses and multi-territory licenses.[78] However, their bargaining power might be lower because in general they must have uniform conditions for all users.[79] In addition, CMOs are often obliged by law to provide licenses to users.[80] For these reasons, researchers tend to conclude that CMOs help to reduce TC,[81] in particular because instead of every service provider negotiating with every right holder, service providers have to negotiate only with one, or a few, CMOs.[82]

On the contrary, CMOs could increase TC, in particular for Creative Upstarts. Actually, innovative services may not benefit from the uniform conditions, as their services are not easily comparable to the existing ones. Moreover, licensing processes can be long and CMOs can still decide on

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76. HANDBOOK OF INDUSTRIAL ORGANIZATION, *supra* note 62, at 142.

77. The other assets are the musical works, which belong to the right holders. However, the recording companies do not necessarily need to be present on these services.

78. KEA & VUB, *supra* 5, at 44.

79. Ghafele & Gibert, *supra* note 72, at 7.

80. KEA & VUB, *supra* 5, at 44.

81. *See generally* STRATEGIC ADVISORY BOARD FOR INTELL. PROP. POL'Y (SABIP), THE RELATIONSHIP BETWEEN COPYRIGHT AND CONTRACT LAW (2010) [hereinafter SABIP], *available at* http://www.ipo.gov.uk/pro-ipresearch/ipresearch-right/ipresearch-right-copy.htm

82. Hansen & Schmidt-Bischoffshausen, *supra* note 69, at 8.

rates, which are sometimes claimed to be too expensive for innovative services.[83]

In addition, in some territories, access to the local repertoire can be crucial; the local repertoire may be owned or managed by independent record producers. Therefore, some independent record producers may have higher bargaining power, which may slow down negotiations.

3. Dimension 2: Frequency of Transactions

Frequency corresponds to the number of transactions, over a given period, that take place between business partners.[84] The impact of frequency on TC (e.g. through duration of licenses or the conditions for their renewal) is ambiguous. Actually when partners have more frequent transactions, this can decrease as well as increase the costs relating to each transaction. Therefore, no assumption could be derived from this dimension.[85]

4. Dimension 3: Uncertainty and the Behavioral Assumptions

Uncertainty refers to both unpredictable external events (e.g. a new technology allowing new uses) and behavioral uncertainty.[86] The greater the uncertainty, the higher the TC,[87] sometimes to the extent that uncertainty prevents transactions from taking place at all. The impact of uncertainty on costs is connected with, and primarily results from, opportunism and bounded rationality.[88]

Bounded rationality corresponds to the fact that human decisions are limited by the information available, their ability to analyse that information, and the time they have to make a decision.[89] More generally, decisions become less "rational" (and hence uncertainty is increased) due to a wider availability of transaction opportunities--with more content being available and technology enabling Internet users to have access to services and content from all around the world--or the fact that information goods (i.e. musical works) are difficult to value.[90]

Opportunism corresponds to the fact that no business partner can completely trust the other. This mainly has an impact on negotiations, since each contractor tries to assess the risks and put in place written clauses to

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83. ELIAMEP (2009), *supra* note 52 at 93; *see also* Robert Andrews, *It's Time For Transparency On Music Streaming Rates*, PAID CONTENT (Nov. 16, 2011, 12:09 AM), http://paidcontent.org/2011/11/16/419-its-time-for-transparency-on-music-streaming-rates/.

84. KEA & VUB, *supra* note 5, at 44.

85. *Id.*

86. HANDBOOK OF INDUSTRIAL ORGANIZATION, *supra* note 62, at 143.

87. SABIP, *supra* note 81, at 54.

88. Anding & Hess, *supra* note 40, at 557.

89. *See generally* HERBERT SIMON, ADMINISTRATIVE BEHAVIOR: A STUDY OF DECISION-MAKING PROCESSES IN ADMINISTRATIVE ORGANIZATIONS 291 (4th ed. 1997).

90. Anding & Hess, *supra* note 40, at 555.

protect them from opportunistic behavior. Thus, right holders can be more reluctant to reach an agreement because they suspect online music service providers do not respect copyright.[91] This can also have an impact on identification costs because right holders have the incentive to let online music service providers meet all the identification costs.[92]

Uncertainty is reinforced by the lack of transparency around repertoire ownership, i.e., the lack of information available on which work belongs to which right holder(s). The service providers are dependent on the information about rights ownership, which is controlled by right holders.[93] In addition, the interviewed service providers complained that right holders, and in particular CMOs and some of the new licensing entities, are unable to properly identify their own catalogue of works and rights.

Because the use of music content by online services is relatively new, transactions take place in an uncertain environment, which may make partners more reluctant to reach an agreement. Therefore, it is expected that some online music services will face higher TC than others. This is the case for the Creative Upstarts because they are new players. In other words, the study assumed that online music services owned by traditional music industry players face lower TC. These services have the most experience in the music industry and as a result should be able to identify the right holders more easily. They may also have more credibility when negotiating, especially compared to newcomers Creative Upstarts. In addition, they may already own or manage rights.

Conversely, the most innovative services in terms of business models will face higher TC, i.e., online music services that propose streaming or subscription services face higher TC than services which operate on a download-to-own model. In addition, the agreements the service providers obtain may not allow them to easily modify their business model (*e.g.*, their commercial offer).

C. Where the Transaction Costs Are: An Analysis Based on a Sample of Services[94]

1. Total Transaction Costs and their Impact on the Roll Out of New Services

According to the estimates, services available in several countries, and with an offer of more than 1 million titles, could face yearly TC of up to €260,000 and employ six full-time equivalents staff (FTE).[95] Services

91. *Id.* at 555.
92. Varian, *supra* note 71, at 17.
93. KEA & VUB, *supra* note 5, at 45.
94. The size of the sample of services does not allow isolating the impact of a given factor.
95. KEA & VUB, *supra* note 5, at 59.

available in only one country and with a very small (less than 2,000 titles) and specialized catalogue (e.g. in local indie rock) could face yearly spending of €6,000 and employ 0.5 FTE.[96]

The difficulties faced in the licensing process also impact the dynamics of the market, specifically the time needed to launch a service. According to the estimations, the identification of the right holders can take up to six months and the negotiations as long as two years.[97] This long process is likely to slow down the rolling out by Creative Upstarts of innovative online music services.

The approach used in the study did not assess the whole impact of TC on the time taken to launch a service. Actually TC theory is more relevant to static analysis.[98] It is also possible that the time taken to identify, and negotiate with, right holders does not cause a delay in the launch of the service because other processes take place at the same moment (e.g. technical development of the platform).

2. *Fragmentation of Rights Increases the Transaction Costs for the Music Service Provider*

With fragmentation, every use of a track requires multiple authorisations, from several right holders, thus a higher number of transactions.[99] Interviews confirm that fragmentation of rights increases TC for online music services, in particular those available in several countries and/or with a bigger catalogue.

The fragmentation of rights adds to the uncertainty of the environment in which the service providers operate, and interviewed service providers frequently claim that they are rarely sure that for any track or repertoire they have acquired all the relevant rights.[100] Rights ownership depends partly on recording contracts, which are often difficult to trace. In many cases, contracts have been drafted years before online music platforms appeared and therefore do not refer to uses that could be particularly relevant to online distribution, e.g. the making available of individual tracks. Thus in 2010, Pink Floyd won a court claim against EMI which prevented the record company from selling downloads of individual tracks from the band's albums on the Internet.[101] In the end, Pink Floyd and EMI reached an agreement which allowed Pink Floyd's music to be available as individual

96. *Id.*

97. *Id.*

98. Bart Nooteboom, *Towards a Dynamic Theory of Transactions*, 2 J. EVOLUTIONARY ECON. 281(1992).

99. KEA & VUB, *supra* note 5, at 47.

100. KEA & VUB, *supra* note 5, at 47.

101. Jane Croft, *Pink Floyd Wins EMI Court Case*, FIN. TIMES (March 11, 2010, 6:51PM), http://www.servizi-italiani.net/allegati/2010/3/12/269648_288698.pdf.

tracks and as albums.[102] However, this shows that online music service providers may be dependent on litigation around contracts of which they were initially not a part.

Uncertainty is further reinforced by the lack of identification systems and databases, in particular for CMOs and some new licensing entities. The internet exacerbates the problem by enabling more uses and because the technology makes it easier to go beyond national borders.[103] For all these reasons, the fragmentation of rights increases identification and negotiation costs.[104]

3. *Multi-Territory Services Face Higher Transaction Costs*

TC are higher for services available in several countries than for those available in only one country, which confirms the conclusions in the literature[105] and those drawn from interviews. Services in the sample which were available in several countries use twice the manpower for licensing rights than services available in only one country (3.1 and 1.7 FTE, respectively).[106] Expressed in financial terms, total costs are four times higher for services available in several countries (€118,000) than in one country (€29,000). The main reason is that online music service providers need to duplicate their costs when they make their service available in another country. With the absence of easy means to acquire multi-territory licenses, TC constitutes a huge barrier for online music services which aim to operate in all EU countries.

In particular, negotiations are more costly for services available in several countries.[107] It takes online music providers, on average, one year and three months to negotiate with major publishers, compared with nine months for services available in one country. It also takes them on average three months to negotiate with the CMOs for authors, in comparison to one week for services available in one country.

However, although our argument is that licensing with one local right holder (e.g. CMO) results in lower TC than acquiring a multi-territory license, this does not necessarily mean that licensing with many (e.g. 27) local right holders to get the equivalent of one multi-territory license results in lower transaction costs than multi-territorial licenses.[108] Thus, a situation

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102. Michelle Castillo, *Pink Floyd Gives Into EMI, Will Still Sell Individual Tracks*, TIME (Jan. 4, 2011), http://techland.time.com/2011/01/04/pink-floyd-gives-into-emi-will-still-sell-individual-tracks/.

103. KEA & VUB, *supra* note 5, at 47. *See also* Varian, *supra* note, at 72.

104. WORKING GROUP ON COPYRIGHT, Copyright in the Music and Audiovisual Sectors (2011).

105. LEURDIJK & NIEUWENHUIS, *supra* note 25, at 71.

106. KEA & VUB, *supra* note 5, at 47.

107. *Id.*

108. *Id.*

in which every right must be acquired on a strictly territorial basis is inadvisable, even though it is moderately easy to acquire a license in every territory.

4. *The Type of Right Holders has an Impact on Negotiation costs*

The analysis confirms that the greatest negotiation costs are faced in negotiating with major record producers and new licensing entities (granting multi-territorial licenses).[109] For example, it takes one year for one service in our sample to negotiate with major record producers compared to only one week with indie record producers or with indie publishers. Similarly for another service, it takes one year and a half to negotiate with new licensing entities, two years with major record producers and 'only' one year with indie record producers.

This confirms that majors wield their higher negotiation power based on the size of their catalogue and the fact that they are unavoidable partners for most online music services.[110] Accordingly, all respondents rated the negotiations with majors as "unreasonably costly or time-consuming." The distinction between CMOs and independent record producers is less straightforward. For most services in the sample, negotiations are as long with CMO as with independent producers.

Finally, TC concerning the negotiation with the new entities created by the major publishers for multi-territorial licensing are still very high, thus one respondent indicated that negotiations can take up to two years.[111]

5. *Services that Propose a Bigger Catalogue Incur Greater Transaction Costs*

Online music services were distinguished according to the number of titles in total in their catalogue (irrespective of the size of the catalogue for every territory). A distinction was drawn between services with a catalogue of around 1,000 or 2,000 titles and those with more than 1 million titles.

As expected, TC are higher for services providing access to a higher number of titles.[112] There is however no proportionality in the cost gap. Thus, it takes two months for the services with a catalogue of less than 2,000 titles to identify right holders against four months for those with a catalogue of more than 1 million titles. Services with a catalogue of more than 1 million titles employ in average 4.7 FTE to deal with the licensing of rights, which costs them in average €163,000. On the other side, services with a catalogue of less than 2,000 titles employ in average 0.7 FTE to deal

109. *Id.* at 48.
110. *Id.*
111. *Id.*
112. KEA & VUB, *supra* note 5, at 49.

with the licensing of rights, which costs them in average €9,000. This is illustrated when comparing two services in our sample. The first offers 17 million titles and incurs costs equivalent to around €220,000 every year to identify, and negotiate with, right holders; whereas the second one offers around 100 albums and incurs costs equivalent to around €6,500.[113]

6. *The Level of Transaction Costs Depends on the Service Providers' Main Activity*

Online music services were distinguished depending on their provider's main activity: pure online music services (services that are independent or belong to online content providers); companies that are technology-driven (e.g. producing mobile devices or ISP); and record labels.

The analysis shows that identification costs, which are the lowest for record labels (almost immediate) compared to online music services (ten weeks) and technology companies (six months). This does not facilitate the entrance for Creative Upstarts.

7. *Services Based on More Established Business Models Face Lower Transaction Costs*

Online music services are distinguished according to their business model (i.e. to their revenue model and or their type of content service), with two categories: services providing permanent downloads on a pay-as-you-go basis; streaming services with subscriptions. More recently, the latter can be considered as Creative Upstarts. In addition, downloading services' revenue model is more akin to the traditional revenue model in the recording industry based on the sales of recordings.

As expected, streaming services in the sample employ 3.9 FTE to deal with online music rights licensing against 2.6 FTE for downloading services, i.e., €133,200 and €95,400, respectively.[114]

CONCLUSION

According to the estimations based on the survey, an online music platform aiming to provide multi-territorial services in Europe would have to invest an average €230,000 in transaction costs alone to get a license for a catalogue of more than one million titles. This is a large amount given that most online music services still do not break even and that this figure only refers to transaction costs and must be considered by the service providers in addition to other key investments, notably technological infrastructure and license fees.

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113. *Id.* at 50.
114. *Id.*

The fragmentation of rights, right holders and repertoires is the cornerstone of the problem. Online music service providers willing to set up multi-territorial services need to enter into negotiations with a multiplicity of right holders and managing entities: record producers, aggregators, CMOs for publishers and authors, new entities for publishers' rights, etc. The providers also need to acquire making available and reproduction rights, which can be split between different right holders for the same title. This multiple fragmentation together with territorial licensing practices makes it extremely costly to license multi-territorial services.

The bargaining power of certain right holders, in particular major publishers and record producers, puts service providers (mainly medium to small) in a difficult negotiating position. This is becauset hose right holders hold the assets that online music services with a generalist catalogue need to acquire. Right holders seem to make extensive use of this bargaining power, according to interviews with service providers. This--together with the finding that the more innovative the business model, the bigger the transaction costs--makes things particularly difficult for the online music Creative Upstarts.

Finally an additional factor multiplying transaction costs is the right holders' inability to properly identify their own catalogue of works and rights and the lack of uniform standards for the monitoring, reporting and invoicing of related uses.

All these factors contribute to slow the licensing process and, consequently, the installment of cross-border European services. In this context, transaction costs are particularly high for Creative Upstarts, namely on the one hand services experimenting with hybrid and/or innovative business models. Uncertain revenue streams and consumer acceptance of their business models weaken their bargaining position, as well as their capacity to lead lengthy negotiations with right holders.

On the other hand, services launched by new market entrants have no long-lasting link with the traditional music industry and might lack important knowledge about the functioning of the music industry when setting up those services.

The main recommendation towards Creative Upstarts is guaranteeing that powerful players license on fair and reasonable terms, which ensures a competitive market and allows Creative Upstarts to flourish. This goes along with other recommendations already partly analyzed in the study.[115] Such analysis would nevertheless deserve more research.

115. *Id.*