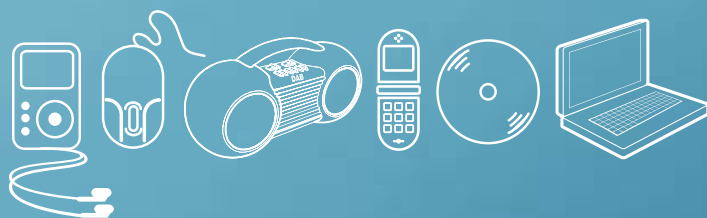












IFPI:06

DIGITAL MUSIC REPORT





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MUSIC – A KEY DRIVER OF THE DIGITAL ECONOMY

A new wave of digital commerce, from mobile to broadband, is rolling out worldwide – and music is driving it.



John Kennedy, Chairman & CEO, IFPI

Two years ago, few could have predicted the extraordinary growth we have seen in the digital music business. Some 420 million single tracks were downloaded in 2005, up more than twenty times on two years ago. And that excludes the entire business of music on mobile phones, a market which is not far behind music downloads in value. Together in 2005, these two new distribution channels took record company revenues from digital sales to an estimated \$US 1.1 billion globally, tripling in value compared to 2004. And there will be further significant growth in 2006.

But, impressive as they are, these statistics only hint at the real underlying value of the digital music revolution. Music is today making an enormous contribution to the development of the world's digital economy. For example, in 2005 consumers bought over 60 million portable digital music players (worth an estimated \$US 9 billion), paid over \$US 75 billion in broadband subscriptions and purchased \$US 50 billion worth of mobile data services. Nokia, the world's largest mobile handset manufacturer, sold over 40 million music-capable phones alone.

The message is clear: a new wave of digital commerce, from mobile to broadband, is rolling out across the world. It is generating billions of dollars in revenues and creating millions of jobs. And it is being driven, to a large extent, by music – by the people who create music, who produce it and who invest in it.

The music industry is delivering on its pledge to license music ubiquitously: as much music, in as many ways, to as many consumers via as many formats and distribution channels as possible – as long as it is licensed and paid for.

At the same time the industry is helping transform the experience of the music fan. In 2005 the number of legitimate music download sites reached 335, up from 50 two years ago. In just two years the volume of music made available online by record companies has increased more than six-fold to over two million songs. Digital music, no longer the preserve of a small core of large markets, is spreading internationally. And it is a reflection of the potential growth in consumer demand that even today, less than 5% of European internet users regularly buy music online.

This is a success story, but one that cannot be taken for granted. Key challenges confront the digital music industry at the start of 2006 and even threaten to hold back its growth. We are meeting these challenges.

Above all, we must protect our product. In an industry dependent on intellectual property, licensing your product is worthless if you cannot also protect it. The music industry has now taken some 20,000 legal actions against illegal file-sharers in 17 countries, and these actions will be stepped up in the next year. The strategy will not eradicate the problem, but it is containing it. Consumer research in this report shows that every second person who cut back on illegally file-sharing has done so out of concern for the legal consequences.

The same research raises other important questions. No one underestimates the challenge of persuading a young generation of music fans to pay for music that they have become used to acquiring for free.

The legitimate digital music business has for years cried out for clearer legal ground rules. On this front, 2005 saw a big leap forward. Four courts in three continents, from the US to Australia, delivered judgements against unauthorised P2P services that will help transform the landscape in which the nascent digital business is growing.

Hearts and minds are critical in this process, too. In 2005 the music industry launched four separate global education campaigns, often sponsored by national governments. They are aimed at specific audiences that shape attitudes to music on the internet – parents, business leaders, legitimate computer users and, last but not least, copyright offenders themselves.

“Music is not only the most popular consumer product in the industrialised world. It is a key driver of the digital economy.”

Digital Rights Management (DRM) is a fundamental, yet sometimes misunderstood element of the digital music business. DRM is an essential tool for all industries trading in intellectual property in the digital era – from music to movies, games and TV. It helps get music to consumers in new and flexible ways and to recompense the many different rights owners involved. Technology companies need to support DRM, making their devices interoperable. Governments also have a key role to play by supporting DRM in managing the delivery and protecting the value of digital music.

We need cooperation from our partners too. Internet Service Providers are becoming the new retailers and distributors of the digital market. They are making revenues from digital music, but not taking enough responsibility for protecting our copyrights. This must change. They must take their share of responsibility in stopping infringements of the copyrighted content. In the physical world, no respectable music store or distributor would stock pirated product on its shelves or allow piracy to take place in a corner of its shop or warehouse.

The digital music business is at a pivotal moment at the start of 2006. Consumers are increasingly turning to legitimate ways of downloading music, the legal environment for our business is improving and record companies are licensing music prolifically and diversely.

The challenges ahead are clear, though. We need greater support in the fight against digital piracy; more recognition of the role of DRM; more cooperation from ISPs; and more respect for the intellectual property on which we and many other industries depend. The record industry now looks squarely at our partners in the marketplace, as well as to governments, to help achieve these aims.

THE DIGITAL MARKET TAKES SHAPE IN 2005



The legitimate digital music business has caught the imagination of consumers, sales have increased steadily and new service launches have accelerated.

2005 was a landmark year for digital music, when online and mobile music distribution emerged as the industry's fastest growing delivery channels. Digital sales in 2005 accounted for approximately 6% of global music sales based on the first six months of the year.

2005 witnessed key milestones in the development of the market:

Digital is the fastest-growing delivery channel for music.

Record company revenues reached an estimated \$US 1.1 billion in 2005, three times the value in 2004 (\$US 380 million), with the split roughly 60:40 between online and mobile music. Digital sales have gone from practically zero to 6% of the recording industry's global worldwide revenues within the last two years.

Single track downloads in 2005 more than doubled to 420 million,

proving to be the most popular online music product. Subscription service users are also growing, up from 1.5 million to 2.8 million in the last year.

Online song catalogues doubled:

there are now at least two million tracks and 165,000 albums available on the major services.

Digital music expanded rapidly across the world.

Globally there are now over 335 legal online music services, up from 50 two years ago. The number of services operating in more than three countries doubled to 20 in the last year.

Apple iTunes extended its service to 21 countries worldwide,

launching in Scandinavia, Japan and Australia. Globally, iTunes reached sales of 850 million tracks since launch in 2003 (Apple counts album tracks in that figure).

Portable video was launched,

marking the arrival of the new portable video entertainment market – one million video iPods were sold in the first three weeks since launch.

The mobile phone became a portable music device.

Specially designed music phones were released by the major handset makers as dozens of 3G music services were launched, making mobile downloads widely available outside Asia.

The world's first publicly available legal peer-to-peer (P2P) service iMesh launched in beta phase,

with a full launch expected early in 2006. Many other P2P providers are now looking to go legitimate following legal decisions against Grokster in the US and Kazaa in Australia. Meanwhile, the legal environment for digital music improved very significantly in 2005, with decisions against file-sharing services Grokster (US) and Kazaa (Australia), as well as similar judgements over Kuro (Taiwan) and Soribada (Korea).

James Blunt topped Europe's first digital songs download chart in 2005.

1. James Blunt/You're Beautiful
2. Madonna/Hung Up
3. Daniel Powter/Bad Day
4. Sugababes/Push the Button
5. Robbie Williams/Tripping
6. Gorillaz/Feel Good Inc.
7. Black Eyed Peas/Don't Phunk with my Heart
8. Coldplay/Speed of Sound
9. Kanye West/Gold Digger
10. Pussy Cat Dolls/Don't Cha

Source: Nielsen SoundScan International
Period: May-December 2005

The advance of the global digital music market			
	2004	2005	Change
Broadband lines (M)	151	190	26%
Single tracks downloaded (M)	156	419	169%
Online music services	230	335	46%
Song catalogue (M)	1	2	100%
Subscription service users (M)	1.5	2.8	87%
Mobile phone subscriptions (M)	1350	1520	13%

Sources: PointTopic-IFPI, Nielsen SoundScan, OCC, IFPI Germany, SNEP, RIAJ, IFPI, subscription service providers, PWC

DIGITAL MUSIC EXPANDS WORLDWIDE

The digital music business spread internationally in 2005 led by the US, with Europe and Asia showing strong growth.

Single track downloads in the **US** more than doubled in 2005 to 353 million (Nielsen SoundScan), with a weekly sales average of 7 million tracks. Digital album downloads grew to 16 million, or 2.6% of the album market, up from 1% in 2004.

Another important development in the US was the launch of portable subscription services such as Napster To Go, Rhapsody To Go and Yahoo Music Unlimited. These allow customers to listen to entire music service libraries directly on their portable player. More recent service launches in the US include Virgin's Red Pass subscription service and music retailer Musicland's online store grazemusic.com. Retail brands Target and Best Buy also plan to launch digital services in 2006. A new MTV/ Microsoft service 'Urge' will launch in 2006.



“The expansion in digital music is providing us with more and more new ways to add value for consumers, artists and an ever-growing circle of business partners and brands. Now we – the music industry, retailers and technology companies – must work together to maximise this unique opportunity.”

Alain Levy, chairman & CEO, EMI Music

The American mobile music market is also taking off. Master ringtones are now outselling ringtones, marking the shift by mobile users towards real music products, and the first 3G full track download service was launched.

In **Europe** the digital market has begun to take shape, with the UK, Germany and France leading the way. In the UK and Germany online downloads are predominant, whereas in France and Italy mobile music has developed more quickly than online. In France mobile accounts for over half of digital sales and in Italy the share is much higher at over 80% (both based on first half of 2005).

The UK is the fastest-growing online music market in Europe. Major retail stores Virgin and HMV launched online, and existing services like Napster and iTunes are marketing their brand heavily. The UK saw sales of 26 million single track downloads during the year – a four-fold increase on 2004. Downloads have been successfully merged into the singles charts, giving digital sales greater media and public exposure.

Germany is Europe's second largest digital market, with sales in 2005 more than tripling in one year to 21 million downloads. In France, sales of 8 million downloads compared to just 1.5 million in 2004. In both markets, local services have focused on local repertoire and more varied pricing options than in the UK. In Germany, for example, Musicload is the market leader, followed by iTunes and AOL. In France, the major players are VirginMega and Fnacmusic, followed by E-Compil and iTunes. Overall in Europe, MSN is the number three retailer after iTunes and Musicload.

In **Eastern Europe** online music is yet to take off, but the mobile music market is developing quickly, with penetration rates reaching 100%



in Czech Republic and Romania. But there have been some advances in the online sector too, with the launch of Onetplejer in Poland offering catalogue from all four majors and independent labels.

There are now nearly 200 music services in total in Europe, with launches in 2005 including iTunes in Scandinavia and Ireland, Virgin in Greece and MyCokeMusic in Italy – which is now available in five markets in Europe. Napster is the first subscription service to launch in Germany, while introducing Napster To Go to offer portable subscriptions in both the UK and Germany. Meanwhile 3G mobile services have steadily expanded.

Mobile music continues to drive the digital business in **Asia**, with mobile sales in Japan accounting, for example, for 96% of Japan's total digital sales of \$US 221 million in the first nine months of 2005.

Internet piracy remains a serious barrier to the development of the online market in Asia. But there are signs of potential. iTunes launched in Japan in August 2005, contributing to strong growth in downloads. Napster also plans to launch a subscription service in Japan in 2006, which should further expand the online market. In addition, Soundbuzz continues to expand and is now

Asia's largest digital music company operating in 13 markets throughout the region. At least 10 new online music services launched in Asia in 2005, and portable player ownership increased. One in three people in Hong Kong now own a portable MP3 player, with ownership already at 28% in China and Korea (Synovate).

In **Australia**, digital sales have arrived with the launch of iTunes in October. It joins existing players Bigpond, NineMSN, HMV and Soundbuzz. With only one third of Australia's six million internet users on broadband, however, the overall market is still relatively small.

Latin America's digital music market continued to develop in 2005 following the launch of iMusica in Brazil in 2000. In Mexico, Tarabu launched in November with a catalogue of 300,000 songs available from all major labels and independents. Argentina also saw the launch of 10musica and Zapmusic in late 2005. Mobile music is also emerging: Brazil is among the top five biggest mobile subscription markets worldwide. However, the low penetration of music-capable phones in the region is restricting the growth of mobile music.



"It has been a tremendous year for Apple and music with the iTunes music store now available in 21 countries. The iTunes music store is the most popular way for Mac and PC users worldwide to legally discover, purchase and download music online, offering users a selection of over 3,000 music videos, Pixar short films, and more than two million songs from the major music companies and independent record labels."
Eddie Cue, Vice President of iTunes, Apple

US digital music market – the key figures

	2004	2005	Change
Broadband lines (M)	34	43	26%
Single tracks downloaded (M)	143	353	147%
Album downloads (M)	6	16	193%
Mobile subscriptions (M)	163	174	7%

Sources: PointTopic-IFPI, Nielsen SoundScan, PWC

European digital market – the key figures

	2004	2005	Change
Broadband lines (M)	43	63	46%
Single tracks downloaded (M)	14	62	355%
Online music services	150	200	33%
3G mobile phone subscriptions (M)	5	18	255%

Sources: PointTopic-IFPI, OCC, IFPI Germany, SNEP, IFPI, Jupiter

ONLINE MUSIC SERVICES EXPAND INTERNATIONALLY **

Argentina

10music*
Zapmusic*

Australia

BigPondMusic
ChaosMusic
HMV
iTunes*
JB Hi-Fi
NineMSN
Sanity.com
Soundbuzz

Austria

AonMusicDownload
Chello Music Zone
Connect
iTunes
MyCokeMusic
MSN Music

Belgium

Belgacom
Connect
Free Record Shop
iTunes
MSN Music
Tiscali

Brazil

Americanas.com
iMusica
MSN Music
Yahoo! Music

Bulgaria

M.Dir
Music.gbg

Canada

Archambault
iTunes
Napster
Puretracks

China

9sky*
AigoMusic*
QQ*

Denmark

Bilka
Box*
CDON
Fona*
iTunes*
Jubii
MSN Music
MTV*
Payload
TDC Online

Finland

Biisi
IltaSanomat Musiikki
iTunes
Laturi
MaxMusic
MSN Music
Musiikkilataamo
NetAntilla

France

Connect
E-Compil
Fnacmusic
iTunes
Magasin U*
MSN Music
MTV
Tiscali
Virgin Mega
Wanadoo

Germany

AOL Music
Connect
iTunes
mp3
MSN Music

Musicload
Napster
Vitaminic

Greece

iTunes
mpGreek*
Virgin*

Hong Kong

Eolasia*
NWTmusic
Soundbuzz*

Iceland

TonList

India

CrimsonBay*
India Times
Soundbuzz

Ireland

Connect*
Eircom
iTunes*
MyCokeMusic
Vitaminic
Wippit

Italy

iTunes
Libero iMusic*
Messaggerie Digitali
MSN Music
MTV IT
MyCokeMusic*
Net Music MediaWorld*
RossoAlice
Tiscali
Buongiorno Vitaminic
Yahoo! Italia

Japan

Excite
iTunes*
Kandora

Listen Music Store
Love Music Store
Mora
MSN Music
Music.jp*
Naxos*
OCN Music Store
Ongem
Oricon Style
Reco-chocku
Yahoo! Music*

Korea

Bugs
Dosirak*
Funcake
Jukeon
Maxmp3
Melon
Mukebox
Musicon
Muz
Mylisten
Oimusic
Tubemusic
Wavva

Luxembourg

Connect
Free Record Shop
iTunes

Malaysia

Soundbuzz

Mexico

Tarabu*

Netherlands

Chello Music Zone
Connect
Download.nl
Free Record Shop
iTunes
MSN Music
MTV Downloads

Planet Internet Music Stream*

Tiscali
Vitaminic
Wanadoo

New Zealand

Amplifier
CokeTunes*
Digirama

Norway

CDON
iTunes*
MSN Music
MusicOnline

Poland

iPlay
Melo
Onetplejer*

Philippines

Soundbuzz

Portugal

iTunes
SAPO

Singapore

Soundbuzz
Starhub

Slovenia

Zabavaj

South Africa

MSN Music
Musica
Samp3

Spain

Carrefour
iTunes
Los40
MSN Music
MTV Downloads

MusicaPremium
Tiscali
Vitaminic
Wanadoo

Sweden

Ahléns
Bengans
CDON
Gunvor
Homedownload
iTunes*
MSN Music
Musicbrigade
Poplife
Skivhugget

Switzerland

Connect
Ex Libris*
Independenddance
i-m Music Download*
iTunes*
MSN Music
MyCokeMusic

Taiwan

KKBox*
HiMusic
Qband

Thailand

Soundbuzz

UK

Connect
HMV Digital*
iTunes
Karmadownload
Loot Tunes
Ministry of Sound
MSN Music
MTV Downloads
MyCokeMusic
Napster
Tesco

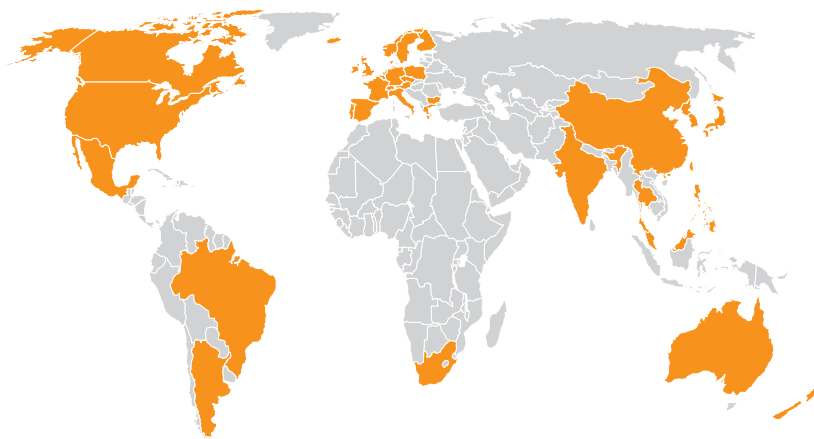
Tiscali
Virgin Digital*
Vitaminic
Wanadoo
Wippit

USA

BuyMusic
Cdlix
Connect
Ctrax2Go*
eMusic
FYE Download
Grazemusic*
iTunes
MSN Music
MusicMatch
Napster
Puretracks
Rhapsody
Streamwaves
Virgin Digital
Wal-Mart
Yahoo! Music*

*2005 launches

**This listing is not exhaustive and is for illustrative purposes only. See www.pro-music.org.



“In Asia, we have witnessed the creation of a singles market over the internet. Additionally, people have been using music to express themselves through their mobiles via applications like ringtones, master ringtones, ringback tones and blog ‘soundtracks’. Both these megatrends are likely to define the future evolution of music into its next form, or ‘avatar’... this is just the beginning.”

Sudhanshu Sarronwala, CEO Soundbuzz Pte Ltd

GETTING MUSIC TO CONSUMERS IN MORE WAYS



There are now dozens of ways in which consumers can sample and buy music legally.

DISTRIBUTION CHANNELS DIVERSIFY

The digital music market is still in an early phase, with several different business models being tried and tested. Digital channels range from master ringtones to satellite radio and vary markedly in popularity from country to country. The most popular online purchasing method for the time being is a-la-carte download – with iTunes claiming as much as 70% market share of single track downloads in the US.

Subscription services are gaining popularity. Worldwide there are 2.8 million subscription service users, nearly double the 1.5 million in 2004. The vast majority of these are in the US. Music brands like Napster, Virgin and HMV have only recently begun offering subscriptions in Europe.

Mobile operators have diversified into online music. Germany's T-Mobile partnered with its sister online music company, current market leader Musicload, to offer dual downloads – that is, songs downloaded to mobile which can also be accessed online at no extra cost. This adds to consumer flexibility and has been adopted by other mobile operators – Sprint and Verizon (US), Orange (Europe) and '3' (Europe).

Conversely, the major online music brands are also branching out to mobile channels. South Korea's mobile operator SK Telecom has launched one of the first subscription services to mobile – Melon. More recently in the US, Rhapsody and Sprint have partnered to offer Rhapsody's subscription service to Sprint's



mobile subscribers. These deals could lead to mobile handset users having full access to subscription services, using mobile handsets exactly like portable digital music players.

A key development for digital music will be to improve the flexibility to play downloads on the range of devices owned by consumers – at home or on the go. Consumers want to access and play music easily through any one of the devices which they own – be that

a mobile phone, PC or a 'home entertainment system' like an internet-enabled Hi-Fi system or TV, or a games platform such as PlayStation 2 or Xbox.

Loudeye already launched a retail platform at the end of 2005 using Intel technology Viiv that enables consumers to buy tracks from a digital music store using a single account and download them directly to any one of these devices.

VIDEO BOOSTS DIGITAL MUSIC

Music video is now a key element in the product mix of almost all existing online and mobile services – a very strong pull from the consumers' perspective. Services like Yahoo and AOL in the US have put video at the centre of their service offerings, and some mobile operators, such as '3', have done the same.

In October 2005, Apple launched the video iPod which can hold 150 hours of video, played back through a 2.5 inch screen. Creative followed with its Zen Vision:M portable video device in December. The introduction of these portable devices highlights the potential for music videos and other music-related visual content.

Many more 'bundles' – multi-media packages with a combination of audio tracks, related sleeve art and lyrics, videos and artist interview clips – are expected to be sold in the coming months. In November 2005 Warner Japan and mobile operator KDDI partnered to launch the first 'mobile music bundle', comprising audio, video, graphic and text elements in a single, downloadable product.



“2005 has taught entertainment retailers about diversification. The sale of traditional music formats alone can no longer be relied upon to maintain entertainment retail as a viable business model. The sale of traditional product coupled with the sale of digital product and music-related goods will be the model moving forward. While online music sales are doing well, we certainly need a combination of all three sales channels to continue to grow as a sector.”

Simon Wright, President, GERA; CEO Virgin Entertainment Group International

THE RECORD COMPANY INVESTMENT

The music industry invests in recording, digitising and marketing some 100,000 albums a year. While record companies continue to focus on this core business – discovering, recording, marketing and licensing music – they are rapidly adapting the ways in which they deliver it in the digital environment.

In the physical world, the release of recordings follows a structured cycle with the CD single leading to the CD album and then a DVD video. With new digital channels, however, comes far greater variety and frequency in getting new music to consumers. Many new recordings now have multiple-planned release ‘windows’, often starting with a ringtone or exclusive digital track several weeks before the CD single is commercially released. By the time the album is released, its individual songs are available in a multitude of ways.

A typical major record company today has between 300 and 400 separate business partners across online and mobile channels. This has been a highly complex undertaking, with the required digital business infrastructure costing many millions of dollars in investment in new technology and music digitisation. The following steps are essential in getting music out to consumers:

Three steps to digital music

Digitising content: each digital recording and original artwork needs a unique I.D. or digital fingerprint, in order to identify recordings for royalty payments.

Rights-clearance and re-negotiations: often digital licensing can mean a review of the contract between the artist and record company. Almost every song is licensed individually.

Consumer-friendly DRM and ‘usage rules’: the industry needs technologies to help to increase consumer choice while protecting the works of music creators from unauthorised distribution and unfair use.

WHAT'S YOUR LISTENING STYLE?



Cherry pick favourite songs with a-la-carte downloads: digital music gives consumers the option to buy only their favourite tracks from an album if they wish to do so. Some tracks are digital-only releases while others may have an exclusive period as a digital track before being released on disc.



‘Try before you buy’ and ‘all you can eat’ with subscription services: music fans have access to a catalogue of two million songs and latest releases for a monthly fee. Sampling is unrestricted, allowing consumers to preview entire tracks before buying.



‘Playlist’ and compile: digital services allow endless opportunities to enjoy making and recommending playlists to friends or putting together compilations.



Create the ultimate personalised radio on demand with shuffle play: many online music services allow consumers both to choose from a wide range of radio channels and to design their own personalised radio. Portable devices now let users play their entire record collections on shuffle play – the ultimate personalised listening experience.



Discover new releases with ringtones and master ringtones: these are premier releases for many artists’ new material, generating demand by word of mouth. Madonna’s single ‘Hung Up’ was available as a 30-second master ringtone four weeks ahead of its global radio and download release date.



Download music videos first: as premiers or exclusives, these are being channelled first via mobile and online services, often before the actual song release. James Blunt’s music video for his single ‘Goodbye My Lover’ received its global premiere on mobile network ‘3’.



Get everything about a favourite artist with digital ‘bundle’ releases: tracks bundled together with videos, artwork and artist interviews are ideal for 3G mobile and online customers.



Enjoy music ‘on the go’ through streaming or download: to a portable music player from an online subscription or to a mobile phone from an operator.



Own the physical copy: on CD single, album, DVD video or DualDisc.



Listen to music on a broadcast: on radio or TV, through analog, digital or satellite.



“Over the past year, two of the biggest developments across the web have been the proliferation of online communities and the creation of new services that let people incorporate digital content into their sites and communities. At Real, we’re now laying the foundation to weave music into the fabric of the internet, creating ways to let people legally incorporate digital music into their sites in ways never before possible.”

Rob Glaser, Chairman & CEO, RealNetworks

THE MARKETING OPPORTUNITY

Online and mobile channels have shaken up traditional music marketing. Today record companies rely on digital channels to promote new and existing artists to their various audiences. There have been many innovations in promoting and selling music. For example:

Concert downloads:

During the White Stripes' recent UK tour, concert goers were given a free blank CD-R with exclusive artwork specific to a show. Fans could burn a download of the performance of the song 'Denial Twist' on it and get an unprecedented memento of the gig.

The Stereophonics invited the audience at recent shows to text a number using their mobiles to receive that concert's version of the single 'Dakota'.

Pre-order exclusives:

Fans who pre-ordered Jamie Cullum's recent 'Catching Tales' album from iTunes also received exclusive audio and video from the artist's recent gigs at the world-renowned Ronnie Scott's Jazz Club.

Meanwhile exclusive download pre-order package for the new Robbie Williams album 'Intensive Care' included the video for the single 'Tripping', an exclusive interview video and related album artwork. In another example, exclusive bonus tracks were offered to fans pre-ordering Eminem's album 'Curtain Call' on iTunes.

Artist websites:

Fans of Gorillaz can navigate the virtual backdrop of Hong Studios, sample the band's music via an online jukebox and buy downloads, wallpapers, master ringtones and exclusive live tracks.



www.gorillaz.com



www.thedarknessrock.com

On the Darkness website, album and single downloads and master ringtones are offered to fans who can stream music clips and videos and listen to exclusive new material.

DIGITAL-ONLY LABELS EMERGE

Major labels and independents have set up digital-only record labels to promote and develop new acts. Universal launched UMe Digital in November 2004 to sign and market new artists and handle digital distribution deals for independent labels. More recently, in November 2005, Warner Music launched its own e-label, Cordless Recordings. Music from the label's first few signed bands is being sold only online, in three-song "clusters" instead of full albums. Instead of big tours, bands will be promoted on blogs and sites like MySpace.com. MySpace is attracting a lot of attention. Launched in 1999 this social networking and music-focused website has exploded in popularity, and was acquired by News Corp.

in mid-2005. MySpace has 22 million member users and is attracting up to 2 million new users per month. TV shows and new music are often debuted on the site, and several US bands have gained large fan bases and record sales almost entirely by word of mouth. Interscope Records signed a deal with the site late in 2005 to create MySpace Records which released its first compilation of previously unsigned bands, known through the site, in November.

THE NEW DIGITAL INTERMEDIARIES

Many companies and services do not have resources to sign and obtain licences from thousands of independent labels. Aggregators and distributors are helping to expand the digital market by making it viable for services to extend their music catalogues with independent label content.

While aggregators collect rights and supply them to digital music stores, other specialised digital ventures have emerged to retail and market music via online and mobile channels. The Orchard is the biggest digital distributor for independent record labels, representing thousands of labels and artists in 73 countries. Vital Pias Digital (VPD) distributes digitally for 90 independents, helping with production, sales and marketing, and digital accounting.

'White label' services that power a number of stores include US-based Loudeye, which acquired digital music pioneers OD2 in June 2004. Loudeye services digital music stores (including MyCokeMusic, MTV and MSN) in over 20 countries with around 1.3 million tracks and a range of online and mobile related services. Another major business-to-business player is 24-7 Musicshop, which operates some 20 download stores for retailers in Europe and North America, including Tesco Downloads.

Similar specialists have emerged for mobile, such as Groove Mobile, MusiWave and Melodeo.



"The biggest development of the year was that given a choice between CD, vinyl or digital, more than 25% (and growing) of consumers chose to buy digital singles in the UK. This creates a huge opportunity for indies that find it difficult to compete for shelf space at physical retail, have limited budgets and have trouble marketing and promoting releases in the traditional music industry."

Scott Cohen, Founder & President, The Orchard

MOBILE MUSIC SHOWS ITS POTENTIAL



Mobile music is a fast-growing revenue stream for record companies, accounting for almost half of the \$US 1.1 billion revenues made from digital music in 2005.

Mobile handsets have evolved from a basic voice-based device to whole entertainment hubs, creating an exciting new channel for music distribution.

The consumer appeal of mobiles for music is generating much commercial activity. One in five of all mobile phone users listen to music on their phones, according to a recent report by TNS¹. This compares with 10% who use a portable music player. Additionally, more than a third of mobile users globally choose mobile music as one of five applications they would like to start using, or use more of in the future.

In some European countries and in Asia, mobile music is developing faster than online music services, boosted by higher penetration of phones compared to portable players or broadband, and by ease of payment.



¹TNS, sample 6,800 adults aged 16–49 in 15 countries across all regions.

Mobile music: focus on Korea

Mobile music has become a major revenue stream for music companies in South Korea, running far ahead of online revenues. While CD sales have fallen dramatically, the mobile music market is thriving.

South Korea has 40 million mobile subscribers in a country of 48 million people and the highest adoption of 3G in the world – nearly 10 million users. The biggest development in mobile music in Korea has been the spread of music-capable phones. Today almost all newly released phones have a digital music function.

The mobile music sector is fiercely competitive, with operators and handset makers both moving actively into the market. In May 2005 SK Telecom, Korea's largest operator, bought one of Korea's leading independent labels YBM Seoul Records. In November 2004 SK Telecom launched the music subscription service Melon, which now has half a million active users and two million subscribers, a catalogue of 800,000 songs and is the number one music site in Korea.

MOBILE MUSIC SPREADS GLOBALLY

The sheer size of the mobile market presents the music industry with enormous opportunities, particularly as handsets develop to fully incorporate music. Today there are over 1.5 billion mobile phone subscribers worldwide – a 50% increase since 2002.

Asia leads the way, accounting for half of all mobile subscriptions in 2005. Penetration of music-capable phones is the highest in the world, given consumers' willingness to pay more for their phones in Asia. In Japan, for example, mobile music revenues totalled \$US 211 million (96% of digital music revenues) in the first nine months of the year (RIAJ). By September 2005 over 70% of handset sales in Japan were 3G phones.

The European mobile music market has great potential, with many countries at 100% mobile penetration.

Mobile music in the US is also growing in popularity. While 2005 was marked by the rapid development of a master ringtone market, 2006 will see wider implementation of 3G and the roll-out of full track downloads to mobile.

GLOSSARY

3G: the term used for third generation of mobile communication systems. 3G allows for high-speed data transmission, greater voice capacity, access to multimedia features (audio and video) and internet access.

Dual download: or dual delivery download. Introduced in 2005, it allows consumers downloading full tracks to mobile to access them over the internet and transfer them to portable players or burn them on to a CD.

Full track download to mobile: an audio track downloaded via music capable phones (mainly via 3G networks).

Greetings & Dedications: messages recorded by artists for use on mobiles.

Master ringtones: are also known as master recording ringtones, true tones, master tones or real tones. These are excerpts from the original sound recording (6, 18 or 30 seconds) played when the phone rings.

Monophonic ringtones: single note sounds played when the phone rings – not sourced from the master recording.

Music-capable phones: mobile phones with integrated MP3 function and music management software.

Polyphonic ringtones: were introduced in 2001 and became mass market by 2003. A combination of notes recreating a musical composition that is played when the phone rings – not sourced from the master recording.

Ringback tones: launched in 2002, they replace the 'ring-ring' sound a waiting caller hears with a song. This is to date mainly an Asian phenomenon – 45% of subscribers to South Korea's largest mobile operator use ringback tones.

Wallpaper: images or logos that can be downloaded and used as a background image on a mobile screen.

FROM RINGTONES TO 'REAL MUSIC'

The development of mobile handsets and the transition of networks from analogue to digital have been key to the early mobile music market. Master ringtones, the first 'real music' product and natural successor to ringtones, have rapidly become the largest mobile music segment by value, and will overtake polyphonic ringtones, in volume terms, by the end of 2006. This is a key development for record companies and artists, since master ringtones are sourced from master recordings, meaning record companies and artists receive a slice of revenue from every master ringtone sold.

In Europe and Japan, master ringtones already account for half the ringtone market. In the US master ringtones represent 60% of total ringtone revenues.

MUSIC DRIVES 3G

Mobile music is rapidly moving beyond just ringtones and master ringtones. With the advent of 3G mobile, download speeds have increased tremendously, allowing a wide range of new music products to be offered such as full track downloads, video streaming, and premium music content.

Introduced only three years ago in Korea, 3G has grown quickly in Asia and Europe. Globally, there were over 70 million 3G subscriptions in 2005. Vodafone, the largest European operator, launched its 3G service in November 2004 and reached 5 million customers by the end of 2005. 3G is expected to grow fast in the next two years. Jupiter estimates that by 2010 3G penetration will reach 60% in Europe. 3G has already

reached 30% penetration in Japan and is expected to roll out in China in 2006.

For mobile operators, the shift from voice calls to data network usage and entertainment via 3G dramatically increased customer revenues. Music, with universal appeal and relatively small network download speeds, has been a key driver of 3G adoption by consumers. Consumer research by mobile operators confirms that music is the top entertainment product, attracting the 18–35 age group in particular.

Record companies have moved quickly into this new market, making hundreds of business deals with operators, aggregators and handset makers. Examples of key mobile music initiatives in 2005 include:

- In Europe, **T-Mobile** partnered with EMI for the release of Robbie Williams' new album offering T-Mobile customers exclusive content such as concert live-streaming, full-track downloads, VIP tickets and hospitality, backstage tours and after show party tickets.
- **French operator SFR** expanded its mobile music catalogue to over 400,000 tracks and joined with Universal to launch 'Label Studio TV' – the first interactive mobile TV in Europe. Label Studio TV provides users with full programming control of nine channels featuring video clips, backstage interviews, documentary footage, interactive games and video-blogging.
- **Vodafone** included Universal's catalogue into its library of full track downloads raising it to 600,000 tracks available in 21 territories. In the US **Sprint** launched the first full track dual download service, offering a catalogue of 250,000 songs. The service is based on

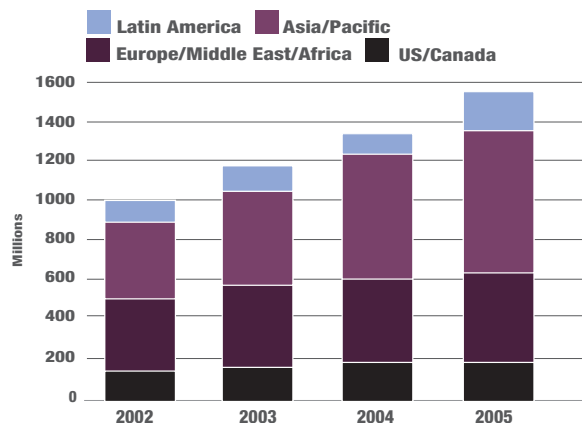
Groove Mobile's music delivery technology and will rely on Sprint's newly introduced high speed network.

- **Japanese operator KDDI** launched its full track download service in 2004 and crossed the 30 million sales mark in December 2005. Over 110,000 songs are available.
- **SonyBMG** joined with MTV for the launch of **MTV 5 Star** featuring Shakira. The initiative included exclusive 30 minute shows, full track streams prior to release and a series of Shakira "mobisodes". 5 Star utilises MTV's television, internet and mobile platforms across Asia-Pacific, Europe, Latin America and Russia to promote new releases and offer fans exclusive content.



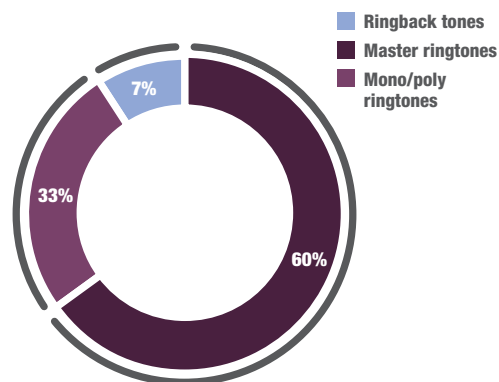
"The proliferation of digital music platforms means that consumers can now, more than ever, enjoy music virtually anytime, anywhere. The digital music revolution is also contributing to the transformation of Warner Music Group from a traditional record and songs-based company into a diverse, music-based content company capable of delivering not only songs and records, but ringtones, master ringtones, music video downloads, album art, lyrics and other content across an ever increasing array of distribution channels, digital devices and music services. Warner Music Group will continue to make digital music and new media a core part of the company's global mission." Alex Zubillaga, Executive Vice President, Digital Strategy and Business Development, Warner Music Group

GROWTH IN MOBILE SUBSCRIBERS



Source: PWC, Global Entertainment and Media Outlook

US RINGTONE MARKET REVENUES



Source: Telephia, Mobile Audio Report, July 2005

■ **France Telecom** partnered with Warner Music to offer consumers in 10 European territories the ability to download ringtones, full tracks and music videos to their mobile or online.

■ During 2005 **mobile operator '3'** ran multiple music campaigns, including a TV, press, outdoor, radio and online campaign with the message 'We like music'. Following the launch of 3's Video Jukebox service in August 2004, more than 15 million music videos have been watched by 3's 3G customers. In Italy, more than 30,000 single track downloads to mobile of Eros Ramazzotti's 'La Nostra Vita' were sold in the first week of release.



THE HANDSET MARKET

Music-capable phones are fast growing in popularity. Nokia sold 10 million music capable phones in 2004 (5% of their total handsets sales) and is expected to reach sales of 40 million worldwide in 2005, making it the largest manufacturer of music enabled phones in the world.

Although there has been discussion about the mobile phone as the 'iPod killer', it is likely that the market for both dedicated portable music players and music-playing mobile phones will grow substantially. While portable music players have more music features (song storage, playback quality, battery life) in the medium term, for millions of consumers the mobile phone will become the preferred portable music device.

Mobile technology is advancing fast, and 2005 saw the launch of new phones with storage capacity comparable to small flash memory portable music players.

THE FUTURE OF MOBILE MUSIC

To become the mass market phenomenon it promises to be, mobile music must continue to develop beyond master ringtones to full track downloads and premium content.

New opportunities lie in the exploitation of live content via handsets, song recognition services, digital audio broadcasting (DAB), visual radio and mobile TV. Ultimately the mobile music market will allow artists both to reach a wider audience and to win back the younger audience by reaching them in a new way.



“There are certain artists whose music appeals very strongly to the mobile customer base but not necessarily to the 30-something male with a broadband connection downloading from iTunes. There are gaps in the market that are not filled by record shops or online services that can be filled by mobile. There are a number of different access points for music and over-the-air is the most convenient for impulse purchasing when you are on the move.”
Ed Kershaw, Head of Music, Vodafone

KEY MUSIC MOBILES

PHONE	LAUNCH	STORAGE CAPACITY	BATTERY LIFE	MUSIC CAPABILITIES	ADDED FEATURES
MOTOROLA ROKR 	September 2005	100 songs + removable memory card	15 hours of music using wired headset and 6 hours using surround sound speakers	Apple iTunes music management software ■ Transfer songs via USB or wireless from PC or Mac ■ Surround sound speakers ■ Album art display ■ Random play ■ 3G	Camera ■ Video capture and playback ■ Games ■ Full screen view for photos and video clips
NOKIA N91 	Early 2006	3000 songs	10 hours of music	Windows Media Player music management software ■ Transfer songs via USB or wireless ■ Create playlists ■ Integrated FM radio with Visual Radio support ■ Connect with home stereo ■ Headset with remote control ■ Music function keys (play, forward, rewind, etc) ■ 3G	Camera ■ Video capture and playback ■ E-mail ■ High resolution screen
ORANGE SPV C550 	August 2005, Europe	500 songs + removable memory card	8 hours of music	Orange Music Player & Windows Media Player music management software ■ Transfer songs via USB or wireless ■ Connect with home stereo system ■ FM radio ■ Create own ringtones ■ Music function keys (play, forward, rewind, etc)	Camera ■ Bluetooth ■ E-mail ■ High resolution screen ■ Games
SAMSUNG SGH-I300 	December 2005	1000 songs	5–9 hours of music	Windows Media Player music management software ■ Transfer songs via USB ■ Dual stereo speakers ■ Scroll wheel navigation	Camera ■ Video capture and playback ■ Bluetooth ■ E-mail ■ High resolution screen
SONY ERICSSON W800 WALKMAN 	July 2005	150 songs + removable memory card	30 hours of music	Sony music management software ■ Transfer songs via USB or wireless ■ Create playlists ■ Create own polyphonic ringtones ■ FM radio ■ Sound recorder ■ Mega Bass ■ 3G	Camera ■ Video capture and playback ■ Bluetooth ■ E-mail ■ Picture editor ■ Video DJ ■ Games
TOSHIBA 803 	October 2005, Europe (exclusive to Vodafone customers)	175 songs	6 hours of music	Transfer songs via USB ■ Stereo twin speakers ■ Stereo handsfree headset with remote control ■ Listen to music and surf the net at same time ■ Create and search playlists ■ 3G	Camera ■ Video capture and playback ■ Bluetooth ■ High resolution screen ■ Games



“The walkman changed the way people used to listen to music, turning it into a mobile experience. Now we have iPods, portable PCs and millions of mobile phones; all are becoming mobile music players. I love it. My job is about developing artists and making sure they are paid for their music. Mobile music is fantastic as far as exposure is concerned, but I have now to worry about bringing the revenue back home.”

Michel Lambot, Chairman of IMPALA (Independent Music Companies Association)

IN THE PIPELINE: LEGITIMATE P2P, DIGITAL RADIO & PODCASTING



2005 has seen three significant developments with future market potential: legitimate P2P, digital radio and podcasting.

LEGITIMATE P2P

Peer-to-Peer (P2P) distribution until now has largely been associated with music and film piracy. However the music industry wants to see P2P technology commercialised for the legal distribution of music. There have been numerous agreements put in place in 2005 to achieve this goal.

Snocap is one of the technology companies currently helping to develop legal P2P. Its technology, which combines audio fingerprinting filtering with a registry for licensed content, allows P2P services to present to users options to purchase a song. Record companies partnering with Snocap can set conditions for song use and can work together with their artists to license previously unreleased tracks such as live recordings.

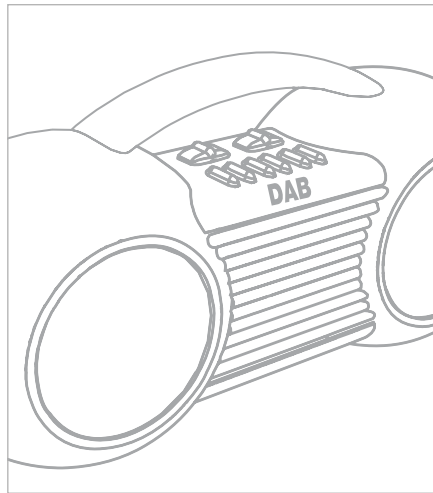
All the major music companies and many more independents have signed deals with Snocap. New P2P service Mashboxx is being developed for launch using Snocap technology.

iMesh is the first legal P2P service to have launched commercially in a beta phase. Launched in October 2005, the iMesh network uses Audible Magic – also an audio fingerprinting technology similar to Snocap's – to identify songs traded on its network.

There are still technological and commercial questions to be resolved for legal P2P. Current models rely on the maintenance of instantly accessible, large databases which hold relevant licenses for each version of a song. This is a complex system which needs to be continuously kept up to date. Pricing structures and business economics are also untested.

DIGITAL RADIO

Digital Audio Broadcasting (DAB) presents an exciting opportunity but is also one of the greatest challenges confronting the music industry. DAB offers many consumer benefits such as a high quality sound, more stations, additional data services and interference-free reception.



DAB services are growing worldwide. Over 475 million people around the world now receive over 800 different DAB services. Likewise, the market for digital receivers is taking off – in the UK, digital receiver sales now exceed analogue.

Satellite radio is also developing fast, particularly in the US. The two companies first operating satellite broadcasting services in the US, XM Satellite Radio and Sirius Satellite Radio, now have 9 million paying subscribers between them – three times as many as online music subscription services in the US. However, digital broadcasters and the recording industry need to work together to ensure that these services do not become an unlicensed source for free downloads.

PODCASTING

Podcasts are programmes recorded in the form of digital audio files, which are downloadable and transferable to portable digital devices like digital audio players such as iPods and MP3 players. Popular content includes radio programmes that in podcast form can be 'played back anytime, anywhere'.

While early signs indicate that podcasting is rapidly spreading – a month following its introduction on iTunes, Apple reported five million podcast subscriptions from a directory of more than 15,000 programmes – its mass market potential is not yet clear.

Podcasts are a potentially interesting commercial opportunity for record companies. Many different models for licensing music in podcasts have been suggested, from a-la-carte charges per podcast, or a subscription charge covering access to a range of podcast shows. There are a number of issues that need to be resolved before podcasts can become a commercially viable delivery model, however. Notably, podcasters need to obtain the proper license agreements from copyright owners. The file format used should offer a framework of content protection based on Digital Rights Management (DRM) to ensure that podcasts are used as they were intended, rather than separated into component songs, creating a digital library.



“We are proud to be the pioneers of a network that will let people explore millions of songs and build a great music community instantaneously, without ripping off the artists. Not only are the songs 100% legal, but our service is adware and spyware free. Building a budding P2P business that is legit is hard work, but ultimately I foresee a bright and busy future for P2Ps like us.”

Robert Summer, Executive Chairman, iMesh

MUSIC CONSUMPTION IS CHANGING



IFPI research finds legal downloading on a par with illegal file-sharing in some key markets, but attracting file-sharers to legal sites is a long-term challenge.

NEW IFPI RESEARCH SPOTLIGHTS THE CONSUMER

A new consumer survey by IFPI¹ shows that for the large majority of people in Europe, digital music – be it legitimate or illegal – is a new concept. Only 11% of European internet users swap files on P2P networks. Fewer, around 6%, regularly (i.e. on a monthly basis) download from P2P networks.

Legal downloading is clearly at an early stage in Europe. Only 6% of internet users have bought from a digital music store, while 4% – less than one in twenty – does so regularly.

Highlights of the findings are:

1 Legal online buying is catching up with illegal file-sharing. Legal buying is now as popular as P2P use in the two major European digital markets, the UK and Germany. Here the number of regular legal buyers exceeds regular illegal file-sharers (5% compared to 4% in both countries). In the US, latest surveys suggest the gap between legal buying and P2P usage is narrowing (NPD). In France, Spain, Sweden and Canada², more users go to P2P networks, but legal online buying is growing.

2 Turning illegal file-swappers into legal online buyers is a long-term challenge. Only 22% of online music buyers are also file-sharers. While this shows that the industry is successfully attracting new users straight to legal services, it also shows that shifting consumers from unauthorised to legal services will take more time. One in every four illegal file-sharers is willing to move to legal services – some 25% say they would pay to download legally. The challenge for the music industry is to shift the others.

3 Portability is a key driver of digital music. Nearly half of all file-sharers (45%) transfer music to portable players on a monthly basis. Legal downloaders are rapidly catching up – 29% transfer to portable



players. One in ten European internet users bought a digital audio player in 2005 (equating to approximately 23 million people) and a further 6% intend to during 2006.

4 Digital consumption competes with CD buying but downloaders still value the CD. Over one third (35%) of illegal file-sharers are buying fewer CDs as a result of their downloading, with 25% of online music buyers also buying fewer. Both file sharers (34%) and online music buyers (37%) value CDs more than digital music.

5 Mobile music has huge mass market potential. Ringtones are the most popular digital music format, with 19% of internet users having downloaded a ringtone – three times the number that have bought a track online. Already 3% of European internet users are frequently using their phones for music downloads.

DIGITAL MUSIC VERSUS THE CD

It is unclear to what extent future CD sales will be substituted by digital music, but research indicates that this will happen gradually rather than rapidly. One in three digital music buyers says that owning CDs is of more value to them than music downloads.



Digital channels promise to expand the music market in the long term. Master ringtones, ringback tones and other mobile music products are new channels – they add to existing formats and they are reaching a wider, younger market and are attracting previous non-music buyers. This is already visible in Asia.

THE POWER OF PORTABILITY

IFPI's research confirms one of the most important drivers behind the digital music market – portability of music.

IFPI's survey in Europe found that 29% of digital music buyers regularly transfer songs to a portable player. Some 10% of internet users have purchased a digital audio player in the past 12 months, which brings the proportion of internet users who own a player to 15%.

Download sales in UK and US saw a huge spike the week after Christmas 2005, with UK download sales of 1 million and US download sales of 20 million. Both spikes are directly related to consumers receiving portable players as Christmas gifts.



“We expect that 2006 will see subscription services become widely accepted as offering consumers the widest choice of music for the best value. In tandem with further growth in portable MP3 player sales, services like Napster To Go will revolutionise how people listen to music by giving them unlimited access to a lifetime's supply of music anytime, anywhere. 2006 will be the year that people embrace the 'own nothing, have everything' philosophy of music subscription.”

Chris Gorog, CEO Napster

¹Research, conducted by Jupiter Research – consisted of a random sample of internet users (sample size 3,900) in France, Germany, Spain, Sweden and the UK.

²Pollara research in Canada, June 2005.

CONFRONTING THE CHALLENGES



Digital music is a huge economic and cultural opportunity – but future growth depends on how present obstacles are faced.

Within only two years, the legitimate digital music market has become a reality of consumer life. This is an important success for a music industry which has faced up to the dramatic changes brought by the internet to its way of doing business.

As with many other media and information industries, however, the transition to a digital music business has taken time and been difficult to achieve. Global music sales have fallen 16% in five years – from \$US 39.7 billion in 2000 to \$US 33.6 billion in 2004 – to a large extent because of the proliferation of free unauthorised music. Digital sales are now beginning to help reverse that decline, and in due course are likely to help offset the continuing fall in the physical music formats.

This new digital music market, driven by the licensing of repertoire in a diverse range of new revenue streams, offers enormous cultural and economic opportunities. But there are big challenges too. These must be addressed if the full potential of digital music is to be unlocked.

In early 2006 a number of significant obstacles hamper the progress of the digital music market. These include internet piracy, which remains a huge problem; the need for more effective cooperation from Internet Service Providers (ISPs) in containing it; the continuing lack of interoperability between formats and devices, which threatens to limit future market growth; and the emerging threat from unlicensed digital stream ripping from digital radio and internet webcasts.

DIGITAL STREAM RIPPING: THE NEXT BIG CHALLENGE

Introducing licensing arrangements that address the threat of digital stream ripping is a key priority for the music industry in the US.

Since tape recorders became available, people have recorded broadcasts from their radios, which has not been problematic – they can listen to the programme at a time more convenient to them. Digital stream ripping, however, is a different challenge.

Today's technologies can not only record continuous programmes (a radio show for example), they can, through what is known as 'digital stream ripping', automatically identify and separate individual tracks from digital broadcasts and store them for future playback. In effect, a broadcast can be turned into a

library of free downloads. For a music industry which has made enormous investments in creating legal, paid-for download services, this presents a significant threat.

If digital services are to be licensed as radio, rather than as on-demand services, they need to implement appropriate technical controls to ensure that they complement and do not undermine on-demand sales services.

Allowing digital stream ripping to go unchecked will be hugely damaging to the music industry. Each song saved and stored as an MP3 is a lost sales opportunity to a digital music store or subscription service, as well as to the songwriter, artist and other rights holders.

INTERNET PIRACY: THE BIGGEST OBSTACLE

Internet piracy is the biggest single obstacle to the development of the digital music market. The problem is as fast-changing as the distribution technologies behind it: in 2001 internet piracy largely took the shape of web sites offering an estimated one million copyright infringing files. Today P2P networks provide the dominant source of

online piracy, and the number of infringing music files on the internet stands at just under one billion.

The recording industry fights internet piracy to protect the rights of artists and other copyright holders. Digital piracy has a direct impact on legitimate music sales. Extensive third party and industry research has confirmed this impact in the last two years.



“With advances in digital technology for the first time in history, vast catalogues of recorded music are instantly and legitimately available to consumers however, wherever, and whenever, they wish to experience it. The ubiquity of available music and the emergence of ever more delivery formats and platforms is creating significant opportunities for artists, entertainment companies, and fans.”

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

Internet Piracy Reduces Music Sales: The Findings

IFPI/Jupiter – Europe November 2005.

One in three illegal file-sharers in Europe buys less music, with the greatest impact on the 15–34 age group.

Pollara – Canada, June 2005.

Downloaders spend less on CDs, with 33% saying they spent less on music compared to only 20% who spent more. The number one reason for buying less music for all respondents is the use of P2P networks and CD burning.
www.cria.ca – www.pollara.ca

TNS/BPI – UK, April 2005.

A two-year study that tracked purchasing habits of downloaders against non-downloaders revealed that over time downloaders bought less music; amounting to a loss of an estimated £650 million over two years. www.bpi.co.uk

The National Bureau of Economic Research – US, October 2004.

Stated that: “downloading [from unauthorized sources] reduced music expenditure by about 10% but possibly much more.”
www.nber.org

Informa Media Group – US,

September 2004. Potential losses to the industry from file-sharing was \$US 2.1 billion in 2004.
www.informamedia.com

Forrester Research – Europe, Aug 2004.

More than one in three (36%) music downloaders say they buy fewer CDs because they can download music for free. Only 10% say they are buying more.
www.forrester.com

THE CALL TO ISPS

Internet Service Providers (ISPs) and telecommunications companies generate huge revenues from music and are themselves becoming music retailers. It is vital that these companies fully cooperate with industries like the music and film industries in making sure that copyright laws are respected on their networks. In 2005 the recording industry stepped up its efforts to have ISPs cooperate in removing copyright-infringing content from their networks, and thereby promote legitimate digital business.

This initiative will be stepped up further in 2006. As creative content industries – first music, then film and video, news media and publishing – drive the growth of business on the internet, ISPs must share responsibility in a business where

they increasingly generate revenues of their own. Revenues in the media and entertainment sectors will explode in the coming years – by 33% in the next four years to 2009, according to PWC (Global Entertainment and Media Outlook: 2005–2009).

The music industry and its ISP partners have a shared interest and a shared responsibility in controlling copyright infringement on the internet. Already, discussions on enhanced cooperation are leading the way in France, Italy, Spain and the UK. The recording industry wants these discussions to go further. ISPs should make concrete commitments to control infringements on their networks. In the European Union, IFPI is supporting the initiative by Commissioner Viviane Reding to draw up a European Charter “Content Online and IPR” by May 2006.



“The music industry has a common aim with the telecoms companies and ISPs. But we cannot realise this aim alone. Service providers and music distributors must help us – and in doing so, they will help themselves. If you want content, then it needs to be respected and cared for, not abused.”

John Kennedy, Chairman & CEO, IFPI

COURTS IMPROVE THE LANDSCAPE



For the recording industry, the business environment in which legitimate digital music has had to compete with mass-scale unauthorised free music is improving rapidly.

COURTS RULE AGAINST ILLEGAL P2P

In 2005 a wave of court rulings within three months and in three continents, gave the recording industry the most significant boost yet in the fight against P2P piracy. Between June and September, judgements against Grokster in the US, Kazaa in Australia, Soribada in Korea and Kuro in Taiwan laid down some key ground rules with global implications for the fight against illegal P2P distribution.

The message sent by the courts has been clear. Operators of unauthorised P2P networks, who encourage the use of their networks for copyright infringement, can be held liable for music piracy. P2P services cannot simply turn a blind eye to ongoing illegal activity and profit from massive infringement while avoiding putting in place effective filters or other methods to prevent it.

These rulings are an important turning point in the recording industry's battle against internet piracy. By clarifying the potential liability of unauthorised P2P network operators, they have confirmed the industry's ability to bring actions directly against such services. This is in addition to legal actions launched against individual uploaders, numbering some 20,000 worldwide at the end of 2005.

The US Supreme Court ruling, in particular, has shown quick results, opening the door to the development of legitimate P2P. Setting the trend, the Grokster service shut down in November following a settlement with IFPI's US affiliate RIAA. Following "cease and desist"

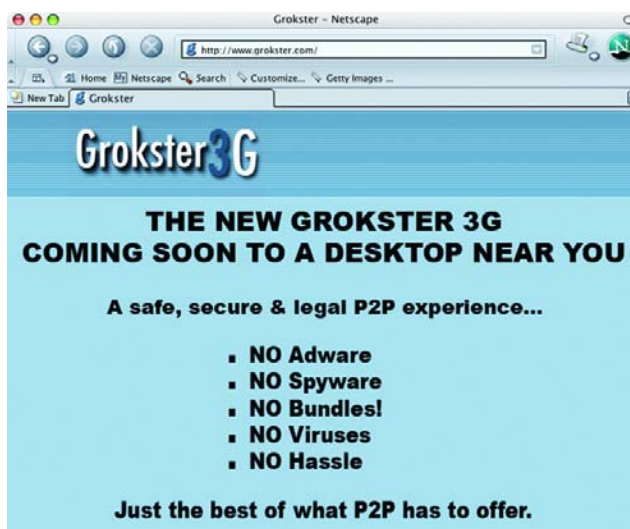
letters sent by the US recording industry to a number of unauthorised P2P services, two major operators, eDonkey and WinMX, announced they would stop illegal activity. BitTorrent has also announced it is cooperating with the film industry to take down infringing material. Others are also involved in negotiations with a variety of industry parties to convert their networks for legitimate business. Kazaa, the biggest international brand name in music piracy, has also been found to be infringing copyright, and in December 2005 was required to filter its service or cease its authorities.

These are highly significant developments in the fight against P2P piracy. For the first time since the original Napster service shut down in 2002, the door appears to be closing even on decentralised unauthorised file-sharing networks. It will be some time

before this translates into large falls in P2P traffic: for example, old versions of the Grokster programme remain available to users, while the decline in the use of programmes like WinMX has been slowed by the emergence of non-commercial clones of the software.

SHUTTING DOWN 'PIRACY HAVENS'

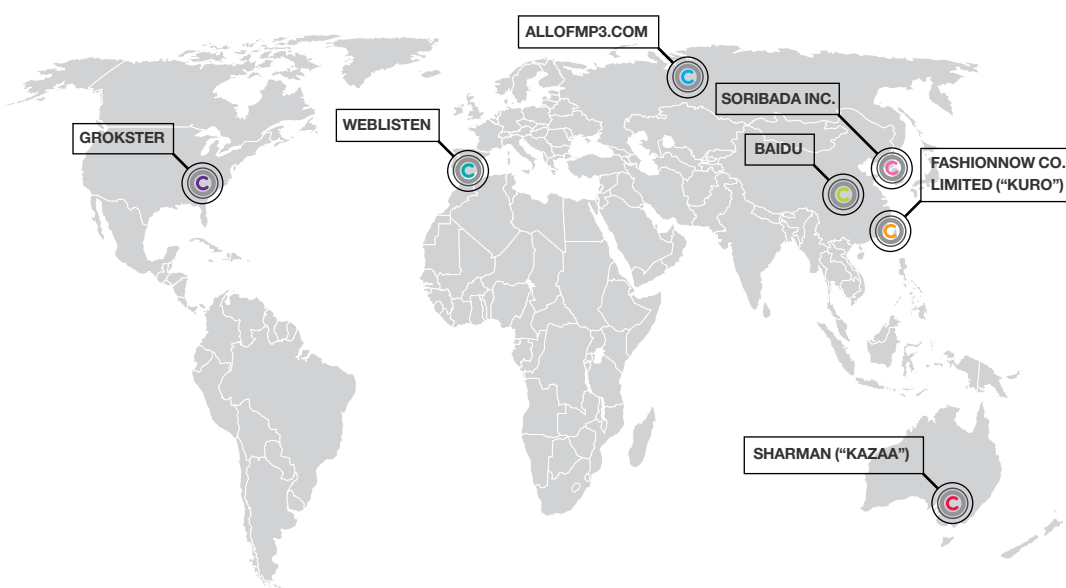
Websites searching for 'piracy havens' from which to make copyrighted repertoire available are a further barrier to the growth of the legitimate market. But there has been important progress in this area in 2005, with cases progressing in Spain, Russia, Australia and elsewhere against companies attempting to profit from others' copyrighted music (see page 19).



"Watching a cultural industry bleeding heavily is a very painful experience. Knowing many of the hundreds of people who have been made redundant over the last three to four years and artists that have been dropped, makes it even worse. We know that one of the main reasons for this is illegal file-sharing. That is why we are determined to do everything we can to contain the amount of music being distributed illegally. Would any business anywhere in the world react differently?"
Ludvig Werner, Managing Director for Bonnier Amigo Music (Swedish Independent)



COURTS TIP THE SCALES AGAINST INTERNET PIRACY IN 2005



“The ability to enjoy music legally online in a huge variety of ways is becoming such an everyday experience that it’s easy to forget just how much progress has been made in the last few years. We have hundreds of legal music sites in Europe today, but the future growth of the legitimate market should not be taken for granted. The European Parliament has an ongoing role to play in encouraging the development of the online market and respect for intellectual property.”

Brian Crowley, Irish Member of the European Parliament

© MGM v GROKSTER – US Supreme Court decision. In June, a 9–0 unanimous decision by the US Supreme Court clearly established that P2P service providers who promote infringing use of their technology can be found liable for inducing that infringement. Providers’ active steps to encourage that infringement, their profit from that infringement and their failure to implement filtering were all factors the Court found could evidence inducement. In November Grokster’s owners and operators entered into a settlement with the music and film industries. Grokster accepted a permanent injunction prohibiting direct or indirect copyright infringement and immediately stopped distributing its software and operating its system.

© SORIBADA INC. – Korean District Court decision. In August the Korean Court granted an injunction against Soribada, the operator of a local P2P service, finding that it had aided and abetted the infringement by its users on its service. Soribada’s knowledge of infringement, profits from the service and failure to filter were all cited as reasons for its liability. Its arguments that it was not actively involved in the infringements because of the system structure were rejected, and because it was unable to put in place effective filters Soribada was forced to close the service. In November Soribada completely shut down all versions of its service.

© UNIVERSAL MUSIC v SHARMAN (“KAZAA”) – Australian Federal Court decision. In September the Australian Federal Court found Kazaa – the world’s biggest brand name in internet piracy – liable for authorising the infringements occurring on its service. Kazaa’s knowledge of infringement, its failure to curb the infringements even though it could, and its encouragement of and direct financial interest in the infringements all lead to the finding. In early 2006 Kazaa’s operators were due to face contempt of court charges for failing to implement the court’s order to filter the Kazaa network.

© FASHIONNOW CO. LIMITED (“KURO”) – Taiwanese District Court decision. In September Kuro, a popular Taiwanese subscription P2P service, and its principals were convicted of criminal copyright infringement by the Taiwanese Court. Kuro solicited users knowing they would infringe and made profits as a result of the infringement. They could have, but refused to install filters. The Court took all these factors into account. The three principals were all sentenced to two or three years’ imprisonment and all three, and the company itself, were each fined \$US 90,000. This is the first criminal ruling of its kind anywhere in the world.

© US-listed internet links service Baidu was found guilty of infringement for providing “deep links” (internet links that directly initiate download of content) to copyrighted music tracks. The case against Baidu was brought by local record company Push Sound and has been followed by seven actions brought by international and local joint venture record companies which are still pending. Earlier in the year a case against ChinaMP3, another link site, was successfully brought by the international record companies. In Australia, a similar deep linking site, mp3s4free.net, was held liable for copyright infringement by the Federal Court of Australia. The ISP hosting the site was also found liable.

© WEBLISTEN, the high-profile Spanish website, shut down after admitting criminal copyright infringement in May 2005. The site had for six years offered many thousands of tracks for download and streaming.

© ALLOFMP3.COM is the best-known of several unlicensed Russian-based websites offering copyrighted music internationally. Allofmp3.com is an unlawful site both inside and outside Russia. IFPI successfully engaged a Moscow prosecutor to act against the site, but progress is very slow and is hampered by the inadequate enforcement procedures in Russia. Meanwhile in Germany there was a court injunction against Allofmp3.com and in Italy a local-based portal to the site was shut down by the police.

CONTAINING ILLEGAL FILE-SHARING



A thriving digital music business means containing piracy; getting support from ISPs; and making formats interoperable for consumers.

DETERRENCE: LEGAL ACTIONS AGAINST FILE-SHARERS

In 2005 the music industry widened its campaign of deterrence against illegal file-sharing, nearly tripling the number of legal actions to a total of some 20,000 cases in 17 countries. The actions, taken under both civil and criminal law depending on the country, are aimed at deterring file-sharing, changing attitudes among internet users, encouraging legal downloading and raising awareness of the law. This last aim has been achieved. Seven out of 10 Europeans and Americans now know that distributing copyrighted music online without the permission of the copyright holder is illegal.

In October the fourth wave of international actions extended the litigation strategy for the first time into South East Asia and Latin America, including Hong Kong, Singapore and Argentina. In every country where actions have been launched, focused warning and education campaigns have preceded legal action. Cases are taken against people distributing hundreds of copyrighted music files, or more. More waves of lawsuits will be rolled out, in more countries, in 2006.

Nearly two years after the first of these actions were launched outside the US (in March 2004), the deterrence strategy has not only proved effective – it has, to date, weathered the cynicism of its critics. Thousands of individuals have paid settlements averaging \$US 3,000 each; settlements and payments of damages have been the rule in the vast number of cases taken; challenges to the actions on data protection grounds, in Sweden and Canada, have failed; deterrent

penalties, though not necessarily popular, have been widely-publicised and have played an important part in changing attitudes to illegal file-sharing.

EDUCATION

Education has a critical part to play in the development of a thriving legitimate digital music market. The recording industry launched four targeted international education campaigns in 2005, by far the biggest expansion of its public information activities in this area. Each campaign has been addressed at specific audiences and aims to help change attitudes to online music, improve understanding of copyright and promote the legitimate services.

■ **Individual file-sharers.** Over 52 million instant messages have been sent directly to illegal music file-sharers in 17 countries.

■ **Parents.** A campaign launched by leading charity Childnet International and the cross-sector alliance Pro-music, is aimed at educating parents about file-sharing and downloading music. The leaflet “Young People, Music and the Internet”, explains the security as well as the legal risks that come with unauthorised P2P file-sharing. The guide has been distributed in schools and retailers around the world.

■ **Companies.** A Copyright Security Guide for companies and governments, launched jointly with the film and video industry associations MPA and IVF, and endorsed by the International Chamber of Commerce, has been mailed to organisations in seven countries.

■ **Computer users.** Free software, Digital File Check, that helps people enjoy music on their computer safely and legally (go to www.ifpi.org/dfc) has been launched initially in seven countries. DFC helps people remove file-sharing programmes from their computer and avoid illegally distributing copyrighted files on P2P networks. DFC is available on disc and online. The programme has seen over 29,000 downloads in the first three months after launch.

Other digital industry players have also realised the importance of educating their customers about the risks of illegal file-sharing. AOL launched its PlayLegal campaign in December 2005.

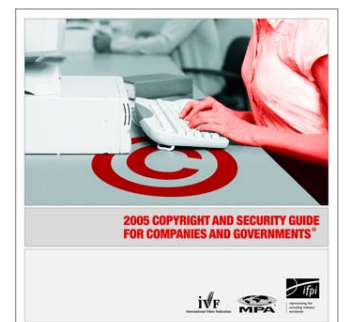


Parents' brochure: 'Young People, Music and the Internet' (www.pro-music.org/guide)



“Companies and enterprises internationally, many of whom depend on intellectual property rights to do their business, will welcome the new Copyright and Security Guide. Online copyright theft should not be tolerated in the workplace or by employers, whatever the business sector and whatever the country involved. This initiative clearly explains what actions companies need to take to avoid legal and security risks on their networks.”

Guy Sebban, Secretary General of the International Chamber of Commerce



IS THE FIGHT AGAINST PIRACY WORKING?

There are countless different methodologies in use to measure trends in internet piracy. They vary from counting website hits to software downloads, traffic and request data and user sampling. All attempts to measure the problem are rough estimates. Results vary considerably according to which methodology is used, and for example, whether movie downloads are taken into account or not.

There is a consensus, however, that illegal file-sharing of music files has been held in check within the last two years in the context of a sharp increase in broadband penetration globally.

In January 2006, IFPI estimates the number of infringing music files available on the internet at any one time – in other words, the simultaneous availability of copyrighted music tracks for illegal download or distribution – at 885 million, of which 775 million are available on P2P networks and the remainder on websites. This is slightly up on the piracy level of January 2005 (870 million) but down compared to the level in June 2005 (900 million). By contrast, broadband uptake has risen by 26% worldwide in the past year.

Total infringing music files are down an estimated 20% on their 1.1 billion peak in April 2003, during which period broadband penetration rose 139%.

CHANGING ATTITUDES

IFPI's latest consumer survey, conducted by Jupiter Research/IPSOS, has given strong evidence that the combination of education and deterrence is changing consumer attitudes. The survey, conducted in November 2005 among a sample of 3,900 online consumers in France, Germany, Spain, Sweden and UK, shows the following:

① Legal actions are working

35% of illegal file-sharers have cut back or stopped the activity, while only 14% have increased it.

Half of illegal file-sharers who cut back on illegal file-sharing did so because of concern over the legal consequences. 35% did so out of concerns about viruses. 15% could not find the song they wanted on the P2P network.

In Spain, the only country surveyed where legal actions have not been taken, fewer file-sharers are cutting back and concern over legal action is the least cited reason.

② Legal downloading is rapidly increasing, but promotion of legal sites is critical

The number of regular legal music downloaders now exceeds the number of regular illegal file-sharers in the UK and Germany. On average only 4% of all European

internet users regularly buy music online – compared to 6% who swap music illegally. Legal downloaders are more likely to be new internet music fans than P2P users: only one in five online buyers are also file-sharers.

25% of illegal file-sharers would pay to download music, but 50% currently say that they would not pay.

③ Illegal file-sharers spend less on music

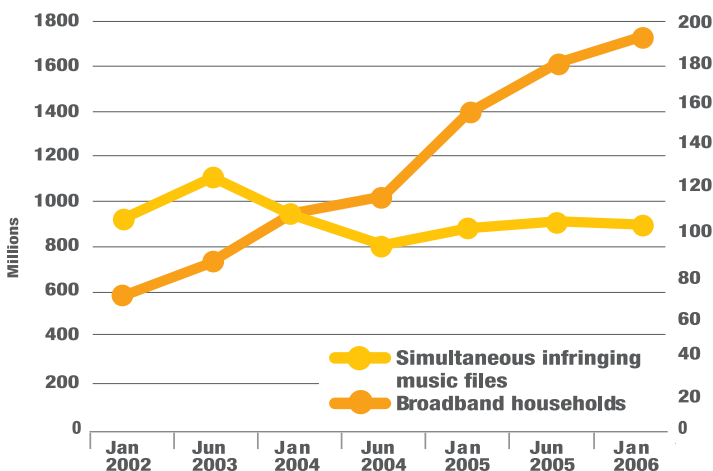
One in three illegal file-sharers buys less music, with the impact heaviest in the 15–34 age group.



“Piracy affects the entire music industry; all the employees that work at the labels and the recording studios as well as the artist himself. We have to become aware in this country that piracy is theft. New digital technologies should become a new tool for the marketing of music and not a tool to promote illegal downloading.”

Gustavo Santaolalla, musician & producer, Latin Grammy Award winner 2005, Argentina

INFRINGING MUSIC FILES ON P2P ARE FLAT; BROADBAND IS UP 26%



Source: IFPI

Actions against illegal file-sharing at a glance

- 19,400 actions in 17 countries
- Settlements averaging \$US 3,000
- Most uploaders are 20–35 year-old men
- All major networks targeted: Kazaa, WinMX, Gnutella, eDonkey, Direct Connect, BitTorrent, Bearshare, Warez, Souleseek

DRM & INTEROPERABILITY: THE KEYS TO FUTURE GROWTH



Digital Rights Management is an essential tool for any industry trading in intellectual property in the digital environment.

THE CHALLENGE FOR DRM

Digital Rights Management (DRM) helps increase consumer choice while protecting the works of creators from unauthorised distribution and unfair use. DRM technologies are sophisticated digital enablers, not simple locks and keys, allowing consumers to enjoy music in more varied ways.

DRM is needed for digital business models to work. For example, the sale of a single track, the multiple playback of a song on a portable music player linked to a subscription service, or a song streamed via an a-la-carte service, all need DRM so that content usage can be recorded and all parties involved in the creation of music can be appropriately remunerated.

DRM helps to manage consumer usage rights. A track purchased on iTunes can be securely transferred to an iPod, or burned to a blank CD, or transferred to a new computer. This is reasonable use which reflects the price paid for the song. It would be unreasonable to allow a new iPod owner to upload someone else's entire song collection on to their device; or for a subscriber to an online music service to transfer a limitless number of songs to someone else's portable player – unless they had paid for it. DRM is designed to stop the uploading of purchased songs onto file-sharing services where they will be distributed without any recompense to the rights owners.

DRM has already been very effective in helping develop the digital music business. Licenced usage rights have been secure, while allowing consumers to get music in a seamless and uncomplicated way. DRM is also allowing digital music fans flexible use with the music they buy – going far beyond the consumer experience in other forms of commercial entertainment, such as movies, games and software.

The biggest challenge with DRM technologies is to make them operate so smoothly that they are not inconvenient to consumers – and this remains a significant challenge in the current digital music market. While there are still some



technical issues to iron out, the problem largely springs from the decision by the leading technology providers to develop DRM systems which are not compatible with each other. This lack of interoperability between devices and services limits consumer choice in terms of which service they decide to use. This in turn undermines the consumer benefits which DRM is designed to provide.

INTEROPERABILITY: A KEY PRIORITY

The incompatibility of DRM systems has created a situation where digital services and devices do not inter-operate, and this lack of interoperability is a barrier to future development of the digital music business.

This situation springs from decisions made by the technology companies behind the major services. Apple, Microsoft, Sony & Real Networks have developed their offerings using preferred or proprietary technologies.

With ownership of digital players now reaching a critical mass, making digital music players compatible with the various online music services is a top priority. Record companies are playing their part, actively licensing music to meet consumers' needs for flexibility and portability. The music industry has licensed over two million songs to over 300 online partners. This has helped encourage strong competition between retailers and improve choice.

However, consumer choice remains frustrated by the limits imposed on them. For example, Apple's iTunes (in which purchased songs are encoded in the AAC format) is only currently compatible with the iPod. Most other legal online music services offer songs in the WMA (Windows Media Audio) format, making them compatible with a wide range of portable players but not including the iPod – the current market leader. There are other exceptions, such as Sony Connect, which offers songs in Sony's ATRAC3 format – compatible only with Sony players.

Achieving interoperability is a high priority for the recording industry. Market research evidence confirms the importance to consumers of the ability to move songs between their various listening devices. These devices will soon extend far beyond portable digital music players. They will include mobile phones, satellite and cable set top boxes, car radios, and games consoles.

Technology companies hold the key to removing this obstacle to future market growth. They need to make proprietary DRM systems interoperable with each other. In the short term, allowing online services to use all the available systems would be an easy first step. Meanwhile new forums like CORAL – a forum of content and technology organisations created in 2005¹ and of which IFPI is a member – is working at a technical level to address this issue.

¹For more information on CORAL go to www.coral-interop.org



“From the vantage point of internet music distribution, the purchaser must be able to use his purchased music simply, quickly and as completely as possible. Increased sales of digital devices that do not harmonise with all music formats cause confusion and can impede market growth.”

Susanne Peter, Director Marketing & Sales, Musicload

WHAT DIGITAL MUSIC OFFERS THE CONSUMER



ONLINE DOWNLOADS

Quickly browse vast music catalogues (two million songs)

Easily find specific songs

Discover new music: find albums of a similar genre, download recommended playlists, have access to exclusive content

Enjoy added features: artwork, charts, artist-related information

Create own playlists, music libraries and compilations

Flexible payment: credit cards, gift vouchers, pre-pay, PayPal

Ability to buy and own songs on an individual basis

30 seconds sampling

ONLINE SUBSCRIPTION

Quickly browse vast music catalogues (two million songs)

Easily find specific songs

Discover new music: find albums of a similar genre, download recommended playlists, have access to exclusive content

Enjoy added features: artwork, charts, artist-related information

Create own playlists, music libraries and compilations

Flexible payment: credit cards, gift vouchers, pre-pay, PayPal

'All you can eat' model: access an entire catalogue for a monthly fee

Unlimited sampling before purchase

Access music as long as subscription is valid

'To Go': transfer as many songs as desired onto a portable player as long as subscription is valid

MOBILE MUSIC

Purchase music on-the-go in any location

Purchase on impulse

Added features: song recognition services, wallpapers and dedications, master ringtones, ringback tunes, exclusives

Stream music videos

One device for music playing and purchasing

Payment via mobile bill



"It should be clear by now that piracy in all of its many forms is something that society cares about. The spirited growth of the digital marketplace reflected in this report highlights two important realities: our efforts in helping legitimate digital services to be as dynamic and easy to use as possible have had a significant impact and must continue at a brisk pace; and, second, this report is a sober reminder that even with the greatest music, the most innovative technology and broadest base of enthusiastic fans, the creation of a formidable digital marketplace will only take place through the cooperative efforts of creators, technologists and local and national governments."

Larry Kenswil, President, Universal Music Group's eLabs

IFPI Secretariat
54 Regent Street
London
W1B 5RE
United Kingdom

Tel: +44 (0)20 7878 7900
Fax: +44 (0)20 7878 7950
www.ifpi.org
www.pro-music.org

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Designed by [elliottyoung](http://elliottyoung.co.uk) +44 (0)845 054 0070 www.elliottyoung.co.uk



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recording industry
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