Apple's digital music showdown

A ruling this week could force online music sellers to pay publishers more money - as an Apple threat to close iTunes looms.

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NEW YORK (Fortune) -- For five years, Apple's iTunes Music Store has been the Internet's most successful music store. But as music publishers have sought a higher share of its proceeds, Apple has threatened to shutter iTunes.

The Copyright Royalty Board in Washington, D.C. is expected to rule Thursday on a request by the National Music Publishers' Association to increase royalty rates paid to its members on songs purchased from online music stores like iTunes. The publishers association wants rates raised from 9 cents to 15 cents a track - a 66% hike.

Apple (AAPL, Fortune 500) declined to discuss the board's pending decision or its previous threat to shut down iTunes. But it adamantly opposes the publishers' request. In a statement submitted to the board last year, iTunes vice president Eddy Cue said Apple might close its download store rather than raise its 99 cents a song price or absorb the higher royalty costs.

"If the [iTunes music store] was forced to absorb any increase in the ... royalty rate, the result would be to significantly increase the likelihood of the store operating at a financial loss - which is no alternative at all," Cue wrote. "Apple has repeatedly made it clear that it is in this business to make money, and most likely would not continue to operate [the iTunes music store] if it were no longer possible to do so profitably."

The Copyright Royalty Board is a three-judge panel that oversees statutory licenses granted under federal copyright law. That includes setting royalty rates for music sales. The current proceeding followed the expiration last year of a 1997 decision that had governed sales of so-called physical music products like CDs for a decade. The board's forthcoming decision, its first affecting digital sales, will set royalty rates for the next five years.
It's hard to believe that Apple will actually shut down iTunes if it doesn't get its way. Apple has shrewdly used the store to help sell iPods, its most popular product. Before the computer manufacturer opened the store in 2003, there was virtually no place for iPod owners to purchase digital music on the Internet. So iTunes helped grow the market for the device by appealing to people who didn't want to patronize illegal file-sharing services and risk a music industry lawsuit.

A fee hike nobody wants to pay

Piper Jaffray estimates that Apple will sell 2.4 billion songs this year, giving it an 85% share of the digital music market. But Apple's rhetoric illustrates the challenges that the nascent digital music industry faces.

The Recording Industry Association of America says sales of digital songs and albums rose 46% last year, to $1.2 billion. But as Cue notes in his statement, Apple's profits from iTunes remain slim. This is because Apple doesn't think the market is strong enough for it to raise its 99-cents-a-song price.

"I have no doubt that an increase in the per track price would lower total music purchases at the store," the Apple executive said in his statement.

Apple pays an estimated 70 cents of every dollar it collects per song to the record companies responsible for each track. The record companies turn over nine cents to the music publishers who control the copyrights to these tunes.

The record companies are in no mood to pay the proposed royalty increase out of their pockets. Not when CD sales, their one-time cash cow, fell last year by 20%, to $7.4 billion. They are asking the Copyright Royalty Board to abandon the fixed per-song payment in favor of 8% of wholesales revenues.

The Digital Media Association, which represents Apple and other online music services, is seeking an even lower rate of 4.8 cents a track, or 6% of "applicable revenues."

"No one disputes the impact of rampant Internet-based piracy in the marketplace," the association's lawyers said in July 2 filing. "The result is drastic reduction in the sales of recorded music in all formats and intense downward pressure on retail prices - along with a brutally difficult competitive environment."

The music publishers are unmoved. They argue that the digital music market is growing and that they should get a higher rate because all parties in this squabble will ultimately prosper. "I think we established a case for an increase in the royalties," said David Israelite, president of the National Music Publishers Association. "More importantly, we were able to beat back the proposal that could be a [royalty] cut."

Israelite said he opposed any attempt by companies like Apple and its record label allies to do away with the fixed royalty rate. "Apple may want to sell songs cheaply to sell iPods," he said. "We don't make a penny on the sale of an iPod."

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