Record Labels, Artists, and Finance

A Contribution to the Economic Analysis of Costs and the Equity of Recoupment Practices in the Music Industry

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The relation between an artist and a label is potentially conflictive from the start. A label advances money for a recording project and it hopes to recoup it later on. In addition, even if the artist sells, he/she will not collect artist royalties before the label reaches the break-even point. In practice, break-even can be fuzzy, and cause more tension.

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Professor Theo Papadopoulos of Victoria University in Australia recently explored such issues in the seminal paper "Are Music Recording Contracts Equitable? An Economic Analysis of the Practice of Recoupment".[1] For Papadopoulos, labels' fixed or 'establishment' cost per release include the recording advance, the budgeted marketing campaign, music videos, payment to independent promoters, retail product placement and tour support. The variable cost per release depends on the marginal cost, and the article shows the following simplification for marginal cost:

$$\text{Marginal Cost} = \text{Marginal Production Cost (MPC)} + \text{Distribution Cost (DIST)} + \text{Artist Royalty } (R_A) + \text{Mechanical Royalty } (R_M)$$

A label's total cost function for that release is:

$$\text{Total Cost} = \text{Fixed Cost (FC)} + \text{Variable Cost (VC)}$$

At a production quantity Q, total cost becomes:

$$\text{Total Cost} = FC + MPC*Q + DIST*Q + R_A*Q + R_M*Q$$

In Papadopoulos's elegant formulation, total cost is an expression of a disbursement that includes payment for an intellectual property component. This is the sum of the mechanical royalty and the artist royalty. A label tries to minimize this cost as it tries to maximize profit. It cannot avoid payment of the statutory mechanical rate but the artist royalty is another matter. Settlements over artist royalties can bring the label into conflict with the artist and raise the issue of contractual equity. Specifically, Papadopoulos asks at what point in the product cycle should a label consider the advance to the artist as paid from artist royalties. He then considers various scenarios.

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Papadopoulos's analysis hinges on the definition of total cost, and therefore fixed cost. In this paper, my colleague Barry Sosnick and I will argue that Papadopoulos's own treatment of the recording advance, a key element of his work, leads him to underestimate a label's break-even point.

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[1] MEIEA Journal, IV:I, 2004, 83-103.

Like Papadopoulos, we see the recording advance as a fixed cost. However, we feel that it is wrong to consider the sum handed to the artist at its face value. The label is parting with a sum of money that would otherwise be earning a steady stream of interest payments if invested elsewhere. When a label signs an artist, this opportunity cost of lending money is very real and has to be included as an additional fixed cost.

This is because for a business to part with a give sum of money P, it must expect to earn a future sum A which is greater than P. If the money were put in a fixed interest bearing investment that paid an annual rate i for N years then,

$A = P(1+i)^N$ and $I = A - P$, where I is interest earned.

In the case of a label, it makes a recording advance P and it is potentially surrendering an interest earning I on an alternative investment that pays a rate i. The true cost of the loan to the label of its recording advance for artists that are not going to break even must therefore be close to $P + I$. This is the majority of artists. For them, this expression, which tends to the future value of the recording advance, is the relevant number for inclusion in a label's overall fixed cost.[2] The fixed cost for artists that will break even, on the other hand, should include the loss of at least one period of unearned interest on the recording advance.

The above reasoning is standard in financial break-even analysis, and we conclude that a financial break-even method is better suited to depict the label-artist relation than accounting break-even.[3] It is interesting that this fundamental point is largely absent in any discussion about the equity of contracts in the recorded music trade. Like Papadopoulos, the existing literature proceeds as if there is no premium attached to liquidity. Cash, of course, is expensive. If, say, artists were able to self-finance their musical project, the cost of drawing from their own funds would be measured by the amount they put down and the interest earning they would forego—not just the temporary drop in their bank balance.

Again, proper valuation of the recording advance in the cost equation of a label for a given artist suggests that the break-even point for that artist comes later than expected by Papadopoulos with accounting break-even.

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A label takes a risk when it signs an artist and the artist-label relationship is full of uncertainty. At the very least, future earnings need to compensate earlier disbursements. To deal with this, Papadopoulos introduces an exogenous stand-alone risk factor that he adds to the artist's total cost function. A label, he argues, is a multi-product firm in which not all of the artists in its roster will recover the recording advance: The label will budget for this loss, which he calls λ. Papadopoulos would then allocate the value of λ among the roster of artists.

The simplification makes sense, but begs many questions that we will address in future work, where we hope to quantify the label risk factor in more depth and establish a statistical basis for analysis. Papadopoulos certainly opens up for discussion the issue of intra-artist equity and good artist-label relations, as he makes clear that the break-even point for successful talent appears much later than otherwise would be the case. The implication is that successful artists are ultimately financing less successful ones.

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[2] In practice, labels do not give the artist the full advance up-front. The equivalent treatment would be to consider the loan as an annuity, and the relevant cost would be then be the future value of that annuity.

[3] See Harold Vogel for a comparative discussion of entertainment company buyouts: Entertainment Industry Economics (Cambridge University Press, 2001), pp. 27-29.

We generally agree with the above. However, we are inclined to be less optimistic about the practical application of a new business model for risk sharing presented by Papadopoulos in the latter part of his paper. He suggests artists agree to aportion royalties to defray the potential losses from λ, helping the label minimize the cost of artist royalties. By definition, the only contributors of such royalties would be successful artists, and there may be little reason for them to do much more than they are doing now. //