NORGES HANDELSHØYSKOLE
Bergen, June 2009

How Has the Changing Demand for Downloadable Music Influenced the Strategic Business Models of Firms?

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Master Thesis

NORGES HANDELSHØYSKOLE

Executive Summary

The purpose of this thesis is to identify the new strategic business models that companies use in the changing competitive landscape of the music market.

Companies that develop and distribute physical music formats, such as compact discs, have encountered challenges due to the increasing consumer demand for downloadable music. Some of these challenges include: decreased demand for physical music, increased competition from online distribution companies, and frequent violations of copyright laws. To maintain dominant positions in the music market, companies must develop new strategies.

Analysing secondary data, different theoretical methods were used to classify companies in the music market, examine the external environment, identify the companies' strengths and weaknesses, and determine the most implemented strategies.

Four main strategies were identified: alliances and networks, product diversification, product and service distribution, and profit maximisation. Since these strategies are still in the development stages, the most profitable ones still have yet to be determined.

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Forward

I have an educational background in business and classical music theory. Therefore I was eager to choose a master thesis topic that satisfied both my academic and artistic interests. Analysing companies that operate in the often diverging areas of business and music was very challenging, yet rewarding. Not only did I learn about the current state of the music market, but I also gained a greater understanding of the technological, financial and legal complexities that music development and distribution companies face.

I did not write this thesis as an advocate or condemner of music piracy, peer-to-peer file-sharing, CD burning, BitTorrent tracking, or any of the other controversial methods used to obtain music. My research is used solely to observe and analyse how music companies react strategically to this situation.

There are many people that I would like to thank. First I have to thank my thesis supervisor, Professor Roger Bivand, for his guidance and patience throughout the thesis writing process. Next, I would like to thank the administration at NHH for admitting me as a student. Living in Norway has been an unforgettable experience. I also have to thank all of the students from around the world that I have met and worked with over the years.

Finally, I would like to thank my mother. Her love, wisdom, friendship and unending support have always been great sources of strength for me. I dedicate this thesis and master degree to her.

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June 2009

1 Introduction

"It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change."

~ Charles Darwin

Technological innovation has had one of the greatest impacts on society during the 20th century. The creation of computers and the Internet have given the world unfettered access to vast amounts of information, created new methods of communication and increased knowledge-sharing. These changes have brought more opportunities, yet more challenges.

Due to changing technology, it has become easier for companies to record and sell music in new formats. Between the 1970s and the 1990s, companies primarily recorded music on magnetic strips in cassette tapes ("Cassette tape", 2009). In the United Kingdom, sales of cassette tapes peaked in 1989 with 83 million units sold. As cassette tapes began to lose popularity, British unit sales dwindled to 900,000 units in 2004 ("Not Long", 2005).

In the 1990s, consumer interest shifted from cassette tapes to audio recordings on compact discs (CDs). CDs use laser technology to store digital data ("Compact Disc", 2009). The enhanced digital audio and compatibility with computers fuelled consumer interest in CDs. Additionally, unlike cassette tapes, digital music on CDs could be continuously copied onto computers or other media without a reduction in sound quality. In the year 2000, global sales of CD albums peaked at 2.5 billon. By 2006, that number decreased to 1.8 billion ("How the CD", 2007). This reduction in CD sales was due to decreasing popularity and increasing competition from other music formats.

Purchasing and downloading digital music on the Internet has become a popular way to obtain music in the new millennium. According to the International Federation of the Phonographic Industry (IFPI), downloadable music sales will account for a quarter of global music sales by the year 2010 ("Compact Disc Hits", 2007).

Since digital music can be duplicated, some customers copy and listen to their purchased music on multiple players (such as laptops, cell phones or other portable music players). Some customers also share music with friends or distribute music on the Internet through Peer-to-Peer (P2P) file-sharing networks. P2P file-sharing allows users to freely exchange, duplicate and download digital content from one computer to another.

P2P file-sharing has become a major area of concern for music development and distribution companies. If customers are able to make or obtain free copies of a product that companies sell for profit, how can those companies maintain long-term profit?

1.1 Importance of Music Downloading for Customers and Firms

In general, if there is a shift in market structure (due to innovative technology, new laws, increased competition, changing consumer preferences, or other externalities), companies that operate within that market normally change their behaviour to adapt to the new environment. The companies change their tactics and strategies in order to keep their market performance at a satisfactory level. In the case of downloadable music and P2P file-sharing, some companies that only sold compact discs adapted to this new situation by using court litigation.

A recent example of a court case between a popular website and music companies was the Pirate Bay trial ("The Pirate Bay Trial", 2009). In January of 2008, Swedish prosecutors filed charges against four men who operated or sold services on Pirate Bay, a torrent tracking website[1]. They were charged with 34 counts of copyright infringement for illegally-traded music, movies and games. Though the website did not provide the downloadable content, it facilitated users' breach of copyright law by directing them to websites with the illegal material. The Pirate Bay founders were convicted in April of 2009 and sentenced to one year in jail ("Court Jails", 2009). If the verdict is upheld on appeal, this court victory for music development and distribution companies will set a precedent for future copyright infringement court cases in Sweden and possibly worldwide.

[1] A torrent tracking website directs users to websites that have downloadable material.

The Pirate Bay case shows the importance of music downloading for customers and firms. Although music development and distribution companies successfully prosecuted Pirate Bay, there are many other P2P file-sharing networks and torrent-tracking websites that can offer similar services. Therefore, the sustainability of a strategy based solely in court litigation comes into question. Companies must identify the underlying reasons why these websites have increased in popularity.

The popularity of file-sharing websites is not solely based on the allure of obtaining free music. Consumers' preference for music is changing and the demand for downloadable music is increasing at a rapid rate. Many established music companies were initially reluctant or unable to change their static business strategies in order to supply new products for this dynamic consumer music market. To fill the void, new companies entered the market to provide innovative goods and services. Established companies must adapt to this changing environment by developing new strategic business models, or they will continue to watch their turnover and profits decrease.

1.2 Thesis Research Framework of the Music Market

This thesis will use secondary data to identify the most implemented strategies of companies in the changing competitive landscape of the music market. A few choices have been made to facilitate research in this thesis. In general, the recorded music market consists of artist discovery and development, as well as the promotion, marketing and sale of recorded music (European Commission 2007, p. 13). However, this thesis will focus on music companies, not music artists. Specifically, the thesis will analyse development and distribution companies in the recorded music market. Development companies record the music and own intellectual property rights. Distribution companies buy licensing agreements and sell the music. The thesis will also analyse companies that sell complementary music products, such as portable music players, because they are an important factor in the total consumption of music.

This thesis will not focus on companies that manufacture physical music formats. Manufacturing is no longer considered a core function of music companies because this activity is increasingly being outsourced. Furthermore, this thesis will not concentrate on the music publishing market because that involves the sale of music in

its written form. Additional criteria used for choosing the companies will be discussed under Relevant Companies in the Music Market.

From this point forward, the thesis will only discuss compact discs in reference to physical music formats. This is because more statistical information is available for CDs. Music on CDs and music downloaded on the Internet are both made in a digital format. Therefore to avoid confusion, music that is downloaded on the Internet will be called downloadable music, not digital music. Music on the Internet can be downloaded in MP3[2], AAC[3] and WMA[4] audio formats, yet they will all be referred to as downloadable music. Downloadable music can be distributed either online or through mobile networks; however the thesis will only focus on distributed music online.

Finally, consumer interest in downloadable music is a global phenomenon. Yet most of the research available on the subject stems from American and European sources. Therefore, music markets in the United States and European Union have been chosen as examples to investigate.

1.3 Limitations of the Research

Music development and distribution companies are still experimenting with different strategic business models to determine which ones are more profitable. Therefore, analysing the companies' main strategies is particularly difficult. Moreover, due to the competitive nature of the music market, companies that have implemented successful strategies are reluctant to share specific information.

Most of the companies involved in the music market are privately-held firms. Therefore, specific financial and company information were sometimes difficult to obtain. In order to alleviate this problem, the theoretical analyses were only conducted on companies that were market leaders in their respective industries.

[2] MPEG-1 Audio Layer 3
[3] Advanced Audio Coding (AAC)
[4] Windows Media Audio (WMA)

2 Relevant Companies in the Music Market

When analysing the impact that downloadable music has had on competing firms, it is first important to identify the relevant companies that are involved in the music market. Within this market, companies have different functions. The first function is music development. Entertainment companies, such as recording companies, usually operate in this function because they find music artists and create the music. The second function is music distribution, which is increasingly being handled by music retailers in the technology sector.

The analysis cannot focus on all of the companies that operate in the music market due to the high number of companies. Therefore, only companies that own the greatest market shares and generate highest profits in their respective industries are mentioned. Since these companies operate in various industries and sectors (such as entertainment, discount variety stores, electronic equipment and technology), companies will only be categorised based on whether they develop or distribute music.

2.1 Development-Focused Companies

Music development companies, such as recording companies, create and supply music. After music artists sign exclusive contracts with recording companies, the firms make initial monetary investments to help the artist produce and promote their music. In return, the companies charge the artists royalty fees. The fee amount is based on what the firm thinks potential customers would be willing to pay for the music (Bockstedt et.al, 2005). The investments that recording companies make in new artists eventually reap profits through music sales in stores and on the Internet. Major recording companies tend to work with artists from all genres of music, while independent labels focus on niche markets.

2.1.1 Major Recording Companies

During the last thirty years, various mergers and acquisitions have dramatically reduced the number of major recording companies. The largest of these firms are

known as the “Big 4” Recording Companies: EMI Group plc, Warner Music Group Corporation, Universal Music Group, and Sony BMG Music Entertainment.

EMI Group plc has a US music market share of 8.35 percent (as of 9 October 2008), which is the smallest market share of the four major recording companies (The Associated Press, 2008). Headquartered in London, its total revenues topped $3.6 billion in 2006. The company was bought by the private equity firm, Terra Firma in 2007 (“EMI”, 2009).

Headquartered in New York City, Warner Music Group Corporation (WMG) is the only stand-alone, publicly traded music company in the United States, issuing an Initial Public Offering in 2005 (*Warner Music Group*, 2009). Its 2008 total revenues reached $3.5 billion (“Warner Music Group Corp.”, 2009) and it owns a 21.12 percent market share. The company’s roots stem from Time Warner and Warner Bros (“Warner Music Group” 2009).

The most recently-formed recording company was Sony BMG Music Entertainment. Sony BMG was a joint venture in 2004 between the Sony Music Entertainment division of the Sony Group in Japan and the Bertelsmann Media Group division of Bertelsmann AG in Germany. The company owned a 22.79 percent market share. It should be noted that the Sony BMG merger ended on 5 August 2008 and is now called Sony Music Entertainment, Inc. This will be discussed in greater detail during the analysis of Alliance and Network Strategies.

Universal Music Group (UMG) is the world’s largest music company, owning 35.12 percent of US market share and twenty record labels (“Universal Music Group”, Yahoo, 2009). Founded in 1934 as Decca Records USA, UMG is currently a subsidiary of the large French communications company Vivendi, yet traces it roots all the way back to the National Grammophon Company in 1898 (“Universal Music Group: History”, 2009).

Due to decades of high revenues, these major recording companies have substantial financial capacity to invest in new artists, leading to more extensive artist repertoires and diverse music portfolios (European Commission, 2007, p. 85). They also currently own about 80 percent of the world’s music market. There were initial

concerns that this type of ownership could lead to higher CD prices and fewer customer choices. Yet the EU Commission stated that these worries were unfounded. Particularly concerning Sony BMG, the recording companies argued that the merger was necessary to combat "pirated CDs and an explosion of illegal music downloading" ("Sony and BMG Merger" 2004).

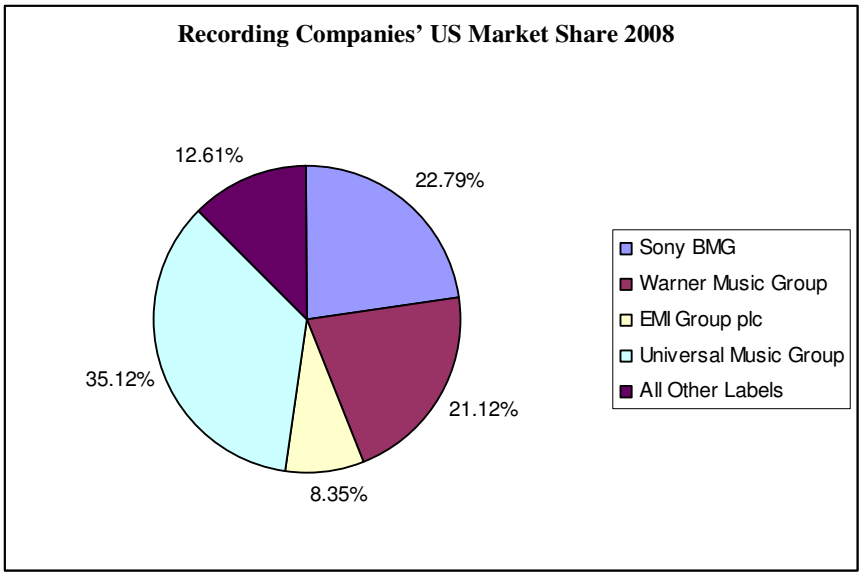

Figure 1: Recording Companies' US Market Share 2008
(The Associated Press, 2008)

2.1.2 Independent Record Labels

Independent record labels are distinctly different than major recording companies for a variety of reasons. First, independent record labels are usually privately funded by a small group of investors and are usually directed by a sole manager. Therefore, they are typically smaller in size, similar to entrepreneurial SMEs [5]. Accordingly, independent record labels have smaller repertoires of artists, specialize in specific genres of music, and market to a niche group of consumers (European Commission, 2007, p. 13). Due to the independent labels' expertise in creating specific music genres, major recording companies are continuously acquiring the smaller labels. Major recording companies also solicit successful artists who are signed with

[5] SME – Small and Medium-Sized Enterprises, with fewer than 50 employees being "small" and fewer than 250 employees being "medium." ("Small and medium enterprise", 2009)

independent labels by offering the artists contracts with better financial terms (European Commission, 2007, p. 89).

Consumers' increasing interest in and easy access to online music has made it easier for independent labels to market and distribute their music to consumers. The downloadable music market has virtually no costs for manufacturing and distribution (European Commission, 2007, p. 34). Major recording companies have the financial wherewithal, music retailer affiliation, and international access to efficiently reach customers through traditional and online sales channels. Even so, the Internet has provided a new venue for independent record labels to efficiently reach customers as well.

Furthermore, the Internet has allowed labels and artists to promote their products and sell music on their own websites. This has decreased the need to pay for access to distribution networks or negotiate joint-ventures with national retailers. Ironically, due to independent labels' increased publicity, online music retailers have become interested in selling more independent music and have begun to encourage these labels to outsource their music distribution (European Commission, 2007, p. 24).

Nevertheless, independent labels cannot benefit from music sales in the same ways as major recording companies because independent labels lack the capacity to handle global deals. They are also dependant on collective licensing solutions (European Commission, 2007, p. 34). Collective licensing solutions require a group to issue blank licenses covering nearly all music copyrights ("A Better Way Forward", 2008).

2.2 Distribution-Focused Companies

After recording companies produce music, they often sell the right to access their music catalogues in the form of copyright licensing agreements. The licensees who buy the agreements are usually music retailers. A music copyright license agreement gives the licensee the permission to use the music for financial gain. These contracts usually specify the agreement parties and warrantor, license content, use of license, terms of agreement, license area/country, license fee collection and payment terms, music purchase and selection, contract termination, and license warranty ("Sample

Business Contracts", 2009). After the licensing agreement is complete, music retailers sell the recorded music to consumers at retail prices.

Distribution methods for physical and downloadable music are used to provide consumers with the same product, which is recorded music. For that reason, there are not enough significant differences between the methods to create two distinct product markets. However using both distribution methods is now essential to meet consumer demand. Some recording companies view downloadable music as a portion of the total recorded music market. Contrarily, some third parties believe that downloadable and physical music formats are substitutes for one another. This is because the increased consumption and purchases of downloadable music has offset the decline of physical CD purchases (European Commission, 2007, p. 15).

2.2.1 Physical and Downloadable Music Retailers

There are three types of music retailers: traditional brick-and-mortar businesses, online retailers and downloadable music retailers. A brick-and-mortar (B&M) business is a company that has a physical presence and offers face-to-face consumer experiences ("Brick", 2009). B&M music retailers sell music in physical formats, such as compact discs. An online music retailer has no physical location, but it can sell CDs via the Internet, and then deliver them by post mail. Online music retailers can also sell downloadable music online. Niche artists are often sold online because they have slow CD sales at B&Ms. A downloadable music retailer sells music online, which can only be downloaded.

An example of a traditional brick-and-mortar music retailer is Wal-Mart, because it sells physical music in its stores. Wal-Mart is also an online music retailer because it sells physical and downloadable music formats via the Internet. Due to licensing restrictions on US-based download services, Wal-Mart's online store is only available to customers who reside in the United States ("Cannot Buy", 2009).

Apple's iTunes Store™ is a downloadable music retailer. The store is based on the Internet and focuses solely on selling downloadable products. Unlike Wal-Mart, the iTunes Store™ has expanded its customer base worldwide.

A profitable online music retailer is Amazon.com, Inc. Initially, Amazon sold all of its goods through the Internet and mailed the purchased products to customers. When Amazon's downloadable music store AmazonMP3 opened in 2007 ("Amazon Timeline", 2009), the company began to sell downloadable music directly to customers. However unlike the iTunes Store™, the downloadable music store is only available to consumers who reside in the United States ("AmazonMP3.com", 2009).

2.2.2 Major Portable Music Player Retailers

Portable music players have incorporated a new element into customers' music experience by allowing them to access music in various locations. Even though companies that sell portable music players are not directly involved in the sale of recorded music, they have indirectly increased downloadable music's popularity in the music market.

Apple's iPod was the biggest seller of portable music players in 2007 with around 52 million iPods sold. This totalled over $8 million in net sales (Apple, "10-K", 2007). Apple's iPod also dominates the portable music player retailers' market share. In the second quarter of 2005 and second quarter of 2006, the various iPod models accounted for 76 percent of the U.S. market for portable music players (not including music phones) (Sacconaghi, 2006). SanDisk's Sansa MP3 player, iPod's closest competitor, only managed to gain ten percent of the market in 2006.

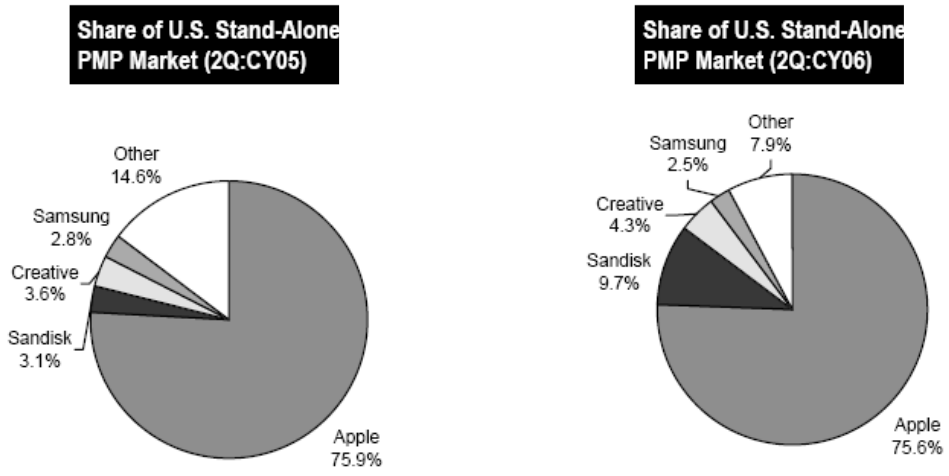

Figure 2: United States Portable Music Player (PMP) Market in 2005 and 2006
(Sacconaghi, 2006)

3 Physical and Downloadable Music Supply Chains

Music development and distribution companies are highly dependant on each other to produce and sell goods. In order to get a clear picture of how goods are transferred from one company to another, it is important to view their supply chain. A supply chain is a chain of activities that transforms a product from raw materials to a finished good (Nagurney, 2006). Without each member of the chain, delivery of the final product or service would not be possible.

Similar to a value chain, a supply chain can consist of primary and support activities. Primary activities directly contribute by developing, producing, and distributing goods and services, while support activities assist the primary ones (Peng, 2006, p. 80). For the music market, primary activities consist of music creation, production and distribution. Support activities are the production of products that aid in the consumption of music products, such as portable music players.

As companies transition from selling physical music to downloadable music, the supply chain changes as well.

3.1 Physical Music Supply Chain

When the sole way of making and distributing recorded music was through physical music production, there were many more actors involved in the supply chain process. After an artist creates a song, a music company records it on a music track and obtains a copyright. After a licensing agreement is made, production is outsourced to a company that records the music onto CDs, packages and ships the CDs to music retailers. The retailer then distributes the finished product to customers. These would be primary activities, while the sale of portable CD players would be a support activity. A diagram of this supply chain is located below.

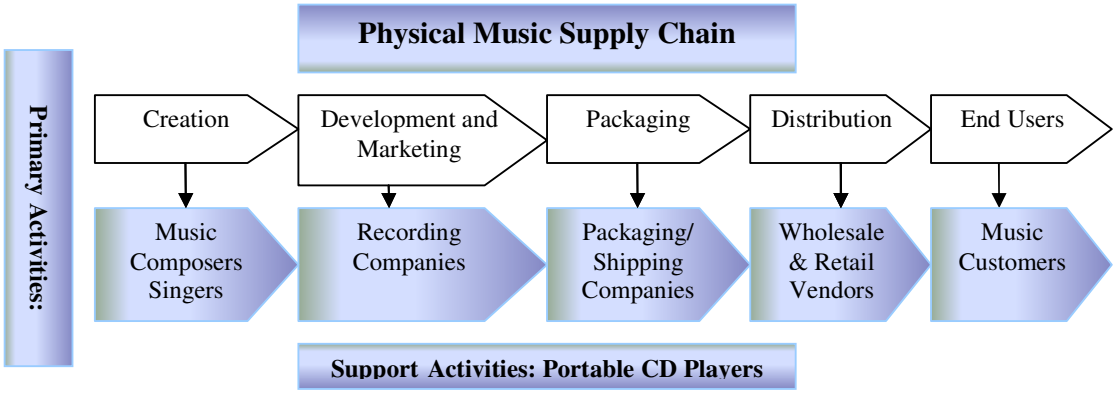

Figure 3: Physical Music Supply Chain
(Source: the author)

3.2 Downloadable Music Supply Chain

The Internet has provided more efficient and cheaper methods of distributing music. Since downloadable music does not need to be packaged and delivered to various locations, many production and shipping costs are avoided.

The primary activities of a downloadable music supply chain are creation, development and marketing, and online distribution. These activities are performed by music artists, recording companies and downloadable music retailers. Companies that produce portable downloadable music players provide support activities to increase the total consumption of downloadable music.

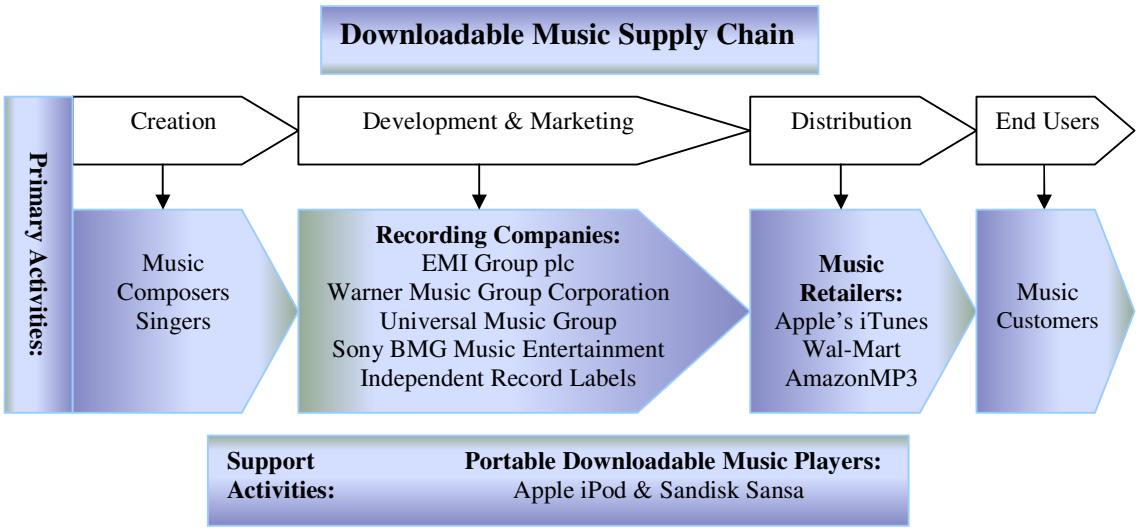

Figure 4: Downloadable Music Supply Chain
(Source: the author)

4 External Market Analysis

Music development and distribution companies are finding new ways to adapt to the changing consumer demand for downloadable music. To strategise a course of action, the companies must first acquire in-depth knowledge about their current and potential competitors, suppliers and customers. The companies should also be aware of the factors that directly and indirectly affect them in the music market. Furthermore, the companies should evaluate what their strengths and weaknesses are, as well as what potential opportunities and threats might be present. This section analyses these issues using Porter's Five Forces Model, PESTEL Analysis and SWOT Analysis.

4.1 Competitive Environment: Porter's Five Forces Model

Michael Porter designed the *Five Forces Model* as a way of identifying the degree of industry competitiveness and how it affects a firm's performance (Porter, 1980, p. 41). The five forces include: intensity of rivalry among existing companies, threat of new entrants, bargaining power of suppliers, bargaining power of buyers, and threat of substitutes. The stronger the forces are, the less likely it will be that the focal firm will gain above-average returns. Michael Porter's theory of the Five Force Framework can be applied to recording companies and downloadable music retailers.

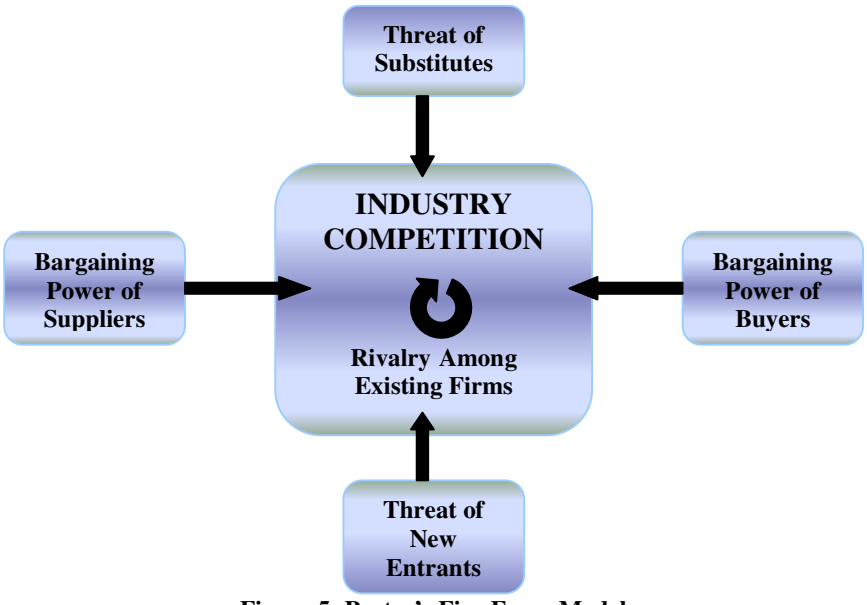

Figure 5: Porter's Five Force Model
(Porter, 1980)

4.1.1 Intensive Rivalry

The first force asks the question, "What conditions lead to intense rivalry?" Rivalry in an industry usually occurs because competitors feel external pressure or see an opportunity to improve their position. In most industries, competitive moves by one firm have noticeable effects on the competing firms and may result in retaliation.

Other factors that might influence industry rivalry include: companies that are of similar size, companies that sell "big-ticket" items that are purchased infrequently, thus creating difficulty in establishing industry dominance, companies that sell frequently-purchased items with brand-loyal consumers, leading to strong industry leaders, companies in slow-growth industries, creating desperation to achieve profits, and companies that are willing to operated at a loss rather than assume high exit closing costs (Peng, 2006, p. 42).

Although Universal Music Group owns the largest share in the US music market, 35 percent, the other three major recording companies own significant shares as well. Since they own similar market sizes, they have similar amounts of power in the music industry. This could induce rivalry.

Secondly, industry rivalry could emerge because the recording companies have similar organisational structures. The firms have horizontally-integrated organizational structures, which are coordinated worldwide (European Commission 2007). Horizontal integration occurs when a firm enters other businesses outside of its own business system (DeWit and Meyer, 1998, p. 417). In the music market, horizontal integration occurs when the recording companies affiliate with companies in other entertainment genres, such as publishing[6], radio and television broadcasting[7], and online music exploitation[8].

Furthermore, recording companies sign contracts with select groups of artists and only produces their music. If customers like those artists and frequently purchases their music, consumer loyalty is created. However, since the artists' music tracks are

[6] Universal bought BMG publishing in for $2.1 billion ("Universal to buy BMG publishing" 2006)
[7] Bertelsmann owns radio and television programs in Germany, France, and Benelux (Belgium, the Netherlands, and Luxembourg), known as the RTL Group (RTL Group, 2009)
[8] Sky Satellite TV teamed with Universal in 2008 to launch a net music service ("Sky", 2008)

licensed to music retailers before they reach the end consumers, the consumers do not develop consumer loyalty directly with the recording companies, but rather with the music retailers. Since all record companies are licensing similar goods to music retailers, this might increase rivalry.

Therefore, due to similar market sizes, organisational structures and similar goods, the competitive rivalry among recording companies is high.

4.1.2 Threat of New Entrants

New entrants enter an industry because of the lucrative returns gained in increased market share. They bring new capacity, innovation and often substantial resources with them. The threat of new entrants depends on the entry barriers that are present in the industry and the potential reactions of incumbents, existing competitors. Therefore, the second force asks the question, "What conditions have created such high entry barriers?"

The first condition would be Economies of Scale. Do the incumbents have decreasing unit costs coupled with increasing production capacity? The longer an incumbent performs a task, the more proficient it becomes, resulting in lower costs. This can be a barrier to new entrants because it would be difficult for new entrants to compete when they have high start-up costs. A second condition would be Proprietary Technology. High entry barriers can be made if incumbents have proprietary technology, such as patents. This ownership, coupled with extensive knowledge and experience in the industry, can be an advantage. A third condition is Product Differentiation. Producing a unique product creates loyalty among frequent consumers.

However, new entrants can benefit from the incumbents' experiences by learning from previous errors, accessing results from R&D, and marketing to an established consumer base once the incumbents' patents have expired (Peng, 2006, p. 45-47).

As discussed in the Independent Record Labels section, smaller record labels try to enter the industry of incumbent recording companies and gain market share. However given the size and power of the "Big 4" recording companies, independent labels do not pose major threats. They might pose minor threats if they have exclusive contracts

with artists or copyrights over popular music collections. Nevertheless, large recording companies can circumvent these problems by either luring the popular artists to their companies with better contracts or acquiring the smaller labels, thus gaining ownership of the music collections. Therefore, there are high entry barriers for recording companies.

Conversely, there are low entry barriers for companies that want to sell downloadable music online. Due to the ease of digitally transferring music, incumbent music retailers experience many new entrants. An example of a new entrant is the former P2P file-sharing network Napster. Napster used to distribute free music online. After the Recording Industry Association of America sued Napster for copyright infringement in 1999 and Napster's conviction in 2001 (Zepeda, 2002), Napster became a legitimate downloadable music retailer. It re-entered the music market in 2003 and merged with Best Buy, Inc. in 2008 ("About Napster" 2009).

4.1.3 Bargaining Power of Suppliers

Suppliers provide a firm with the material or services in order for the firm to create a product. The ability to raise prices or reduce the quantity of goods available is considered the amount of bargaining power a supplier has. The greater the power of suppliers, the more they can charge for their goods or services. The amount of power is based on several factors.

A supplier is considered powerful when its product is important to the buyer's business. For instance, if there are few suppliers who provide unique, differentiated products with few substitutes, they will have considerably more power than numerous suppliers who provide generic goods. Also, if the supplier can enter the firm's industry through forward integration, this can cause substantial damage to the focal firm (Peng, 2006, p. 47).

Since the suppliers of recording companies are music artists, artists generally have a low bargaining position. This is because the supply of available talent is very high. Since most artists seek contracts with recording companies at the beginning of their careers, they do not have enough leverage in the form of popularity or experience to successfully bargain with large music companies. If an artist refuses to accept the

terms of the contract, the recording company could easily find another artist who would accept them.

Music retailers, on the other hand, have the recording companies as suppliers. Since there are only a few suppliers, they have considerably more bargaining power. Additionally, the products they are supplying to the retailers are essential to the music retailer's core business. Therefore, the details of the licensing agreements are usually in favour of the recording companies. This relationship will be further analysed in Optimal Pricing Strategy section.

4.1.4 Bargaining Power of Buyers

Supplying goods and services to customers is also a high priority to the focal firm. The amount of power that buyers have is based on certain conditions, such as the number of buyers and the added value that the good provides for them. These conditions can influence the price of the good or service. There are additional conditions that could influence buyers' bargaining power.

Undifferentiated goods offered by the focal firm could cause buyers to have more bargaining power. If many firms provide a similar product, the buyer could purchase the product from the company that states the lowest price. However, switching costs can affect the buying decision. If the buyer is currently using a product and the switching costs to a similar product are high, the less likely it is that the customer will change to another product. Economic difficulties and drastic events are also known to have significant effects on consumer spending. Furthermore, if buyers are able to enter the focal firm's industry through backwards integration; they could become a potential competitor (Peng, 2006, p.49).

As previously stated, the buyers of recording companies' music licenses are music retailers. Even though music retailers have low buyer bargaining power when determining the conditions of the licensing agreements, they have higher bargaining power when deciding from which recording company to buy the licensing agreements. For example, if a music retailer made licensing agreements with three of the four major recording companies, yet could not obtain a license from the forth company, the retailer would still have access to a sizable portion of the music market.

The buyers of music retailers' products are the end users, music buyers/listeners. Individually, music buyers do not have a strong bargaining position, but as a group, they have massive power. They especially have a strong position when determining what price they are willing to pay for music, the software attached to the music, as well as if they will buy the music at all.

4.1.5 Threat of Substitutes

A good or service that performs nearly the same function in an industry can be viewed as a substitute. Substitutes limit the price companies in the industry can charge, thus placing a cap on possible company profits. If substitutes are higher in quality than what the firm currently offers, buyers might prefer those goods. Also, if the switching costs between goods are low, buyers have more opportunities to try different products (Peng, 2006, p. 50).

Potential major threats of substitution are other entertainment products. Video game and movie companies could potentially take the customers of downloadable music retailers. This issue will be further discussed in the PESTEL Analysis Social Factors.

4.2 Macro-Environment: PESTEL Analysis

The PESTEL Analysis looks at the external factors that may have an effect on a particular industry. After identifying the political, economical, social, technological, environmental, and legal factors, managers can more effectively make decisions ("PESTEL", 2007). The main factors involved in music development and distribution companies are legal, technological, economical and social factors. Some of the issues mentioned focus on law from the United States.

4.2.1 Legal Factors

Legal factors are laws that can affect how a company operates, its costs, and consumer demand. One important legal factor for music development and distribution companies concerning downloadable music is the customer's right to copy the purchased music. As mentioned earlier, CD customers often copy digital music to their personal computers. This is permitted in the United States, as long as the copying is within "fair use". Fair Use is explained under Title 17 of the US Code of Copyright Law (U.S. Copyright Office, 2009).

4.2.1.1 Fair Use and Copyright Law

Chapter 1§106 of Title 17 of the US Code on Copyright Law specifies the exclusive rights of copyright owners. Copyright owners have the sole right to distribute copies to the public by sale, transfer of ownership, rental, lease, lending or digital audio transmission. However, chapter 1§107 discusses the limitation of exclusive rights that copyright owners have over content. Specifically, content reproduction is not an infringement of the copyright if it is used for criticism, comment, news reporting, teaching, scholarship, or research. Therefore, as long as the customer does not disburse the copied content, especially with the intent of profit, there is no copyright infringement.

Even though file-sharing networks distribute downloadable music without the network users paying for the music, the file-sharing networks are not reproducing the content for one of the purposes discussed in chapter 1§107. Additionally, uploading the music to a file-sharing network allows the content to be downloaded and

reproduced multiple times, thus negatively affecting the potential profits of those who created the content. Therefore in this instance, chapter 1§107 protects the copyright owner, not the file-sharing network.

4.2.1.2 Recording Industry Association of America

The group that has taken one of the most active roles against peer-to-peer (P2P) file-sharing networks is the Recording Industry Association of America (RIAA). The RIAA is an organisation that advocates on behalf of the US recording industry. Its membership includes prominent recording companies who manufacture and/or distribute around 90 percent of all legal sound recordings in the country. The RIAA provides its members business and legal support to help sustain their creative and financial longevity. To promote intellectual property rights protection, the RIAA researches consumer, market, and technical aspects of the recording industry. The organisation also monitors state and federal laws and regulations regarding copyright protection ("RIAA", 2009).

One of the more controversial aspects of the RIAA is the manner in which it attempts to reduce illegally distributed downloadable music. It searches for and sues copyright infringement perpetrators on peer-to-peer network and individual levels. On a network level, RIAA has reprimanded popular file-sharing networks, such as Kazaa and Napster.

However in 2003, the organisation began a massive offensive against individual online file-swappers, filing 261 lawsuits. This was the first time that copyright law was used on such a large scale on individual Internet users. The RIAA was initially apprehensive about targeting individual file sharers because they could also be music customers, but the industry executives lost their patience with file sharers who had disregarded the illegality of their actions. At that time, a study conducted by the Pew Internet and American Life Project found that 67 percent of users who downloaded music said that they did not care if the music was copyrighted or not (Borland, 2003).

Also in 2003, there was a backlash against the RIAA and the music industry regarding lawsuits directed toward individuals. This backlash was due to the group's inaccuracies when issuing subpoenas. For example, due to the easy accessibility of

wireless Internet networks, it was possible for third parties to gain unfettered access to unencrypted networks. Unbeknownst to the owners of the wireless networks, the third party downloaded files without the risk of being directly linked to "the scene of the crime." Therefore, when RIAA detected a wireless Internet network that illegally downloaded music, the culprit could only be traced to the owner of the network. It was not possible to trace all of the computers that accessed that network. Hence the problem arose of mistaken identities and false accusations.

In 2008, the RIAA subsequently dropped this counterproductive strategy of suing customers and began working with Internet Service Providers (ISP) to more accurately identify those who were suspected of sharing copyrighted files. However fair-use advocate groups, such as the Public Knowledge interest group, were wary that this collaboration might give ISPs the improper role as "copyright cop". Advocates also stressed that customers' privacy should not be invaded, nor should they be denied Internet service solely on the basis of a copyright holder's file-sharing claim (Telecommunications Reports, 2009).

4.2.2 Technological Factors

In the year 2000, major recording companies began to test the business model of selling downloadable music. Sony was the first to try when it released 50 music singles. Universal followed suit, releasing 60 singles (Gillen, 2000). However, the recording companies encrypted the downloadable music with digital protection software. This software made it difficult for users to transfer or copy protected content more than the amount of times that is considered within fair use. This type of software protection is called Digital Rights Management.

4.2.2.1 What is Digital Rights Management?

Digital Rights Management (DRM) addresses the issue of digital content protection and is becoming one of the most debated and controversial aspects of intellectual property rights. There are many components to Digital Rights Management, but it is first necessary to understand exactly what DRM is. In 2003, the CEN/ISSS DRM

Group[9] created a report on the current status of DRM and the ways that it could be successfully implemented into today's marketplace. This group also attempted to establish a definition for DRM. Also known as Digital Content Management Solutions (Helberger, 2004), DRM has been defined by CEN/ISSS as, "[t]he management of rights to digital goods and content, including its confinement to authorized use and users and the management of any consequences of that use throughout the entire life cycle of the content" ("Digital Rights Management", 2003). In other words, DRM supervises digital content, prevents unauthorized access and handles any infringement if it arises.

Under this umbrella term there are three DRM subcategories. *DRM Technology* is the actual encryption that allows access to and control over the digital content. *DRM Platform* is a framework that integrates the technology with other components, such as subscription management. Finally, *DRM Solution* allows firms to implement business models geared toward content consumption by integrating technology and services. DRM is used in many other applications besides music. Here is a list of other DRM applications.

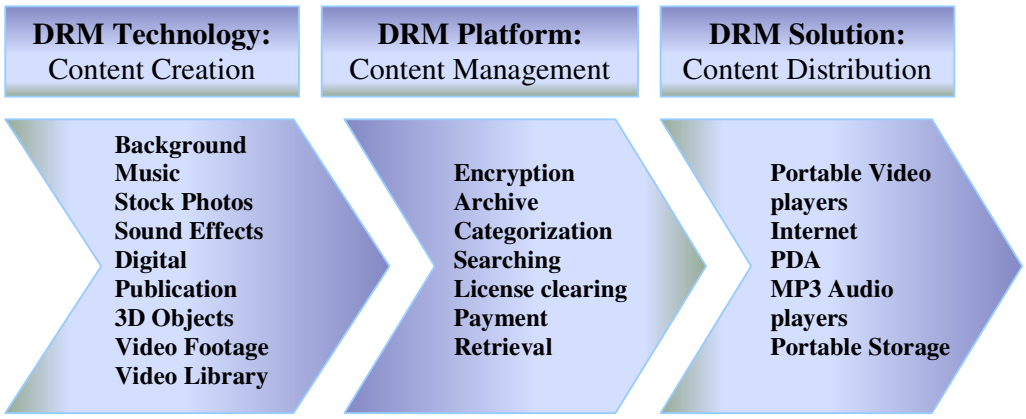

Figure 6: DRM Platform Overview
("DAM/DRM Platform Overview", 2005)

[9] The CEN/ISSS DRM Group was appointed by the European Commission to research and present a report on DRM standardization. "CEN (European Standards Committee) is one of three formally recognized European Standards Organizations, and ISSS (Information Society Standardization System) is the Department responsible for standards activity within CEN for information and communications technologies (ICTs)" ("Digital Rights Management", 2003)

4.2.2.2 The Digital Millennium Copyright Act

What happens when individuals try to override the DRM system and gain free access to the copyrighted digital content? The United States made an amendment to the US Code of Copyright Law to address this potential problem, known as the Digital Millennium Copyright Act (DMCA) (The Library of Congress, 2009). Voted into law in 1998, the DMCA makes it a crime for people to circumvent anti-piracy measures built into most commercial software. Additionally, the Act outlaws the manufacture, sale or distribution of code-cracking devices that would illegally copy computer software. More importantly, the Act limits Internet Service Providers' copyright infringement liability for illegal information which is transmitted over their Internet service. Nevertheless, ISPs are obliged to remove any material from users' websites which appear to be copyright infringement ("Highlights", 2001).

Countries that have entered into Free Trade Agreements, such as Australia in 2004, have tried to align its copyright laws with the DMCA of the US (Thompson, 2004).

Microsoft was one of the first companies to create and use DRM protection software to guard its digital intellectual property. Despite laws such as the Digital Millennium Copyright Act, many groups have tried to override the firm's DRM system. A case study of Microsoft's DRM protected software can be found in Appendix I.

4.2.2.3 Consumers Resist DRM-Protected Music

After recording companies began releasing downloadable music, they began selling licensing agreements to music retailers so the companies could sell the music online. One of the reasons why Apple's iTunes Store™ was initially popular with the recording companies was because Apple used DRM technology to protect its digital content. Consumers became dissatisfied with this technology because their legally purchased products were being tied to a particular software platform and hardware. Such was the link between Apple's iTunes Store™ and iPod portable music player. Apple's DRM software made it difficult for customers to play their purchased music on non-Apple devices unless they converted the music, which reduced its digital quality.

A landmark case between the Norwegian Consumer Council and Apple's iTunes Store™ sheds light on this issue. Customers sought to protect their rights as music owners, iPod hardware buyers, and iTunes software users. They felt that their purchased music should not be only useable with Apple's hardware and software applications. More information about this case can be found in Appendix II.

4.2.2.4 Recording Companies Embrace DRM-Free Music

After refusing to make deals with non-DRM music retailers, recording companies realized that releasing the DRM protection made content available to a wider consumer base, thus increasing the chance of future sales. In March of 2008, three of the four major recording companies, Warner, EMI and Universal, signed agreements with Amazon.com, Inc. to drop DRM protection on their music, which would be sold on the AmazonMP3 website. With these three major recording company contracts, in addition to over 33,000 independent record label contracts, AmazonMP3 was able to offer 2.9 million DRM-free songs. This shift in recording companies' preferences in the level of music security could encourage customers to buy more music, due to the increased compatibility with various portable music players. This could, in turn, loosen Apple's dominance in the music retail and portable music player markets (Sayer, 2008).

However on 7 January 2009, Apple agreed to sell all ten million of its digital songs on the iTunes store without the DRM protection software. This decision stemmed from an agreement with Sony BMG, Universal and Warner Music to end the use of DRM software on their licensed music. Some market analysts speculate that the reason why recording companies waited so long to remove DRM software from iTunes songs was to give the other music retailers the opportunity to increase their music sales ("Apple to End Music Restrictions", 2009).

4.2.3 Economic Factors

4.2.3.1 Legal Music Downloading on the Rise

In 2007, the amount of music purchased by US consumers increased by six percent. This was due to a surge in legally downloaded music sales. Downloadable music accounted for ten percent of total music obtained in the US. Due to the larger amount of legal downloads from customers between the ages of 35 and 50, the total number of music consumers actually increased by 5 million. This has promoted growth in the downloadable music industry.

However, the increase in sales could not compensate for the large decline in CD purchases. The net result was a ten percent decline in total music spending ($44 to $38 per capita among Internet users). Estimates show that over one million US consumers exited the CD market in 2007, with the majority of those consumers being teenagers. That year, 48 percent of teenagers did not purchase CDs, compared to 38 percent in 2006 (The NPD Group, "Consumers Acquired", 2009).

4.2.3.2 Profit for Music Retailers

As previously stated, traditional brick-and-mortar, online and downloadable music retailers such as Wal-Mart, AmazonMP3, and Apple's iTunes Store™ have embraced the possibilities of selling downloadable music online. They have seen the profit potential associated with this type of venture.

For example, due to Wal-Mart's decision to sell both physical CDs and downloadable music, the company surpassed Apple's iTunes Store™ to become the largest music vendor in the United States (The NPD Group, "Consumers Acquired", 2009). It now owns over 20 percent of the music retailers' market share (Christman, 2008). In February of 2008, Wal-Mart's downloadable music sales were ranked third behind Apple and Amazon.com's online music stores, which ranked first and second respectively (The NPD Group, "AmazonMP3", 2008)

After opening its Internet store in 2003, Apple's iTunes Store™ sold over 70 million downloads in one year (McGuire, 2004). By 2008, it sold over 4 billion downloads, attracted 50 million iTunes Store™ customers (Apple, Inc., "iTunes", 2008), and

accounted for approximately 70 percent of downloadable music sold online worldwide (Van Buskirk, 2008).

4.2.4 Social Factors

Increasing interest in downloadable media is the result of many societal changes such as innovative technology, increased electronic equipment purchases, improved channels of communication, expedited content delivery, demanding consumer preferences, increasing entertainment choices, new fashion trends, and changing consumer disposable incomes.

This constantly shifting consumer landscape provides a greater variety of entertainment outlets. Yet each outlet must compete for a decreasing share of consumers' fixed or reduced leisure time (The NPD Group, "Entertainment", 2008). Additionally, studies have shown that consumers' disposable incomes are being spent more on new electronic devices, such as portable music players and gaming consoles, and less on new entertainment content, such as downloadable music and CDs (The NPD Group, "U.S. Consumers", 2008). Since downloadable music tracks are often cheaper than CDs with similar content ($0.99 for a downloadable music track from the iTunes Store™ (Christman and Bruno, 2008) versus a $3.00 single track CD from Wal-Mart in 2008 ("Music single", 2009)), consumer preference gravitates toward the less expensive option. Downloadable music also has fewer transaction costs, since consumers do not need to travel to the store or wait for the music by post mail.

There is also evidence to show that the rise in popularity of one music retailer does not occur to the detriment of another. For example, even though AmazonMP3's consumer base is increasing, this growth is not mainly attributed to previous or current iTunes Store™ customers. In a consumer trial conducted by the NPD Group in February of 2008, only ten percent of AmazonMP3's customers had previously purchased music from the iTunes Store™. This result shows that the total consumer market for downloadable music is growing. Although the iTunes Store™ still sells ten times more music than AmazonMP3 on a per unit basis, AmazonMP3 has begun to create loyal consumer bases in demographics where iTunes is not particularly strong. For example in 2007, 64 percent of AmazonMP3 sales were from male consumers, compared to 44 percent of iTunes' sales. Additionally, AmazonMP3 showed strength

in the young adult consumer group (ages 18 to 25), whereas the iTunes Store™ was more popular among teenagers (ages 13 to 17) (The NPD Group, "AmazonMP3", 2008).

4.3 SWOT Analysis

A SWOT analysis identifies the strengths, weaknesses, opportunities and threats that are present or may be present in a market. Identifying these factors helps the companies to assess where they are, and develop strategies that help them get where they need to be (Peng, 2006, p. 12).

4.3.1 Opportunities and Threats

When analysing opportunities and threats, a company must identify and monitor important micro- and macroenvironment factors that affect its ability to earn profits. Microenvironment actors include customers, competitors, distributors and suppliers. Macroenvironment forces consists of demographic-economic, technological, political-legal, and social-cultural (Kolter, 2000, p. 76). These factors were identified above using the Porter's Five Forces Model and the PESTEL Analysis. After identifying these factors, a company should then classify the associated opportunities and threats.

Opportunities can be classified for their attractiveness and success probability. The probability of success depends on two things: if the company's strengths are aligned with the success requirements for operating in its target market, and if those strengths exceed the company's competitors. Threats can be classified based on the seriousness and probability of its occurrence (Kolter, 2000, p. 77).

The competitive advantage of size and innovation can present a source of opportunity for both music development and distribution companies. Take for example the major portable music player retailer, Apple. This company has used technological and operational innovation to link its MP3 player, iPod, to its computer-based music system and Internet retail store, the iTunes Store™. This has created a niche market where consumers utilize both systems to enhance their level of entertainment, thus creating a competitive advantage for Apple. This achievement will be further discussed in the section which analyses Product-Related Diversification strategies.

Peer-to-peer file-sharing networks still pose a clear threat to potential profits of music development companies. Now that recording companies have embraced music downloading and started licensing music to online retailers, they are better able to

develop strategies that can compete against file-sharing networks. Online retailers are threatened by the low entry barriers for new companies to enter the market. By developing their consumer base, customer loyalty can be created, thus making it harder for new companies to establish sufficient clientele.

4.3.2 Strengths and Weaknesses

Identifying strengths and weaknesses helps to evaluate a firm's internal environment (Kolter, 2000, p. 78).

The strength of companies that develop music has already been highlighted above in the analysis of major recording companies. Since there are few recording companies with large market shares in the industry, they have a competitive advantage over smaller labels. Particularly concerning Universal Music Group, the company's position as the world's largest music company gives it an unsurpassed level of authority concerning what deals transpire in the music industry.

The strength of companies that distribute music stems from the amount of innovative ideas that is poured into them. Staying ahead of the competition through technological or organisational innovation is regarded by many companies as a key success factor and a source of competitive advantage (De Wit and Meyer, 1998, p. 239).

One clear weakness of companies that develop music has been their slow reactive strategy to the changing music distribution landscape. Recording companies' business strategies only focused on recording and distributing music on physical music formats. As mentioned in the Introduction, downloadable music became popular around the year 2000. Yet, recording companies did not begin to accept the idea of promoting and selling DRM-free downloadable music until 2008. In a reactive strategy, companies are forced to change their strategy only after intense external pressure compels them to act (Peng, 2006, p. 128).

5 New Strategic Business Models

Now it is time to determine which new strategic business models development and distribution companies have used in the music market. These models will give an insight into what strategies are important to regain consumer interest and maintain the success of companies. These strategies include: alliances and networks, product diversification, product and service distribution, and profit maximisation.

5.1 Alliance and Network Strategies

Strategic alliances bring firms together to develop a new product, technology or service. There are contractual or equity-based alliances for either short or long-term ventures (Peng, 2006, p. 255). Some contractual-based alliances include co-marketing, R&D contracting and franchising, while equity-based alliances focus on strategic investments, cross-shareholding and joint ventures. Many considerations are taken into account when a company is deciding whether or not to engage in strategic alliances and networks. For the types of firms that sell homogeneous goods, the important considerations are industry-based and resource-based.

5.1.1 Industry-Based Considerations

Industry-based considerations are closely tied to Porter's Five Forces model. As stated before, this model gauges a company's competitiveness within an industry. However, more companies are collaborating within the same industry or compatible industries in order to maximize their performance and revenue. Inter- and Intra-industry collaborations are beneficial because firm rivalry tends to reduces total profits.

5.1.1.1 Prisoner's Dilemma

For instance, if two companies with similar or substitute products compete, one firm might reduce the price of its products in order to attract more customers. The second firm might then undercut this new price, thus regaining its customer base. As a result, the first firm might feel that the only way to attract more customers would be to slash prices again. Thus the cycle of price reduction continues. This situation is often referred to as a Prisoner's Dilemma, one of the basic ideas behind John Nash's Game

Theory (Peng, 2006, p. 298). If the two companies had not engaged in price wars, they would have maintained higher prices.

5.1.1.2 Joint Ventures and Mergers & Acquisitions

Companies with similar or complementary products can work together through equity-based alliances such as Joint Ventures and Mergers. A joint venture is a new entity formed by two or more parent companies (Peng, 2006, p. 236). Contracted over short or long-term agreements, a company establishes this alliance in an attempt to enter a new market segment or industry in which the other company has greater expertise. Within a joint venture agreement each company maintains limited liability, thus decreasing each firm's risk of financial exposure.

A merger occurs when two companies combine their assets, operations and management to form a new legal entity (Peng, 2006, p. 377). It is more binding than a joint venture due to the long-term and financially-revealing nature of the agreement. Even though a merger is the union of two entities, often the more dominant firm acquires, or buys-out, the other firm. Regulatory bodies are more likely to approve joint ventures over mergers because the former promotes collaboration among competitors, while the latter reduces the total amount of competitors within an industry.

Many different types of mergers and acquisitions (M&A) have occurred in music development and distribution companies. The Vivendi/Universal M&A in 2006 was an example of a conglomerate M&A, which involved firms in unrelated product industries. Vivendi entertainment was created in 2000 with the merger of Vivendi media, Canal+ television networks, and the acquisition of Universal Studios ("Vivendi", 2008). This M&A was a precursor to the creation of the wholly-owned subsidiary, Universal Music Group.

The union of two competing firms within the same industry is known as a horizontal M&A, such as the merger of Sony Music Entertainment and Bertelsmann Media Group to form Sony BMG.

5.1.1.3 Tacit & Explicit Collusion

The merger of Sony BMG was approved by the European Commission (EC) in 2004. However, the approval was annulled by the Court of First Instance in 2006. The court was worried that not enough rigor was used during the merger's initial approval process. In March of 2007, the EC's Competition Unit recommenced investigations to make sure that the merger would not inadvertently permit the collusion of wholesale music prices among the four remaining recording companies (EUROPA, 2007).

Collusion is the collective attempt to reduce competition. Certain market factors make it possible for collusion to exist in an industry, such as few competing firms, homogeneous products, high entry barriers, and friendly relationships among rival firms (Peng, 2006, p. 299). Tacit collusion occurs when firms indirectly coordinate their actions by signalling their intent to reduce output, thus maintaining prices above competition levels. If firms directly negotiate output and prices in order to decrease competition, this is explicit collusion. Explicit collusion is evident in cartels, which are illegal output- and price-fixing entities formed by competitors (Peng, 2006, p. 296).

In October of 2007, the European Commission's Competition Unit finished its investigation of the Sony BMG merger. Since no evidence of possible industry collusion was found, the firm's approval status was reinstated. Tangentially, this investigation unveiled an in-depth analysis of the current state of the recorded music industry. Not only did it reveal both physical and downloadable music sales of the biggest music providers, but it supplied country-specific information in Europe as well. This information had not been quantitatively amassed on such a grand scale before.

5.1.1.4 Creating Economic Sustainability

Even though prisoner's dilemma and collusion both seek to increase a firm's market share and revenue, they use polar pricing and collaborative strategies in order to achieve those goals. The prisoner's dilemma strategy is self-defeating, due to its individualistic nature and imminent profit loss. Collusion is combated by antitrust policies which seek to promote efficiency and fairness among companies and

consumers (Peng, 2006, p. 304). Therefore, in order to have sustainable profit, companies with homogeneous or complimentary products must maintain a balance between appealing to consumers' preference for low prices and not controlling the market through monopolistic or collusion-based strategies.

5.1.2 Resource-Based Considerations

A resource-based view assumes that firms have resource heterogeneity. Each firm has unique resources and capabilities that add value to a firm (Peng 2006, p. 77). Strategic alliances can also be analysed using this framework. When considering whether a strategic alliance will create value, it is necessary to acknowledge the potential advantages and disadvantages that the union may bring.

Possible advantages include reduced costs and risk, increased access to complementary assets, learning opportunities, and the possibility to treat the alliance as a real option. A real option is a small, initial investment that gives a company the right to make a larger investment in the future, without being obligated to make the larger investment. Many companies use real options as a way to have access to a new industry or to observe potential partners.

Conversely, many disadvantages of a strategic alliance include choosing the wrong partner, negotiation and coordination costs, partner opportunism, and potentially helping to nurture a competitor. Partner opportunism occurs when one company takes advantage of the other in order to profit from the information that it received. By giving a current or potential competitor access to firm-specific capabilities, the first company might lose its unique knowledge on a product or industry.

5.1.2.1 When Strategic Alliances End

Since the European Commission's second approval of the Sony BMG merger in 2007, the new entity has had unexpected difficulties on a number of fronts. Collaboratively, Sony Music Entertainment and Bertelsmann Media Group have not shared the best relationship (Sony Corp., "Sony to Purchase", 2008). The two companies' views diverged significantly in regards to the future of recorded music and the influence of the merger on their respective parties. Sony believed that the merger represented a

"gamble" for its music entertainment firm, in which the music industry would try to regain its dominance after years of disturbance caused by the increase of digital technology. Alternatively, Bertelsmann considered the merger as a strategic divergence from the media group's traditional outlets while it continued to build other service businesses.

It was reported on 5 August 2008 that Bertelsmann had become worried that the music entertainment industry would continue to deteriorate financially, due to the decreasing sales of physically recorded music. Having a change of heart and strategy, Bertelsmann decided to leave the recorded music industry completely, thus ending its four-year partnership with Sony. Sony agreed to purchase Bertelsmann's 50 percent stake in Sony BMG for $900 million, far less than the $1.6 billion that Bertelsmann hoped to sell its share for after a number of years. Bertelsmann will retain rights to over 200 of its European artists while Sony transforms Sony BMG into a wholly-owned subsidiary of Sony Corporation of America (Landler, 2008).

5.2 Diversification Strategies

Corporate strategy is the way that a firm creates value by coordinating its multimarket activities. A key aspect of a firm's corporate strategy is diversification, which is achieved by adding new business units that are different from the firm's existing operations. A company can diversify through either product or geographic diversification. Product diversification occurs when a firm enters diverse product markets and industries. Geographic diversification takes place when the firm enters new regions and countries (Peng, 2006, p. 360).

The following analysis will focus on product diversification strategies. This is because product diversification has significant implications for music development and distribution companies that want to enter new product markets.

5.2.1 Product-Related Diversification

When a firm enters a new market that deals with products or business activities that are similar to the firm's previous ventures, the firm is practicing the strategy of product-related diversification. This type of diversification occurs when a company focuses on operational synergy. The firm becomes more competitive by engaging in similar product markets than if it had entered the two product markets separately. The benefit from increased competitiveness stems from declining unit costs by leveraging related products. Most product-diversified companies focus on their core competencies, which can be implemented in each of their new business activities (Peng, 2006, p. 361).

An example of a company that has been successful in implementing product-related diversification is Apple Incorporated. Apple has diversified into many business areas which all benefit from its core competency in computer technology. The firm's range of personal computing product lines include hardware products, music products and services, peripheral products, software products and computer technologies, application software, Internet software and services, and wireless connectivity and networking (Apple, Inc., "10-K", 2007). The business areas that will be analysed in depth are music products and services.

Within the business units of music products and services, Apple has developed an iPod product line of downloadable music players and an iPhone multimedia communications device. Both of these products function seamlessly with the iTunes downloadable music management software. This software can in turn be used as an online music service, iTunes Store™, to distribute third-party material such as music, movies, television shows and iPod games. The operational symmetry and integration among these distinct product lines is the key to Apple's success. Apple is able to use these sources of operational symmetry in order to increase its economies of scale.

Apple consumers are primarily found in the education, creative professional, consumer, and business markets. The company has been able to penetrate each of those consumer demographics by using its established brand name to create marketing symmetry. Since all of the iPod and iPhone products run on the common platform of iTunes, the company had also established technological symmetry. However, most of the company's manufacturing and logistics services are performed by third parties, since this segment does not involve the firm's core competences. Nevertheless, the physical similarities among the various Apple products allow manufactures and distributors to have an easy transition when a new model in introduced.

5.2.2 Product-Unrelated Diversification

Conglomerates are large companies that practice the strategy of product-unrelated diversification in order to focus on financial synergy. Product-unrelated diversification occurs when a company enters different industries that have few clear product connections to the company's current business lines. The key objective of the firm's corporate headquarters is to identify and invest in various profitable opportunities. Financial synergy is achieved when each division that is financial controlled by corporate headquarters becomes more competitive than it would have been had it competed as an independent firm. When the divisions are worth more as a unit than they would be as stand-alone entities, a diversification premium or conglomerate advantage occurs. Therefore, unrelated-product diversification adds value to the total firm (Peng, 2006, p. 362).

One example of a conglomerate company that has achieved financial synergy with product-unrelated diversification is the Sony Group of Japan. This gargantuan firm

invests in a wide variety of product industries such as entertainment, games, electronics, and financial services (Sony Corp., "Sony Annual Report 2007"). The two divisions that will be analysed further are entertainment and electronics.

Within the entertainment division, Sony Music Entertainment is mainly involved in music recording and publishing. It also established formal partnerships to form Sony/ATV Music Publishing and Sony BMG. Not only did Sony BMG help to develop some of the world's most popular music artists, but it had a presence in the Internet and mobile phone arenas with downloadable music sales as well. In 2007, downloadable music accounted for 31 and 18 percent of Sony BMG's revenues in the US and worldwide, respectively. Additionally, Sony BMG has partnered with Myspace, Nokia, and Amazon to explore additional distribution channels and develop a wider range of business models (Sony Corp., "Sony Annual Report 2008").

Inside the electronics business, Sony's product lines are comprised of video, audio, communication and information equipment, televisions, semiconductors, portable audio, and various other high definition and mobile electronics. In the portable audio group, the success of the Walkman® series of portable music players has helped the company to take advantage of the increasing popularity of the downloadable music distribution industry. In 2007, Sony's downloadable music player sales exceeded 5.8 million units while grasping over seven percent of the industry's market share. (Sony Corp., "Sony Annual Report 2008").

Unlike product-related diversification, some strategists argue that product-unrelated diversification tends to decrease overall company performance. This decrease might occur due the firm's inability to successfully execute its financial strategy. Becoming a conglomerate calls for the corporate headquarters to enact strict financial discipline. The firm must also acquire the innate ability to quickly detect and eliminate or improve the units which are doing poorly before the entire corporation's performance suffers.

As previously analysed in Alliance Strategies, the Sony Group had trouble in the Sony BMG business venture. In addition to the difficulties in maintaining a partnership with strategic differences, Sony BMG had financial problems as well. Sony reported a net loss of $24 million for Sony BMG during the company's first quarter of 2008.

This loss represented a decrease of $36.5 million from a net income that was reported one year prior. According to Sony, the 2008 results were due to a continued decline in the worldwide physical music market, higher restructuring costs, and a discontinuation of gains made in 2007 on the sale of an interest in Sony BMG (Sony Corp., "Sony News", 2008).

As a successful conglomerate with strict financial discipline, Sony's corporate headquarters should have detected the financial dissymmetry caused by Sony BMG and proactively dealt with the failing business unit. Yet it was Bertelsmann that reportedly made the first move by deciding to leave the venture. However in this instance, Sony's decision not to be the proactive partner might have been in the company's best interest. Under the terms of Sony BMG's partnership, either company could have forced a sale the following year. By agreeing to buy BMG and folding the division into its operations, Sony Music Entertainment will be within close range in size with that of Universal Music Group, the world's largest music company.

In a telephone interview between the New York Times and Sony's chairman and CEO, Howard Stringer, Stringer seemed optimistic about the increasing possibilities in the music industry and adamantly stressed that the music industry is not dead. People are beginning to learn how to profit from the increasing amount of music downloads. By not having to pay Bertelsmann a large sum of money for its half of the venture, $900 million instead of $1.6 billion, Sony will have more capital to invest in new ventures, particularly by injecting more downloadable music in the mobile phone market. "With partners, there are bound to be divergent agendas and interests," said Stringer. As a single entity with full control, Sony Music Entertainment will be able to more freely expand its music horizons (Landler, 2008).

5.3 Distribution Strategies

Downloadable music retailers must choose how to supply the music demands of consumers. There has been a debate as to whether or not it is better to offer music as a product or a service. If the downloadable music is purchased as a product, the consumer chooses from a list of songs provided by the retailer. The client would obtain permanent ownership of the music that is downloaded from the retailer. Alternatively, if the downloadable music is offered as a service, the online digital retailer would maintain ownership of the music. The consumer would rent access to the music for a finite amount of time.

5.3.1 Product Distribution Strategy

The main proponents for selling music as a product are the two main downloadable music retailers, the iTunes Store™ and AmazonMP3. Typically selling music singles for $0.99 and albums for $9.99 in the US market, the iTunes Store™ has made itself a leader in downloadable music retailing since its debut in 2003. However, since iTunes songs were downloaded with FairplayDRM, they were not operable on most portable players other than the iPod. This DRM restriction has since been lifted.

Amazon established its music store in 2007. It tried to undercut the iTunes Store™ on prices (ranging from 89 to 99 cents for a single) (Lu, 2007) and digital compatibility through DRM-free downloads.

Even though the iTunes Store™ and AmazonMP3's pricing and distribution strategies are different, both retailers stress the importance of making music available for purchase. This "A-La-Carte" method of music retailing creates a sense of ownership for the consumers.

5.3.2 Service Distribution Strategy

When a downloadable music retailer maintains ownership of the music, it is possible to profit directly or indirectly from the service provided to consumers. Retailers indirectly profit when customers are given free access to streaming music. The cost of streaming the music is then compensated by the advertising revenues from companies

who pay a fee to broadcast commercials aimed toward the music listeners. The direct profit strategy is when customers are charged a subscription fee to access the music for a specific period of time.

5.3.2.1 Indirect Service Strategy: Advertising Service

When a downloadable music retailer uses the option of streaming free music, their goal is to attract the largest amount of users as possible. A large network will entice more advertisers to pay the fee to broadcast their commercials on the retailer's website. Part of the retailer's revenue from advertising fees will then be used to pay for the music licensing fees of recording companies. In this alternative, it is not always the consumer's decision which specific songs are played. Rather, the consumer picks a certain category or genre of music. Then the digital retailer will compile a playlist of music which fit within that category or genre. This was the distribution strategy that Yahoo used with the LAUNCH streaming music and music video service. In 2004, LAUNCH was hailed as number one in online music by the Nielsen//NetRatings and comScore Media Metrix. Additionally, comScore stated that LAUNCH captured almost 50 percent of the total audience who listens to streaming music online ("LAUNCH", 2004).

Conversely, Spotify music player allows consumers to pick the exact songs they want to hear and compile their own lists. Launched in 2008, Spotify requires its users to download its program. Then the playlists compiled can be shared with friends. Advertisements are played intermittently between the songs ("Spotify", 2009).

However, obtaining revenues indirectly through advertising is not always a consistent way to profit from music distribution. Firstly, there is no guarantee that users will be initially attracted to the retailer's website. It is important that the retailer establish a user-friendly networking website, similar to the ones developed by Myspace and Facebook. Secondly, there is no guarantee that advertisers will pay the fee for the commercial time. This participation depends on the amount that is charged. Next, if both users and advertisers participate, the retailer must make sure that the revenues can cover the cost that recording companies charge in licensing fees. Finally, when all of the licensing and other operational costs are covered, the retailer will hopefully receive a net profit for its efforts.

5.3.2.2 Direct Service Strategy: Subscription Service

The subscription-based business model had been one of the more popular forms of downloadable music distribution among music recording companies. Recording companies were more willing to agree to this model because it does not allow consumers to have full access of copyrighted material. In this distribution strategy, consumers can pay a subscription fee to download specific songs and listen to them for a predetermined period of time. Once the period of time has elapsed, the customer will no longer be able to access the music.

In addition to Yahoo's music services, first-generation music subscription services included such Internet giants as MTV and AOL. These companies were the ones who first introduced the concept of online music distribution through subscriptions to consumers. Yet, some of these companies have migrated from subscription-based distribution. Reasons for this transition are varied, but most of the companies battled complex business rules, unfriendly economics and high marketing costs. The only major subscription-based retailers remaining today are Napster and Rhapsody (Bruno, 2008).

In January of 2008, Napster's subscription-based music distribution was offered to customers for $10 per month. After paying the fee, customers would have access to Napster's entire music catalogue. For an extra fee, users could upload songs onto Microsoft PlayForSure portable music devices (Lu, 2007). PlaysForSure was a certification given by Microsoft to portable music devices. Rhapsody had a similar music distribution model as Napster; however the retailer's songs were not compatible with Apple's iPod, due to Apple's FairPlay DRM restrictions. Since the iPod was one of the most popular portable music players in the world, this incompatibility had seriously hindered Rhapsody's growth potential.

The reason why consumers have trouble embracing the subscription model is because after a period of time, their rights to access the music will expire. In a recent Forrester Research report, the subscription services market is supposed to increase to $459 million by 2012. However in 2008, only seven percent of US adult Internet users had ever tried a subscription service. Of that seven percent, only one-third considered it to be a better value than the product distribution strategy, and only 18 percent would

recommend it to others (Bruno, 2008). Since consumers have become accustomed to acquiring their music (in both physical and downloadable forms) through purchases, the idea of relinquishing ownership rights is unfamiliar territory. The iTunes Store™ has been able to successfully tailor the idea of ownership to fit this new arena, which is one of the reasons for its success.

5.3.3 Combination of Distribution Strategies

As stated earlier, Napster is in the forefront of subscription-based music distribution models. However, on 20 May 2008, Napster decided to compete directly with the iTunes Store™ by releasing its own product distribution music service for consumers. Offering over six million songs (Adegoke, 2008), this strategic move has lead Napster to become the world's largest digital catalogue in the downloadable music retailing industry, as well as the largest library of independent music ("Napster", 2008). The retailer offers music singles for 99 cents and albums for $9.95, slightly lower than iTunes' album price. By utilizing both product- and subscription-based distribution strategies, Napster hopes to appeal to a broader spectrum of music consumers and downloadable music player owners.

5.4 Profit Maximization Strategies

Within the product-based distribution business model, there is a debate on what should be the most profitable pricing policy for music. The two leading contenders are Uniform and Tiered Pricing Strategies. These strategies can be analyzed using Michael Porter's Generic Competitive Strategies: cost leadership and differentiation (Peng, 2006, p. 52). Porter's generic competitive strategies are used to help a firm make strategic choices, thus strengthening a firm's position relative to the five competitive forces spoken of earlier.

5.4.1 Cost Leadership and Differentiation

The cost leadership strategy explains when successful competition is achieved through low costs and prices. This strategy is usually used in firms that have high-volume, homogeneous goods, which are mass-marketed to consumers. Consumers perceive value to be based on lower prices for the same product. The uniform pricing strategy is a good example of when "one-size-fits-all" music pricing can be used as a strategic advantage. Customers value the low cost of the good, as well as the reliability of static or decreasing prices.

The differentiation strategy focuses on marketing products that are considered unique and valuable. Firms target specific customers that are willing to pay a premium price for these goods. The price can be based on the product itself, the way that it is distributed, or the way it is marketed (Porter, 1998, p. 14). The challenge of marketing a differentiated good is identifying unique attributes, such as quality, sophistication, prestige or luxury. Tiered pricing is an example of when less emphasis is placed on the cost of the good, while more is placed on its value. If the value of the good is identified and emphasized, the consumer will be more willing to pay higher prices.

5.4.2 Tiered Pricing Strategy

Pricing strategies in the physical music market, such as for CD singles and albums, have been much more sensitive to the heterogeneity of music than in the downloadable music market. One can see the evidence of tiered CD pricing policies in

the case of Wal-Mart. In order to maintain its top position as a music retailer, as well as combat the music industry's declining CD sales, Wal-Mart proposed a five-tiered pricing scheme in March 2008. Music albums would be priced according to groups such as: hottest titles promotional campaign, hits and current titles, top catalogue, midline catalogue, and budget products (priced at $10, $12, $9, $7, and $5 respectively). This strategy would allow consumers to not only decide on the costs, but also the value of the product.

Usually, recording companies are proponents of tiered pricing strategies, yet this proposal could actually force recording companies to incur lower profits. This is because Wal-Mart's proposed pricing strategy would have lower per-unit returns than its current two-tiered CD pricing model ($9.88 and $13.88). Some recording company executives feel that this pricing issue could have an effect on the entire music industry. While some executives feel that the idea is appropriate, given the current state of slumping CD sales, others speculate about an imminent profit loss. Those executives think that if they contest Wal-Mart's decision and no agreement is made, the recording companies could possibly lose 20 percent of business. Yet, this implies that Wal-Mart would either penalize or completely stop buying licensed music from certain companies. More speculations abound, but this proposal is only a starting point (Christman, 2008).

5.4.3 Uniform Pricing Strategy

Apple's iTunes Store™ has used the uniform pricing strategy for downloadable music pricing since 2003. The company charges a standard price of $0.99 for singles and $9.99 for albums in the United States. Recently, recording companies have called for the iTunes Store™ to change its flat rate strategy to a price differentiation strategy in order to better reflect market demands. Price differentiation in the music industry can be based on the song's genre, release date, artist popularity or chart success. Recording companies feel that new releases and popular downloads should be sold at a premium, thus increasing their potential profits. At the same time, maturing releases and back catalogues could be discounted. Also, recording companies suggested that the songs of top-selling bands should be priced higher, while discounting lesser-known artists (European Commission, 2007, p. 24).

Apple has rejected tiered pricing because it believes the downloadable music market is still in its initial growth stage. Therefore, implementing a uniform pricing strategy is crucial if the industry wants to increase its market size. They feel that a price of $0.99 is the maximum that customers are willing to spend on music, which they could have equally obtained for free through other means. The customer experience is a central aspect of Apple's strategic pricing decisions. Variable pricing might be viewed as unfair and unreasonable, thus hindering the relationship that Apple tries to develop with consumers ("One Price Fits All?", 2007).

5.4.4 Choosing the Optimal Pricing Strategy

Pricing strategy proposals usually are created by the party who stands to benefit the most. In the iTunes Store™ example, recording companies proposed the tiered pricing model because they felt that the change would increase their future profits. Recording companies even tried to renegotiate their supply agreements to influence iTunes' decision on differentiated pricing. The iTunes Store™ chose to maintain the cost leadership position after evaluating its options from revenue and cost perspectives.

From a revenue standpoint, as a cost leader the iTunes Store™ could charge substantially lower prices and still make better profits than its rivals. Secondly, this low cost position would help to build entry barriers and keep other rivals out. Next, by buying in bulk from suppliers, the suppliers' bargaining power would be reduced. Finally, a cost leader could effectively challenge its products' substitutes on product utility and prices (Peng, 2006, p. 53).

From a cost standpoint, a cost leader would be less affected by increasing costs from suppliers and decreasing profits from powerful buyers who push prices down. Specifically, recording companies take substantial amounts of the revenue from the iTunes Store's music sales. In current agreements, recording companies earn 70 percent per music track through the iTunes Store™. Apple keeps the remaining 30 percent to cover costs, such as maintenance, infrastructure, encoding, and credit card company fees (European Commission, 2007, p. 29). If the iTunes Store™ was to suddenly change pricing strategies, it risks dividing those fixed costs over a shrinking profit.

6 Conclusions

Over the last forty years, music format preferences have changed from cassette tapes, to compact discs, to downloadable music. Music downloading is a recent phenomenon, joining the worlds of artistic development and technological innovation. Due to the changing consumer demand towards downloadable music, it has become increasingly difficult for companies to profit from selling physical music formats. Finding ways to improving strategic business models is a very important for music development and distribution companies.

6.1 Main Findings Summarized

The research question of this thesis asked how the changing demand for downloadable music influenced the strategic business models of firms. In order to answer this question, one had to begin by identifying the companies that currently supplied the demand for music. Recording companies, music retailers and companies that sell portable music players have the greatest influence on the music market. Their supply chains showed how dependant the companies are on one another to create and deliver music to consumers.

To gain deeper insight into the music market, the thesis then analysed the external environment of recording companies and music retailers. By evaluating microenvironment factors, it was found that recording companies and music retailers had opposing results when assessing market entry barriers, supplier bargaining power, and buyer bargaining power. However, these companies faced similar macroenvironment factors, such as copyright law, digital protection software, profit from legal music downloading, and competing entertainment outlets.

After completing the analysis, the thesis highlighted four different strategies used to increase companies' competitive advantage: alliances and networks, product diversification, product and service distribution, and profit maximisation.

6.2 Questions for the Future

Now that one is aware of the numerous strategies music development and distribution companies use to maintain market share, what does the future hold for the music industry? Will companies' strategies successfully convince customers to buy their products and services? Will recording companies ever regain their status as an essential element in music production, or will their services become obsolete? Will new online music retailers maintain consumer interests in the long-term? Or is paying for downloadable music merely a passing trend when so many free options are available to consumers? Only time will tell which strategies and companies will succeed.

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8 Appendixes

8.1 Appendix I – Case Study: Microsoft's DRM Software

Microsoft has been a pioneer in the technology sector with its leading software operation systems, Microsoft Windows. Within Windows there is a multimedia framework, entitled Windows Media, which can be used for digital media playback, streaming media services, and media conversion ("Windows Media", 2009). In order to protect this content and successfully deliver it to subscribers or individuals for digital playback, a protective software system needed to be developed. That is why Microsoft created Windows Media DRM. This program is adaptable to network and portable devices, and comes equipped with a software development kit ("Windows Media DRM FAQ", 2005).

Particularly, the Windows Media DRM that deals with portable media devices, such as downloadable music players, is codenamed Janus. This copyright protection technology is used with major downloadable music distributors, such as AOL Music, Yahoo! Music Unlimited, and Napster To Go ("Janus (DRM)", 2008). These companies use Janus to provide consumers with subscriptions for unlimited media access on their websites (Block, 2006). This system also allows customers to store and access the website's content on their portable devices while offline. Introduced by Microsoft in 2004, Janus technology was created as a downloadable program that can be constantly updated. Numerous versions of this software have been created to combat program codes created by hackers to override DRM software. However, a renewable DRM program does not guarantee protection.

In 2006, an overriding tool called FairUse4WM was able to successfully strip DRM technology from Janus' digital media files. FairUse4WM was created by a group called Viodentia ("Viodentia", 2008). After news of this program reached Microsoft, the company immediately filed a federal lawsuit claiming that Viodentia infringed on its copyrights by creating and distributing the anti-DRM technology (Farivar, 2006). However, the only information known about this digital adversary was that it was located outside of the United States. Since Microsoft had no way of finding them, a real culprit was difficult to identify. After a 120-day search with no identifiable

culprits, the charges were subsequently dropped. Since then, Microsoft has created a DRM system for Windows XP that has yet to be overridden by anti-DRM software ("Windows Media DRM", 2009).

Why would Microsoft go through so much trouble to find such an elusive adversary? The potential release and success of this type of anti-DRM technology could have colossal negative effects on Microsoft's bottom line, as well as decrease its market share in DRM content protection. Since its consumers in this market are mainly comprised of downloadable music distribution companies, a breach in this technology would allow non-subscribers to illegally download from their websites.

8.2 Appendix II – Norwegian Consumer Council vs. Apple's iTunes Store™

In January of 2006, the Consumer Council of Norway submitted a formal complaint against Apple's iTunes Store™. The council, along with the Consumer Ombudsman, felt that the iTunes Store™ Norge was in violation of fundamental consumer rights. iTunes' standard terms and conditions, to which customers had to agree upon purchase, were mainly in violation of Section 9a of the Norwegian Marketing Control Act. The terms and conditions were also in breach of various principles of contract and EEA law (Singstad, 2006).

Two issues in the iTunes terms and conditions were particularly unsettling. Firstly, consumers had to give consent to an agreement that was regulated by English law. The Consumer Council considered this request to be unreasonable, since the agreement was governed by the Norwegian rules on consumer protection. Secondly, products downloaded from the music store were protected by iTunes' Fairplay DRM software. Purchased content could only be played on an iPod portable music player. Both the iTunes Store™ and iPod were owned by Apple Incorporated.

Therefore, the sole purpose of using the Fairplay DRM software was to force consumers to buy Apple products, the dominant market player in its industry. However, the DRM software was able to be circumvented. Yet this circumvention entailed copying a music file from the computer to a CD, and then uploading it back onto the computer. Due to the unreasonable terms of use, as well as the technical blocks for consumers to freely use their purchased goods, the Consumer Council demanded that the iTunes Store™ alter its terms and conditions to comply with Norwegian law by June of 2006 (Grøndal, 2006).