303-211-1

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Apple's iTunes:

Changing the Face of On-line Music Retailing

*This case was written by **V Sarvani,** under the direction of **A Mukund**, ICFAI Center for Management Research (ICMR). It is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation.*

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APPLE'S iTUNES: CHANGING THE FACE OF ONLINE MUSIC RETAILING

"The iTunes Music Store is changing the way people buy music."[1]

- Steve Jobs, Apple's CEO, in June 2003.

"The iTunes Music Store has defined what it means for people to have music instantly – and legally – at their fingertips."[2]

- Doug Morris, CEO, Universal Music Group, June 24, 2003.

APPLE SPELLS SUCCESS WITH iTUNES

In June 2003, Apple Computer Inc (Apple)[3] announced that its Internet-based music selling initiative, the iTunes Music Store (iTunes), had sold more than three million songs in the first month of its launch. This figure, far beyond even the company's expectations, took the music retailing industry by surprise. All those who had predicted doom for iTunes at the time of its launch, watched in disbelief as Apple reported total sales of five million songs by the end of the second month. The music store was reportedly attracting a growing audience day by day owing to its simplicity and ease of use (Refer Exhibit I for a look at the iTunes webpage).

iTunes was now being labeled by industry analysts as a revolutionary concept that was all set to change the way music was traded – offline as well as online. Commenting on this, Doug Morris, CEO, Universal Music Group, said, "iTunes is pushing us into the future of how music is produced and consumed."[4] Using iTunes, songs could be downloaded at a nominal charge for each song, and copied to or played on portable music players such as Apple's iPod. Apart from being simple to use, iTunes reportedly offered good quality music downloads as compared to the other music download services available on the Internet.

More significantly, iTunes had emerged as a legal alternative to downloading music using file swapping services like Kazaa, Morpheus and the erstwhile Napster. Corporate players were happy that there seemed to be hope for legal, paid music downloading services. Industry observers as well as companies in the music and Internet businesses were liberal in praising iTunes, calling it one of the best things to have happened to the ailing music industry (Refer Exhibit II for information about the major players in the industry).

Commenting on how iTunes had shown that selling music over the Internet was viable and safe, David Goldberg, General Manager for Music, Yahoo, said, "Apple's service shows there is consumer demand; and it shows they have built a great product."[5] Roger Ames, Chairman and

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[1] 'Apple Touts iTunes Success,' www.pcworld.com, June 24, 2003.

[2] 'Apple Touts iTunes Success,' www.pcworld.com, June 24, 2003.

[3] The US-based Apple manufactures and sells personal computers and other personal computing solutions (hardware and software). It owns a network of retail stores where it sells Apple offerings and third-party products. For the nine-month period ended June 28, 2003, Apple posted $4.49 billion in revenues and a net profit of $25 million. The company, renowned for its innovative products, was ranked ninth among global PC manufacturers and had a 2.1% market share in the first quarter of 2003 (2.9% in the US).

[4] 'The Chilli Peppers' Sour Grapes Over iTunes', *BusinessWeek*, July 16, 2003.

[5] 'Big Names Ready to Rival Apple,' www.pcworld.com, June 10, 2003.

CEO of Warner Music Group, said, "Everyone in our industry is looking for a solution, and Apple is leading the way with the iTunes Music Store."[6]

BACKGROUND NOTE – EMERGENCE OF ONLINE MUSIC DISTRIBUTION

The music industry across the globe can broadly be divided into three segments: creation, marketing and distribution. Music artists create music, which is marketed and distributed by a network of record labels, distributors, retailers, broadcasters and DJs/clubs. Labels (record companies) play an important role in all three stages by providing capital and the marketing know-how to create, promote and distribute music. Music marketing takes place through branding, community building and information dissemination. Music is sold in 'containers' like compact discs (CDs) and audio cassettes[7] through distribution channels. Another form of music distribution is conducting public and private music shows.

The business of music involves many intermediaries between artists (creators) and customers (end users). Each intermediary adds to the final cost of the product. Therefore, some record companies like Bertelsmann combine the roles of multiple intermediaries to reduce overall costs by selling music directly to their club members at low prices. Another way to reduce the cost of promotion and distribution was to sell music in the form of albums containing many solos[8]. Companies such as EMI, Warner and BMG have been doing this for a long time.

Record companies have always been a dominating force in this industry since they control major marketing and distribution channels. They exert their might by binding individual artists to long-term contracts. Most of the artists bound themselves to record companies lured by the latter's financial muscle, experience' and marketing prowess – all of which were necessary to succeed in the business, and none of which the artists had. This also meant that emerging artists could not compete on their own as they did not have access to big companies. Therefore, they either had to be 'lucky/resourceful enough' for a record company to spot and sign them, or they had to be content with operating in niche markets. Due to the clout labels wielded on the industry, they reportedly took away a huge share (around 80%-90%) of profits.

The practice of selling music in the album format forced music artists to compose several solos in order to make the end product commercially viable. Under pressure from their labels, the trend of artists composing just three or four good songs emerged. These songs were then packaged along with fillers (songs that seemed to be there just to fill out the CD) and marketed by the record companies. Typically, customers had to pay $15 to $20 per CD for an album. However, music lovers recognized the trickery behind this strategy. They argued that it was not justifiable that an individual should buy an entire album to listen to just one or two songs he/she liked. This had been a sore point with music customers all over the world, considering the fact that the cost of manufacturing a CD/audio cassette was less than a dollar.

Music enthusiasts found an answer to their problems in the Internet. As the use of the Internet spread phenomenally in the 1990s, the music retailing landscape changed. Companies like Amazon.com and CDNow began selling CDs and audio cassettes over the Internet. This model was better than the existing set up in many ways. Companies did not have to invest heavily in

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[6] 'Apple Touts iTunes Success,' www.pcworld.com, June 24, 2003.

[7] The music industry evolved through adapting itself to many technological innovations over the past century. Media technologies evolved from vinyl to audio cassettes to CDs and mini discs. Technological advances in playback devices helped in this growth through gramophones and large stereo systems to portable digital audio devices.

[8] Individual songs are referred to as solos – a collection of such songs forms an 'album.'

maintaining a physical store and inventory, and customers could search from a large database of artists which was much more convenient than traveling to physical retail stores to buy CDs.

Although selling music on the Internet removed certain logistics costs from the business, the issue of customers being charged excessively for CDs/audio cassettes remained unanswered. This led to the emergence of digital distribution of music, that is, downloading of music in digital format from the Internet to the personal computers of users. Using Internet audio technologies like MP3, Real Audio and Microsoft's Windows Media Player, music could be converted into software (digital files) and compressed[9] and transferred over the net.

Due to the ease of transferring music in the above manner, and the fact that MP3 technology was a freeware (not the property of any company), music lovers took to online transferring in a major way. By the late 1990s, the industry even saw the emergence of portable digital music players from companies such as Creative Labs and Samsung that played MP3 songs.

THE DEBATE ON ONLINE MUSIC DISTRIBUTION

By 2000, two kinds of services took shape in the field of online music distribution: free to share and subscription based. Free to share services such as Napster ran on peer to peer (P2P) technology wherein, using file sharing networks, it became possible to swap music files from one system to another. Such services became extremely popular because of the ease of use and the availability of a wide selection of songs. But above all, their popularity was due to the fact that they were entirely free. Napster, launched in mid-1999, became extremely popular with 1.6 million people using its services during the height of its popularity in early 2000.

However, these P2P services gave rise to music piracy since they violated music copyrights and intellectual property rights of music companies. By making available songs that were the 'property' of record companies at no cost, the business of these companies was under threat (Refer Exhibit III for a note on music piracy).

The Recording Industry Association of America (RIAA)[10] strongly condemned the use of P2P technology stating that it was illegal. This was because the technology allowed users to copy and download music without payment and without the express permission of the rights' owners. The most popular of such services, Napster, became the first target of RIAA's ire when the latter filed a copyright infringement suit against it. In mid-2001, Napster was shut down after the courts ruled in favor of RIAA.

This development did not deter P2P technology service providers and its users from floating similar services like Kazaa, BearShare, Grokster and Morpheus. After the closure of Napster, P2P technology became even more popular. According to a market survey conducted by RIAA, an estimated 2.6 billion copyrighted files were traded over P2P networks every month. This seemed to be true considering that Kazaa attracted 100 million users in July 2002.

Reportedly, the P2P websites were responsible for sales in the music industry declining alarmingly. Some companies even tried adopting new technologies that made it impossible for customers to copy songs sold in the CD format. In fact, an album released by Sony Music in early-2002 (featuring popular singer Celine Dion) could not be played on computers. If customers tried to do so, their computers crashed due to the technology used. However, this move

[9] Typically, a three-minute song after digital conversion occupied 30 megabytes of computer memory space. By using technologies such as MP3, the 30 MB song file could be compressed into a 3 MB file. This made it easier for Internet browsers to transfer the file in a short span of time.

[10] RIAA was a trade group which represented the biggest music record labels like Universal Music, Warner Music, Sony Music, Bertelsmann AG and the EMI Group.

evoked strong protests from many customers. Other music companies too tried out similar tactics– but to no avail. As piracy continued eating into the industry's fortunes, many debt ridden media conglomerates even began considering selling their music businesses.

The other mode of online music distribution, subscription-based services, levied a subscription fee on registered users besides a charge for each song downloaded. These services entered into revenue sharing agreements with record companies to provide users with a wide selection of songs. Reportedly, RIAA member companies had agreed to make their songs available on the subscription-based websites, since this seemed to be a better alternative to file swapping services.

In mid-2003, some popular subscription-based services included America Online's MusicNet, Full Audio's MusicNow, RealOne's Rhapsody, Music Match's MX, EMusic and Pressplay. The subscription fee varied according to the services offered. Pressplay charged a monthly fee of \$9.95 for providing unlimited streaming/downloading of songs. These songs could not be burned (copied) onto a CD. However, by paying a higher monthly fee of \$17.95, users could burn 10 songs per month. An additional \$1 was charged for each extra song burned.

Similarly, Rhapsody charged a monthly fee of \$ 9.95 and an additional 75 cents per song to burn a CD. MusicNow charged \$ 9.95 per month and an additional 99 cents per song to burn a CD. MX charged a monthly fee starting from \$4.95 for unlimited streaming, but did not allow burning to CD. Another service, EMusic, offered unlimited streaming and burning for a monthly fee of \$9.95. However, the selection did not include big label artists but songs/music from independent artists (Refer Exhibit IV for a comparison of online music services on various parameters).

While record companies claimed that subscription-based services were the answer to the menace of P2P networks, music buyers had a different story to tell. They argued that buying a music album was easier than keeping track of the pricing options from such services. Due to pressure from record labels, all the subscription-based services offered music with many restrictions on how and where it could be used. For instance, most fee-based services had made burning CDs either too costly and complicated, or impossible altogether.

Due to the above reasons, the subscription model never really became popular with music lovers. Meanwhile, the record companies attempted to provide 'pay per song' services as well, although at prices as high as \$3.99 per song. This move was a miserable failure. The music industry's woes worsened when a federal court judge, in April 2003, ruled that file swapping services like Streamcast (parent of Morpheus) and Grokster were legal technological tools similar to video cassette recorders and copy machines. The ruling stated that the websites were not liable for its users who engage in copyrights infringements as these technologies had other valuable uses also.

Although the ruling was a setback to RIAA, the fact that the law had recognized that individual users were accountable for illegally using P2P networks, came as a boon. In early 2003, reportedly, RIAA was planning to take action against individuals engaging in music piracy. Some industry observers felt that this development would deter many music file swappers and they would start using paid services.

However, P2P services continued to flourish. Reportedly, the number of people using Kazaa (offering around 719,280,000 MP3 files) was 230 million by May 2003. A survey conducted by Ipsos Insight, a US-based market research firm, in June 2003, revealed that in the US alone, there were more than 21 million people using P2P services every month. These figures were further substantiated by Big Champagne (an online media research firm), which reported that in 2002-2003 around 3.4 million MP3 files were being traded every month through Kazaa and Grokster.

Contrary to what RIAA believed, many analysts said that the reason users did not turn to legal music download services was not that they did not want to pay, but because these services did not offer wide selections and ability to copy music files to computer hard drives, CDs and portable players. Supporting the above stand, Josh Bernoff (Bernoff) of Forrester Research, said, "The reason people use free services is because they did not find what they were looking for – not that they did not want to pay."[11]

That music listeners liked to download music from the Internet was an established fact. However, when the subscription model seemed to be failing, the industry was at a loss to find a solution to the problem of illegal swapping of music files.

iTUNES PROVIDES A SOLUTION

Aware of the shortcomings of the existing models of online music retailing, Apple's CEO Steve Jobs (Jobs), reportedly, said that though free services offered a vast selection of songs for unlimited downloads, their quality was poor and performance unreliable. Also, subscription-based services were not popular due to the limitations they imposed on downloading songs – many even suspended access to songs when the subscriptions expired.

Jobs believed that the problem of music piracy was a behavioral one and technological solutions could not tackle it. He felt that users resorted to piracy because they were not offered any viable alternative for buying music at a reasonable price. Peter Lowe (Lowe), Director, Marketing Consumer Application, Apple, said, "In future the real sea-changes in our industry will be driven by things that truly empower users, rather than tech-fads."[12]

Commenting on the belief that Apple could offer a solution to change this behavioral pattern, Lowe said, "We fundamentally believe that most people are honest. The illegal file sharing services have prospered because there have been no elegant legal alternatives. We think if you give people great value, a really good selection of music, and fast, good-quality downloads, they will use the service in preference to the illegal ones."[13] Analysts summed up Apple's stand as 'an approach that makes buying music online easier rather than trying to make pirating it harder.'

Apple's decision to launch iTunes thus seemed to offer a solution to some of the difficulties faced by the music buyers as well as the music industry. iTunes offered several improvements to the services offered by P2P and subscription-based services. Launched on April 28, 2003, iTunes was not a subscription-based service – it charged 99 cents for every song downloaded, had a library of 200,000 music tracks, did not enforce any restrictions on use of the songs, and provided the option of burning CDs – all packaged in an easy to use, no frills website. Apple seemed to have devised a business model that combined both the advantages of subscription-based services (legality) and free services (easy to use and low/zero costs).

For obtaining the music tracks, the company entered into a revenue sharing agreement with five of the big music labels in the country: BMG, EMI, Sony, Universal and Warner. Analysts expressed surprise over the ready support Apple got from the big labels. While some perceived this move as an indication that the music industry was ready to shift from the traditional business model to the cost-effective online model, others believed that it was an experimental venture.

By agreeing to tie-up with Apple, the industry had given a clear signal that it was willing to try out new business models rather than allow illegal services to continue. Commenting on this, a music label executive said, "Until Apple, it was not cool to buy digital music. This was about

[11] 'Music Downloads Is It Time To Pay?' www.pcworld.com, June 05, 2003.

[12] 'iTunes for Windows: Coming Soon?' www.pcworld.com, June 16, 2003.

[13] 'iTunes For Windows Coming Soon,' www.pcworld.com, June 16, 2003.

getting to that pivotal group of people – the people who buy the cool sneakers and wear the right clothes – and showing them that legally downloading music could be cooler than stealing it."[14]

However, some reports stated that Apple's (particularly Jobs') popularity among elite influencers in the music industry (and Hollywood), helped the company get the required licenses to create a viable service. A digital music analyst at the US based research firm, Raymond James & Associates, stated that even if iTunes' market was limited [iTunes was compatible only with Macintoshes[15] (Mac) that comprised only 3% of desktops globally], the segment was big enough for record labels to test a new business model for online music retailing.

Interestingly, apart from the deal from record labels, iTunes also featured songs from 80-100 independent artists. Some of the songs at the store were accompanied by their respective videos also. The store also had exclusive songs from 20 popular artists, including Bob Dylan and U2. Although the music store had a limited collection of songs, the database was expected to be enhanced depending upon the response received from users.

iTunes gave users 30 seconds to listen to songs before deciding to buy. This was a unique feature that was not available at other online services. Even at physical record stores, users were allowed to listen to songs only from those CDs which the music companies were promoting at that point of time. Analysts considered this feature of iTunes as a sensible move since it allowed users to be sure about their purchase decisions.

Another innovative feature was that users were allowed to compile their own albums from the existing library of songs. This addressed the decades old problem of music lovers having to buy a complete album, when they liked only a couple of songs in it. Not only did this eliminate the need to pay a high price for CDs, the fee of 99 cents per song was affordable for a majority of online music buyers. An analyst based in New York commented, "Under a dollar is a fair price. A whole CD from a retail store costs at least 15 bucks."[16] This feature was expected to have another advantage – if fillers did not sell, record labels could decide not to force artists to produce them. This would, in turn, lead to an overall improvement in the quality of the albums.

The licensing terms of iTunes did not put any restrictions on the users as it allowed them to save songs on their hard disk, burn them onto a CD, or transfer them onto digital music players. Apple offered a broad set of rights across all its music, which was considered a commendable achievement. The only major restriction Apple imposed was not allowing the copying of more than 10 songs per CD of an individual artist. This was done in order to prevent users from burning such a 'collection' on a large number of CDs and making money out of it.

Thus, iTunes was the first paid service that gave all the rights to the users, in sharp contrast to other music stores that offered complicated, different rights for different sets of music (certain songs could not be copied onto a CD or transferred to other computers/portable music players). Analysts observed that by removing the complexities in the licensing terms that confused users, iTunes had made it easy to purchase music online.

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[14] 'Where "Think Different" is Taking Apple,' *BusinessWeek*, August 05, 2003.

[15] Launched in the early 1980s, the Mac was considered to be a significant technological advancement over the existing computers in the industry as it could provide several functions other than calculation. Although Macs were superior technologically to Windows-based PCs offered by Microsoft, they were not widely used by people due to their high price. Comparatively, Windows-based PCs were cheaper and affordable by most people. Due to its mass appeal, Windows PCs were more popular than Macs. Over the decades, Macs evolved into a niche product, catering to a small segment of loyal customers.

[16] 'Music Downloads: Is It Time to Pay', www.pcworld.com, June 05, 2003.

The service was launched only for Mac users. To use the service, Mac users had to download the iTunes software, which was available free at Apple's website. As users began burning songs as many times as they wanted on a CD, and transferred the songs to a number of iPods (a portable music player offered by Apple), they began appreciating iTunes more.

The response to iTunes vindicated the move by Jobs, Lowe and Apple – one millions songs were sold within the first week of launch, setting a new record for online music sales (downloads). Company reports revealed that more than 46% of songs were purchased as albums and around 80% of available songs at the store were purchased at least once. According to Jobs, the best part about the whole business was, 'It is not stealing, which is good karma.'[17] As mentioned earlier, sales increased to over five million songs by the end of eight weeks. Jobs said, "Selling five million songs in the first eight weeks has far surpassed our expectations, and clearly illustrates that many customers are hungry for a legal way to acquire their music online."[18]

Looking at the financial performance of iTunes, since revenues were shared between Apple, record labels and artists, the company would earn relatively less (estimated $2 million) in the first quarter of the services' launch. However, Apple did not have to spend on the infrastructure of iTunes as the software already existed in Macs.[19] Their only expenditure was on building the website. Therefore, the incremental cost was much less than that spent by other online music stores, who had to build everything from scratch. Company watchers believed that Apple stood to gain a lot from iTunes in the long-run.

iTUNES – FACING COMPETITION

Although iTunes was considered a remarkable improvement over the previous services available in the market, it did have some drawbacks. Firstly, critics argued that the collection of songs at the store was limited (200,000), and did not give much choice to the users. Secondly, songs downloaded from iTunes could be played only in Macs since the software was not compatible with Windows-based PCs.

The biggest problem, however, was the emergence of similar services that had been inspired by the growing popularity of iTunes. All these new services were working on a Windows version to tap the 97% of the global PC market that iTunes could not reach out to. Commenting on this, Bernoff, said, "The race has been on since iTunes was launched to produce a similar service for the Windows market."[20]

One such service was BuyMusic.com (BuyMusic), launched by Buy.com, an online retailer, on July 22, 2003. BuyMusic offered 300,000 tracks from five of the major record labels and also from hundreds of independent artists. BuyMusic also operated on a pay per download basis and charged between 79 cents and $1.29 per track. Individual albums were sold at prices ranging from $7.95 to $12. Songs downloaded from this site were in the Windows Media Audio (WMA) format and could be listened to using Windows Media Player (Version 9). Since WMA files

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[17] 'Apple Unveils Online Music Service,' www.pcworld.com, April 28, 2003.

[18] 'Apple Touts iTunes Success,' www.pcworld.com, June 24, 2003.

[19] Launched in January 2001, the iTunes software was used for managing digital audio files for Macs.

[20] 'BuyMusic.com Offers Tunes for Windows', www.pcworld.com, July 22, 2003.

could not be transferred over P2P file sharing services, BuyMusic scored over iTunes (which offered MP3 files) in terms of piracy prevention.[21]

The first Windows-based service similar to iTunes, BuyMusic, was expected to take the market by storm. However, this did not happen due to a host of reasons. While BuyMusic marketed itself as a store that sold songs starting from 79 cents, the website reportedly had only one song for that price, the prices for the rest of the songs ranged between 99 cents and $1.29. Also, it limited the number of times a song could be burned on CDs (ranging from one to 10 for different songs). It also limited the number of computers and portable MP3 players users could transfer the songs to. Moreover, the songs which were in the WMA format, were reportedly not compatible with many portable digital music players including popular ones like iPod. BuyMusic, reportedly, had many technical glitches as well, such as its search engine not returning results for search queries.

There were other websites like Full Audio's MusicNow (improved version) and AOL's MusicNet. Tracks at MusicNow were priced at $1 each, in addition to a monthly subscription of $10. The songs were compatible with Windows, could be burned on a CD and transferred to those portable players which could read WMA files. The website also offered good quality radio streaming. However, the collection available was, reportedly, not considered good as it comprised songs mostly from jam bands (those who compose songs by fusion of various music genres – these bands were not as popular as mainstream commercial bands and the quality of their songs was believed to be not very good).

AOL's MusicNet had a library of over 300,000 songs that were offered on a monthly subscription basis. The website offered three subscription options: $4 to download and stream 20 songs, $9 to download and stream any number of tracks, and $18 to burn 10 tracks and to download and stream an unlimited number of tracks. However, to access these services, users had to be AOL subscribers. Also, songs from MusicNet could not be transferred to any portable player.

A legal version of the defunct Napster was also expected to be launched by the end of 2003. Reportedly, the new version would feature 500,000 tracks from five of the major record labels and a number of independent artists. Napster planned to offer various options to users, like pay per download, monthly subscription, Internet radio streaming or combinations of these. Napster's comeback was expected to give tough competition to iTunes in 2004. Companies like Microsoft, AOL and Yahoo were also expected to launch similar services by the end of 2003.

Market observers pointed out that though competition seemed to be intensifying for iTunes, until now none of the new services matched it on the user friendliness front. Moreover, the limitations faced by iTunes were considered far less than those experienced by other services. Also, in the short-term, the success of iTunes was believed to be more 'symbolic' than in terms of financial viability. A source at Warner Brothers said that Apple's business model had "A real business potential for selling downloads."[22]

Though the market scenario in 2003 seemed bright, analysts at Jupiter Research stated that, despite the hype generated by iTunes, online music sales for 2003 would not generate more than $80 million. Analysts expected the market to grow to $3.8 billion in 2008, as compared to an earlier estimate of $5.1 billion by 2007. However, most industry observers were optimistic and believed that the results shown by iTunes could be the beginning of a revolution long-delayed – a financially viable, legal online music distribution system.

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[21] WMA incorporates an anti-piracy technology called Digital Rights Management (DRM) which prevents users from making copies of music files.
[22] 'iTunes Music Store 'Best News' Music Industry has had,' http://maccentral.mcworld.com, July 21, 2003.

THE FUTURE OF iTUNES – NOT SWEET MUSIC ALL ALONG

The going seemed to be smooth for iTunes in mid-2003, with the music industry as well as customers apparently happy with the service. Thus, the opposition to iTunes from popular music bands such as Red Hot Chilli Peppers and Metallica, was totally unexpected. These artists argued that they would lose creative control of their albums if companies like Apple were allowed to sell songs individually. In a statement made to Reuters, Mark Reiter of Q Prime Management Company, which managed Red Hot Chili Peppers, Metallica and many other artists, said, "Our artists would rather not contribute to the demise of the album format."[23]

Analysts refuted this argument saying that if music artists refused to sell individual songs through legal websites like iTunes, the consequences would only be adverse. This was because music lovers would inevitably find and download songs through the innumerable file sharing services available on the Internet. Industry observers said that cooperating with legal websites was a practical and sensible way of combating piracy.

Supporting this argument was a statement from a Metallica fan, Marc McCoy, who bought two songs of Metallica's latest music album, St. Anger, instead of buying the whole album. Referring to the PC version of Windows, he said, "When iTunes for Windows rears its head, we will see who is in control."[24] Analysts argued that instead of opposing pay per download websites, artists should be able to use this technology for their benefit.

In July 2003, Apple announced that it was preparing to release the Windows version of the iTunes software to address what had been termed as the service's biggest weakness. Analysts observed that with this, Apple's online music business could grow seven-fold. An analyst at Needham & Co, Charles Wolf, estimated that through iTunes (with Windows and Mac versions), Apple could capture 20% of the pay per download music market. This would translate into $600 million in annual revenues and about $50 million-$60 million in operating income.

Considering the fact that this amount was almost equal to Apple's total profits in 2002 ($65 million), the potential for iTunes seemed immense. Commenting on the above, Wolf said, "Apple is abandoning its strategy of confining its software to the Mac platform. This overdue move will enable it to target its digital entertainment products and services at the entire market, not just the 5% Apple currently addresses."[25]

The most positive outcome of the iTunes story, however, would perhaps be that the stranglehold of record companies on the music business would loosen, and the industry would become more artist/customer friendly. Commenting on how iTunes had played a pioneering role in this, one of the world's most successful and popular music stars, Michael Jackson, said, "We should look to new technologies, like Apple's new music store, for solutions. It is the fans that drive the success of the music business; I wish this would not be forgotten."[26]

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[23] 'The Chilli Peppers Sour Grapes Over iTunes,' *BusinessWeek*, July 16, 2003.

[24] 'Why iTunes has Bands on Run', *BusinessWeek*, July 30, 2003.

[25] 'iTunes Store Puts Company at the Forefront of the Digital Media Market,' www.sunspot.net, July 24, 2003.

[26] 'Pop Star Michael Jackson Lauds Apple's iTunes', http://maccentral.macworld.com, July 22, 2003.

QUESTIONS FOR DISCUSSION:

1. Examine the structure and functioning of the music industry and comment on how technological advancements over the years have impacted its functioning.

2. What were the reasons that led to the emergence of digital music distribution? What steps did the music industry take to address the issue of music piracy in the wake of the growing popularity of P2P services?

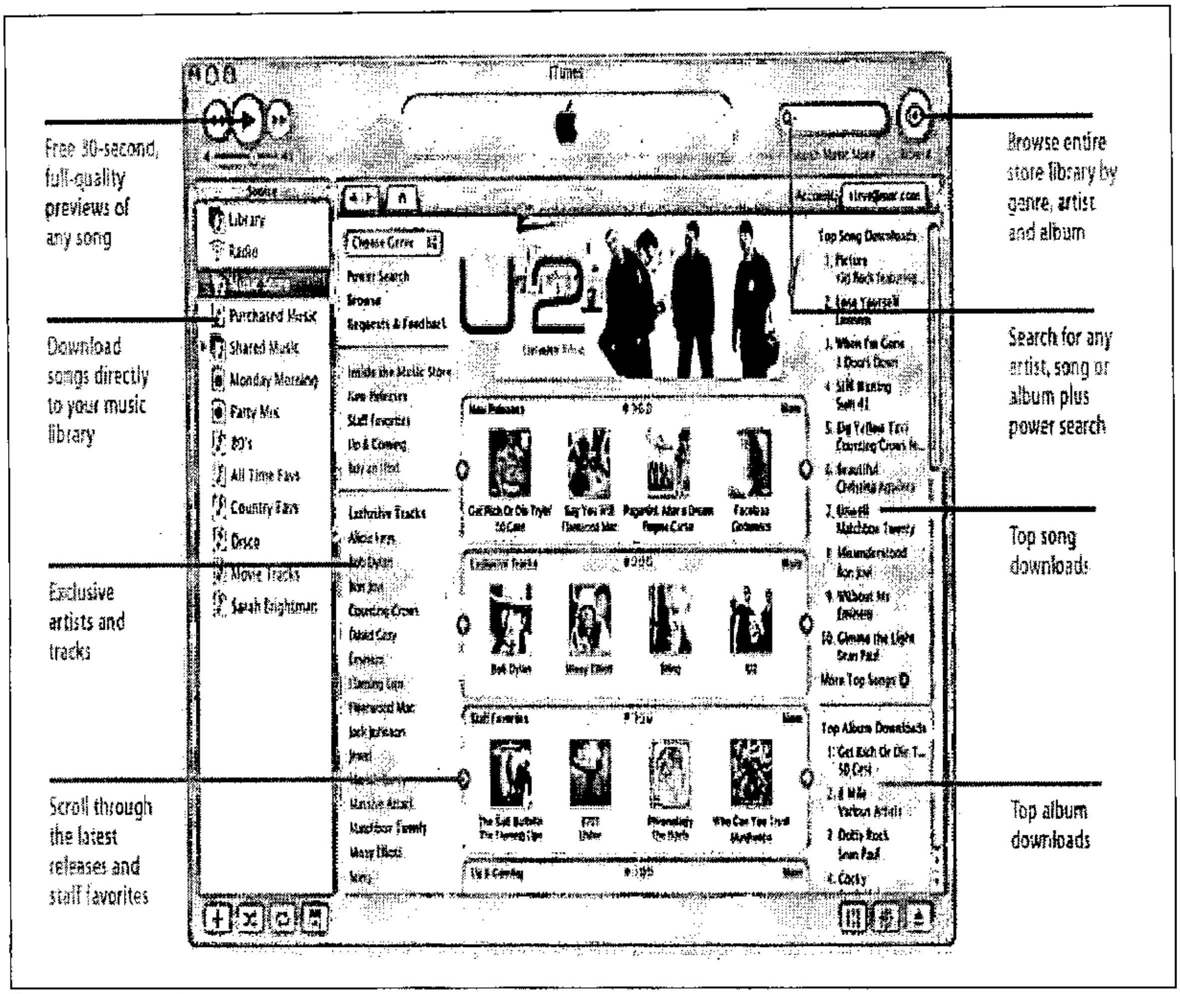
3. Examine the advantages and disadvantages of subscription-based services as compared to P2P networks. What were the reasons that contributed to the popularity of P2P services and the failure of subscription-based services?

4. Would you agree that music piracy is more of a behavioral issue on the part of customers than a technological one? Is iTunes the solution to the industry's problems? What were the reasons for the rapid acceptance of iTunes by customers?

5. Given the level of competition in the business of digital distribution of music, which direction is the iTunes Music Store headed in? If you were sitting at the Apple headquarters, what strategy framework would you design to ensure that iTunes sustains the growth momentum it picked up in mid-2003?

EXHIBIT I

THE iTUNES MUSIC STORE WEBPAGE



Source: www.apple.com

EXHIBIT II

A NOTE ON THE MAJOR PLAYERS IN THE MUSIC INDUSTRY

In 2002, the global recording music market was estimated to be worth $32 billion. The market was mainly dominated by five major recording labels, Universal Music Group, Sony Music, Warner Music, EMI Music and BMG Music, in the given order. Apart from them, many thousands of small record companies and individual players existed in the market. Most of these smaller players operated on a regional basis, with a few local record companies ruling the roost in most countries of the world.

The Universal Music Group was the world's number one music company; it was formed in 1998 as a result of the merger between Polygram (Europe) and the US-based MCA/Universal Group. Before being acquired by Vivendi Universal in 2000, it was the flagship brand of Seagram, a Canadian beverages company. In 2001, Universal posted revenues of $6.2 billion.

Sony Music Entertainment was the US-based music subsidiary of Japan's Sony Corporation. The number two player in the industry, Sony comprised a huge portfolio of artists and record labels including Columbia Records, Epic Records, Legacy Recording, Sony Classic, Sony Nashville and Sony Wonder. The company's revenues in 2001 stood at $4.6 billion.

Warner Music group, the worlds #3 music company, comprised some of the world's leading record companies like Electra Entertainment Group, the Atlantic Group, Rhino Entertainment, Word Entertainment and Warner Bros. Records Inc. The company operated in more than 70 countries. In 2001, Warner Music posted revenues of $3.9 billion.

EMI Music was the UK's leading record company. With a presence in over 30 countries, the company included record labels like Virgin Records, EMI Music Publishing, EMI Records, Capitol Records and Angel Records. In 2001, EMI's revenues amounted to $3.8 billion.

BMG Music was the third largest music distributor and the leading distributor of singles in the US. The company operated in ten countries around the world. BMG earned revenues of €2.7 billion in 2002, 44.1% from North America, 8.8% from Germany, 28.1% from Europe (excluding Germany), and the remaining from other countries.

After the emergence of online music distribution, many Internet companies established online music stores in association with the recording labels. Some of the well-known stores were MP3.com, MusicMatch.com, Pressplay (from Sony) and LaunchCast (from Yahoo).

Compiled from various sources.

EXHIBIT III

A NOTE ON MUSIC PIRACY

The International Federation of Phonographic Industry (IFPI), an organization that represented 1500 record companies in 70 countries around the world, estimated the value of the global music piracy market at $4.6 billion in 2002, an increase of 7% over 2001. This excluded the estimated losses due to distribution of unauthorized files over the Internet and private copying by individuals. The global music piracy market was reportedly bigger than any individual national music market except the US and Japan.

Music piracy included disc piracy (pressed disks and CD-R) and audio cassette piracy. Disc piracy was estimated to be around 1.1 billion units in 2002, an increase of 14% over 2001, and more than double the units sold in 1999 (510 million units). According to IFPI findings, every one in three disks, and two in five audio cassettes, were pirated. However, the threat to the industry from the Internet, that is, digital music piracy, had emerged as the biggest menace by the 21st century. According to a research study conducted by RIAA in early 2002, 50% of music buyers who downloaded music from the Internet made illegal copies of it in 2001, as against 13% in 2000.

The pressed disks (mass produced in factories by using a mould or press of a single master disk), dominated the piracy market in Asia (especially in China and Indonesia) and Russia. According to IFPI reports, more than three-fourths of the world's pressed disks were sold in these regions. CD-R piracy, wherein copies are created by burning CDs, was prevalent in Latin America and Southern Europe. Reportedly, CD-R piracy was considered to be a major threat because of the ease of mass pirate production with the help of legally available low-cost and high-speed CD burners. Due to the widespread music piracy, global recording music sales fell by 7% in value and 8% in units in 2002.

The music piracy menace prompted major players in the industry to take various combative measures. They campaigned to the effect that piracy was unethical and some of the record labels even released CDs that incorporated piracy protection technology. However, these measures were not considered to be foolproof. The companies also backed legal digital music download services, which failed due to complexity in usage.

IFPI even organized a 'Digital Download Day' in Europe in January 2003. On this day, the music industry, including the major labels as well as the small and individual labels, offered consumers in France, Germany, Spain Italy and the UK free downloadable songs at their websites. This move was aimed at making users aware of the evils of music piracy and to educate them on where and how to download quality legal digital music. Despite all the above measures and the emergence of easy to use, affordable and legal digital music download services, the menace of music piracy was expected to continue plaguing the industry.

Compiled from various sources.

EXHIBIT IV

ONLINE MUSIC SERVICES*

	Name	Tracks	Charges	Features
P2P services				
1	Kazaa	719,280,000 MP3 files	Free	Unlimited downloads, can be copied to any number of CDs and computer hard disks.
2	Grokster	Unlimited	Free	Unlimited downloads, can be copied to any number of CDs and computer hard disks.
3	Morpheus	Unlimited	Free	Unlimited downloads, can be copied to any number of CDs and computer hard disks.
Subscription based services				
1	MusicNet	300,000	$4 (monthly fee)	Download and stream 20 songs. Restricted user rights for different songs.
			$9 (monthly fee)	Download and stream unlimited tracks. Restricted user rights for different songs.
			$18 (monthly fee)	Download and stream unlimited number of tracks; allows to burn 10 tracks.
2	Music Now	Limited	$9.95 (monthly fee)	One time download only. Different licensing terms for different songs. Compatible only with Windows Media Player. Additional cost of 99 cents per song to burn a CD.
3	Rhapsody	Limited	$9.95 (monthly fee)	For downloading songs only and an additional cost of 75 cents/song to burn a CD.
4	Pressplay	Limited	$9.95 (monthly fee)	Unlimited streaming and downloading of songs to a computer hard disk. Cannot copy songs to a CD.
		Limited	$ 17.95 (monthly fee)	Burn 10 songs per month and an additional 1$ per extra song.
5	MX	Limited	$4.95 (monthly fee)	Unlimited streaming but no downloading. Cannot burn CDs.
6	EMusic	Limited	$9.95 (monthly fee)	Unlimited streaming. Cannot burn CDs.
Pay Per Song Services				
1	iTunes	200,000	99 cents/song $10 for certain albums.	Uniform rights for all songs, no restriction on copying songs to any number of CDs and Macintoshes. Songs can be transferred to any number of portable digital players. Compatible only with Macintoshes.
2	BuyMusic	300,000	79 cents - $1.29 per song. Individual albums between $7.95 and $12	Restrictions on CD burning. Varying rights for different songs. Not compatible with all portable digital players.

Compiled from various sources.
* The list is not exhaustive.