



E-business Research Paper  
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# **THE DIGITAL MUSIC INDUSTRY**

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## **ACHIEVING SUSTAINABLE COMPETITIVE ADVANTAGE**

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## ABSTRACT

The recorded music industry is not unfamiliar with change. It has experienced remarkable changes since the development and commercialization of Edison's cylinder to the arrival of the CD. However, there is no single technology that has challenged and threatened the livelihood of the industry like the advents of the MP3 standard and the emergence of the Internet and its related technologies. With the rise in technological advances, illegal sharing of music online is becoming easier and faster. This illegal sharing of copyrighted music through peer-to-peer (P2P) systems has grown tremendously the last years, since companies offering P2P services are by nature virtually impossible to stop through the legal system. This poses a major threat to the music recording industry and has caused significant financial damage to musicians around the world. This paper's main focus lies on how e-music retailers (EMRs) can tackle the threat posed by companies offering free P2P applications. Applying a traditional value-adding differentiation strategy is forwarded to be a sustainable competitive approach against the free P2P services "low-cost" (read free) strategy. This suggestion is in this paper well grounded in literature but not empirically tested, merely proposed to lie as a solid framework for further research.

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## 1. INTRODUCTION

Perhaps no industry has been more fundamentally challenged by the growth of the Internet and its related technologies than the recorded music industry. For most industries, the Internet has presented the challenge of a new and far more efficient distribution channel. For the recording industry Internet has provided a platform for the distribution of prerecorded music in a form that is substantially different from music sold in physical stores or online CD retailers; namely the MP3 standard format. A major threat to the music industry on the whole is companies which offer Internet-users free online file-sharing programs that enable illegal exchange of music over the Web. The file-sharing systems which began to appear in the beginning of 2000 ([Evangelista, 2003](#)), are built on true P2P technologies, where no central file server is required. The idea is that as long as users have the application and the Internet, they can connect to each other and share files. This makes the companies behind these systems impossible to attack from a legal standpoint. File-sharing programs like [Kazaa](#), [Morpheus](#), [Grokster](#) and [iMesh](#) have made the illegal sharing of copyrighted music more popular than ever before. An estimated 60 million Americans have downloaded music from the Internet ([Ispos-Reid, 2002](#)) and the record industry blames piracy in large part for the 31 percent drop in CD sales since mid-2001 ([Evangelista, 2003](#)). As the Recording Industry Association of America ([RIAA](#)) has been unable to shut down file-sharing providers ([Evangelista, 2003](#)), the music industry in general and EMRs in particular face a tremendously challenging future. This paper will analyze and discuss how EMRs can sustainably compete with the free P2P networks.

### 1.1. Outline of paper

The paper continues with a problem definition and problem analysis. This is, in Section 3, followed by a research model proposition. Section 4 starts by analyzing the most prominent business models of EMRs. Then outlining the strengths and weaknesses of the free P2Ps. Part 3 of Section 4 will, by elaborating upon the proposed research model, discuss how EMRs can compete with the free P2P networks and maintain a sustainable competitive advantage, also including some thoughts regarding future challenges to the EMRs. The paper ends with conclusions in Section 5.

## 2. PROBLEM DEFINITION AND PROBLEM ANALYSIS

### 2.1. Problem Definition

The definition of the problem addressed in this paper is;

*How can digital music retailers compete with the free P2P networks and maintain a sustainable competitive advantage?*

With true P2P systems gaining strength and being virtually impossible to stop through the legal system, the recording industry faces hard strategic choices about future actions.

## 2.2. Problem Analysis

EMRs have tackled the challenge posed by free P2P services by developing competing on-line music services. The service offers a more comprehensive catalog of music with benefits of information richness, product information, media richness and variety, service and support etc, that only a fully legal system could provide (e.g. links to videos, web sites, detailed information on songs and artists, lyrics, user support). ([Ghosemajumde et al, 2002](#))

However, there are a number of concerns about this strategy. This principal concern is whether or not users would even be willing to pay for the service. According to Jupiter Consumer Survey Report: Online Music in Europe ([2002](#)) there is clear demand for paid music services; 37 percent of Europe's digital music fans said they are willing to pay for digital music. This suggests there is a market for EMRs, even though it is unclear whether these responses can accurately predict the users' behavior in when other free services are available.

Another competitive threat is represented by "music-locker" companies like [MP3.com](#) (Appendix 1 for a description) and the rise of artists who are willing to give away high quality content for free legally. These artists use MP3.com and other similar websites to gain visibility, and could potentially represent threats to major commercial artists ([MP3.com, 2002](#)). However, so far this threat has failed to materialize, since national and international artists get the majority of radio and video airplay (and radio and television continue to be primary drivers of listening tastes). ([Ghosemajumde et al, 2002](#)). Thus, this threat to EMRs will not be further elaborated upon in this paper.

## 3. RESEARCH MODEL

As a framework for the proposed research model lays Michael Porter's (1980) well-established theory of generic strategies. Porter (1980) argues that there are two basic types of competitive advantage a firm can possess: low cost or differentiation (the strategy approach, focus, will not be elaborated upon here due to content constraints posed upon this paper). Even though the companies behind the P2P systems may not focus on tight cost control and offer a product not only for a low cost but for free, one can partly apply Porter's (1980) *low cost strategy*, with regard to the low price (read *free*) of the company's digital music product. These companies do not offer any additional services or perks other than the music files. The quality of these files is uncontrollable for the P2P network providers, since it depends on other users in the network. (Their revenue streams come from other sources such as advertising and software bundling, which in turn rely on people actually using their systems). In a *differentiation strategy* a firm seeks to be

unique in its industry along some dimensions that are widely valued by buyers. It selects one or more attributes that many buyers in an industry perceive as important, and uniquely positions itself to meet those needs. The firm is rewarded for its uniqueness with a premium price (Porter, 1980). EMRs can be placed under this approach, since these companies offer the same product as the companies behind the free P2P services, but at a higher price ( $>0$ ). By offering dimensions valued by buyers, it is plausible that the EMRs can compete on a sustainable basis. These dimensions can incorporate premium product quality and an augmented product in form of a legal option of downloading music and additional services such as information richness, product information, media richness and variety, customer service, security (virus free files), usability, interactivity and personalization options. Porter (1980) argues that a differentiation strategy leads brand loyalty. This has always been considered to be a key to e-business success (Turban et al, 2002). The variables proposed in this model partly draw upon earlier work of Eklöf et al (2003) concerning consumer-centric criteria for e-business success. The additional services will be described and elaborated upon in Section 4. The research model proposal (Figure 1) builds on the following research question:

*Will greater differentiation lead to increased competitive advantage for EMRs?*

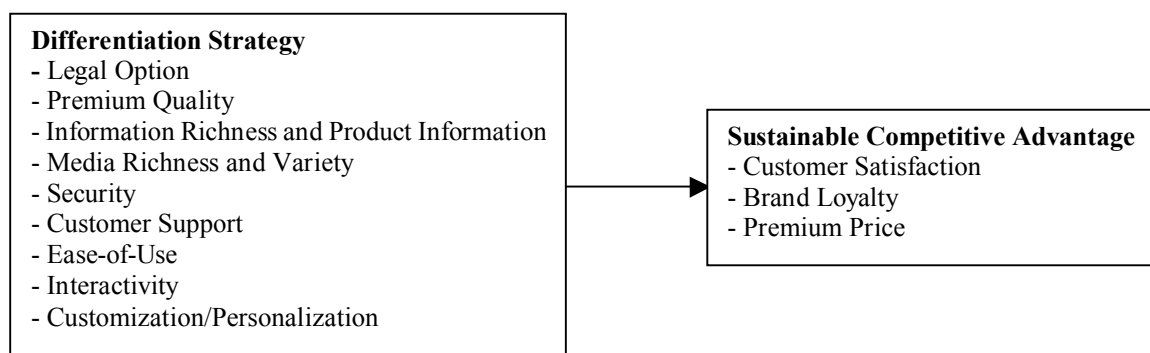


Figure 1. Research Model Proposal for Achieving Sustainable Competitive Advantage for EMRs facing Competitive Challenges from free P2P Services Companies.

### 3.1. Research Design

The study of this paper is based on secondary sources. Through a literature review, the authors of this paper argue for and support the research model presented above. The aim of this paper is not to empirically test the model, rather to underpin it theoretically, with the objective for the model to lie as a sound framework for future research.

### 3.2. Limitations of the Research Model

One limitation lies in the soundness of the business model underpinning the proposed research model. Perhaps a more suitable and sustainable business model for the new e-business environment should base revenue streams on other sources than the readily available music files e.g. charging for additional

services or advertisement. However, the purpose of this paper is to suggest a strategic approach for achieving competitive advantage for companies employing the current business model of EMRs.

The next section of this paper will, based on the research model, analyze and discuss the identified problem of how EMRs can compete with the free P2P networks and maintain a sustainable competitive advantage.

#### **4. ANALYSIS AND DISCUSSION OF HOW EMRs CAN ACHIEVE SUSTAINABLE COMPETITIVE ADVANTAGE**

This section will start by analyzing the most prominent business models of the EMRs. Then the strengths and weaknesses of the free P2Ps will be discussed. Part 4.3 of this section will, by elaborating upon the proposed research model, discuss how EMRs can compete with the free P2P networks, and include some considerations regarding future challenges to the EMRs.

##### **4.1. Business Models**

The demand for digitally encoded music has gradually become one of the most prevalent in internet-based technology. P2P file sharing applications such as [Kazaa](#) and [Morpheus](#) boast to have millions of users and hundreds of thousands of new users joining weekly ([Download.com, 2003](#)). In response to this heightened demand and copyright legislation that has led to scrutiny of such services, several actors have emerged on the market, attempting to profit from music downloads. The idea is to redefine the way music is bought and sold by allowing consumers to purchase single tracks instead of entire CD's, and create more value for the customer through lower prices than traditional CD retailers. An examination of several digital music retailers reveals different approaches used in achieving success, which primarily manifest themselves in the business models employed by the companies. Of particular interest are the revenue models that these companies use to generate profit. The two most prominent are subscription based and pay-per-download, where the former requires the customer to pay a subscription fee and the latter charges per single song download.

A survey published by Ipsos-Reid (2002) indicates that current users of file sharing applications would strongly prefer a pay-per-download solution rather than a subscribing to a music service. Nevertheless, subscription based services are acquiring a substantial part of the market share. This section will present several companies and their respective revenue models in an attempt to build a clear picture of the digital music marketplace and identify the most prominent actors.

##### **4.1.1. Subscription based**

There are several companies that offer subscription based music purchasing. In essence, this requires the customer to pay a monthly fee for downloading music. In this respect, such companies function both as

online retailers and content providers as defined by Eisenmann (2001). In addition having similar revenue models, companies in this category require users to download an application that acts as an interface to their store. The companies discussed in this section are [RealNetworks](#) and [EMusic](#).

**RealNetworks** – One of the most prominent actors within this particular type of initiative is [RealNetworks](#) with its Rhapsody music service, which in 2003 had 250,000 registered and *paying* users ([Borland, 2003c](#)) Though this number can hardly be compared with the millions using the free file-sharing applications, the message is clear: there is a definite market for subscription based online music sales. Something that is particularly interesting with RealNetworks's approach is that, while unlimited downloads are included in the monthly fee, customers must pay an additional 79 cents per song if they wish to burn music to a CD. This additional fee does not seem to discourage customers. RealNetworks holds a substantial part of the marketshare with regard to subscription based digital music services, and is far more successful than its competitors. It was voted as the number one ranking online music provider in 2003. ([PCWorld](#))

**EMusic.com** - [EMusic.com](#) was one of the forerunners in the digital music market. In 1998 it was the first company to begin selling singles and full albums in MP3 format, and in 2000 it launched the first downloadable subscription service ([EMusic.com, 2003](#)). To begin with, customers received unlimited downloads for a monthly fee. However, after the company was bought by a private New York equity group, Dimensional Associates, the policies were changed ([Borland, 2003b](#)). The current pricing policy gives customers a maximum of 40 downloads for a monthly fee of 10 USD and a maximum of 65 downloads for a fee of 15 USD ([EMusic.com, 2003](#)). Today EMusic.com has 70,000 paying subscribers, a number which is very small compared to the customer base of RealNetworks, and even smaller compared to the number of users of P2P file-sharing programs. An apparent obstacle in competing with companies such as RealNetworks seems to be limiting the number of downloads. Although RealNetworks Rhapsody service was launched in 2003 and is relatively new to the digital music market, it clearly attracts more customers than the seemingly more experienced and innovative EMusic.com. A plausible conclusion is therefore that customers do not want to be limited in their ability to download music.

#### ***4.1.2. Pay-per-download***

Companies employing the so-called pay-per-download model charge their customers a fee for each downloaded song. Thus, their business activities are very similar to those of online retailers: in essence, they are selling music tracks. As mentioned earlier in this section, research has shown that users P2P technology would strongly prefer to pay for each download separately, rather than pay a monthly subscription fee. Companies employing the pay-per-download approach cater more closely to this market demand than their subscription based counterparts. This section will present [iTunes.com](#), [BuyMusic.com](#) and [LiquidAudio.com](#).

**iTunes.com** - Apple's digital music solution became an instant success after its launch in April 2003, with over 1 million sales during the first week, and over five million in the first two months ([Apple.com, 2003a](#)). Since the launch of the service, sales have averaged 500 000 per week ([Apple.com, 2003b](#)). The solution requires customers to download a piece of software that acts as a store, enabling the user to purchase music tracks. Three days after Apple launched a new version of the iTunes software for Windows, over 1 million copies were downloaded ([Apple, 2003c](#)). Adding this to the existing Mac user base renders a total of over 7 million users ([FutureOfMusic.org, 2003](#)). There are several characteristics of iTunes's business model that contribute to its success. The first notable factor is the simple pricing policy: each song costs 99 cents to download. In addition, no registration fees are necessary, and the user is free to browse the store without having to pay upfront subscription fees. Furthermore, there are no national restrictions on who can download songs, which creates a potentially unlimited customer base for iTunes since several actors within this field cater only to the USA. Additional value adding factors include song previews, availability of cover images and synchronization with hand held devices, i.e. iPod ([FutureOfMusic.org, 2003](#)).

**BuyMusic.com, and LiquidAudio.com** - The models employed by these two retailers are quite similar. Both offer single track downloads for 99 cents as well as the ability for customers to burn songs to CD's and portable devices. In addition, both album covers and track previews are available. The notable difference between the approaches taken by these companies and that of Apple's iTunes, is that the market is limited to the USA only, i.e. European customers cannot purchase from these sites. A valuable addition to the market with respect to this limitation is Microsoft's recently launched digital music store. It is available only on the British website ([msn.co.uk](#)), however all European users may purchase from them.

#### **4.2. Weaknesses of free P2Ps**

This paper argues that in order to compete with P2P companies, EMRs need to differentiate themselves along value adding factors. This concept is tightly coupled with exploiting the weaknesses of their competitors to their advantage. By providing a legal service, EMRs promote a moral solution to a service that has been dominated by the copyright infringement activities of P2P networks. Since the file databases can be centralized, EMRs may guarantee a better quality of provided files. This is completely impossible for P2P service providers, since files are distributed between individual users and the quality depends solely on the users. P2P services are also very limited in the scope of available information, since the available content is once again dependent on individual users. The lack of adequate security measures is also a weakness of P2P networks. Recently, Hewlett-Packard identified a security breach in Kazaa that have made unknowing users share content that was not intended to be shared. ([Musil, 2002](#)). In addition, virus infected files can be spread through these networks, often disguised as MP3 files. Furthermore, since P2P programs are often bundled with spy-ware, certain privacy issues are raised.

Additional weaknesses include lack of customer support and interactivity, and limitations on ease of use and personalization. These will be elaborated upon in the following section, where strategies to sustainable competition will be presented.

#### **4.3. How can EMRs compete with the free P2P networks and maintain a sustainable competitive advantage.**

How can e-music retailers such as Apple's iTunes and RealNetwork's Rhapsody compete against free services like Kazaa, Grokster, Morpheus and LimeWire? Levin (2003) argues that the EMRs need to minimize the barriers to purchasing music online, and to provide a better user experience than free P2P services. Minimizing the barriers to purchasing music online, as well as providing a better user experience are accounted for in the research model and plausible strategic advantage outcomes. The authors of this paper argue that the EMRs should differentiate themselves to be able to effectively compete with the free P2P services.

EMRs must take advantage of the shortcoming of the P2P clients by offering a superior product and service in order to draw customers away from P2P networks. Below, the authors of this paper present suggestions on how EMRs can differentiate themselves, and cater for the shortcomings of P2P. The suggestions are based on the research model presented in Section 3. The research model presents 10 variables that are suggested to enhance differentiation for EMRs in relation to P2Ps, ultimately leading to increased competitive advantage for EMRs. The variables are (1) Legal Option, (2) Perceived Premium Quality, (3) Information Richness, (4) Product Information and Standardization, (5) Media Richness and Variety, (6) Security, (7) Customer Service (8) Usability, (9) Interactivity, (10) Customization/Personalization. (For a more comprehensive outline of some of these criteria and how they in general can enhance e-business success see Eklöf et al, 2003)

**1. Legal Option** – Buying digital music from EMRs is legal, since the music has been approved for distribution in MP3 and EMRs pay royalties to producers and artists. However, sharing MP3s of copyrighted music that has not been approved for distribution in MP3 form is technically illegal. It is illegal to distribute it to anyone who does not own a physical copy of the song, regardless of whether you leave it on a server with restricted access, or mail someone a CD-R full of MP3 files. Downloading music that has not been approved for distribution through P2P file sharing programs, such as [Kazaa](#) and [Morpheus](#) is also illegal. Using file-sharing programs to download MP3s has become so prevalent, that the RIAA have begun tracking down users on the Kazaa network, and filing lawsuits against them. ([RIAA, 2003](#))

**2. Premium Quality** – Since EMRs can control the quality of the music they distribute (in contrast to the music in P2P networks which is dependent on the users of the network) EMRs can uniquely (in relation to P2Ps) position themselves to meet quality standards, and hence be rewarded for their uniqueness with a premium price (Porter, 1980) and, through quality, compete on a sustainable basis.

**3. Information Richness and Product Information** – EMRs can improve the customer experience by focusing on thorough product descriptions and explanatory documentation ([Bannister, 2002](#)). EMRs can provide detailed artist and album information, lyrics and links to billboard chart information etc.

**4. Media Richness and Variety** – This is about possibilities to link different type of information e. g. text, graphics, audio, pictures, and video and display them together as a multimedia object, to enhance the value of an ERM's service. E.g. users can be able to listen to 30-second clips of all songs in the music catalog and view music videos. Madeja and Schoder (2003) argue for the value of media richness and variety for e-business success.

**5. Security** – Security is a major selling proposition, and is becoming more significant. The increasing importance of virus protection and the protection of users from ad-ware, spy-ware and spam E-mail needs to be incorporated into an EMRs competitive strategy. Several viruses are spread through P2P networks as both infected files and camouflaged as MP3 files. Spy-ware may be secretly logging the users' Internet behavior, providing hackers with the possibility to exploit the system for criminal purposes. This complements the case identified by HP. EMRs need to communicate to its potential customers that the security of using their software compared to its P2P competitors lies in the fact that they can provide spy-ware free software. In addition, this software will enable the user to download virus free music files with superior integrity. Since security and integrity are crucial issues in today's use of the Internet, users would be favorable towards this solution.

**6. Customer Support** – Studying some of the most popular sites for P2P software downloads reveals that customer support is virtually non-existent. Users are encouraged to post their concerns in online forums and pray that other users will resolve the problems they have incurred. This is another shortcoming that EMRs could accommodate for in their strategy. Having customer support will enable the company to differentiate it from its competitors and to promote loyalty and satisfaction (Kotler, 2002).

**7. Ease-of-Use** – A critical success factor for websites in general is ease-of use (Madeja and Schoder, 2003). Even though P2Ps do not necessarily have to be hard to use, some of the functionalities can cause frustration (as discussed under 4.2. in this paper). Only one hit for a specific song should be displayed when searching (in contrast to P2Ps' lengthy hitlists). The customer should also have the option of

selecting the quality (measured in kbits) of the song, ranging from 320 kbits to 96 kbits, as well as offering variable bit-rate (VBR) songs (not always the case with P2Ps). Bandwidth is also important. Customers with broadband connection must be able to download the file faster than would be the case with most P2P clients. Furthermore, P2P shared files often suffer from inconsistent filenames and incomplete ID3 tags. These tags are important for the customer, since they contain information on the song title, the artist, the album name, the release year, etc. EMRs can easily facilitate this through standardization. Based on complete ID3 tags, the customer should be able to select the output filename and its destination folder. This can be a very useful feature for those that are maintaining huge libraries of MP3 files. When selecting songs for download, the software should also suggest other songs that are liked by peers, similar to the way that [Amazon](#) recommends books, CD's and other items. To further enhance the value of EMRs' service, they could offer an option to print high quality CD covers that will fit a standard CD case, fast and easy CD burning with a drag-and-drop functionality, filtering out music with parental advisory labels, etc.

**8. Interactivity** – Offering communication with and between users increase a websites value (Madeja and Schoder, 2003). EMRs can offer feedback channels through which users may get answers to their questions, get in touch with customer service representatives, report errors, etc. They can also provide message boards for users to share opinions and offer suggestions. By taking advantage of the network of Internet, EMRs can enhance customer value further by creating communities (i.e. for music genres) enabling interaction between users.

**9. Customization/Personalization** – An EMR could offer their users the opportunity to compose individual information or content according to individual preferences of user profiles, like personalized websites or e-mail or provide personally relevant features (i.e. music genres). Customization can strengthen relationships with customers as it allows the customer to have an individualized online presence with information which meets his or hers specific interests (Turban, 2002).

#### ***4.2.1. Challenges for EMRs***

Although the future for EMRs may seem rosy based on the above discussion, this may not be so. This is due to many factors, primarily at the hands of the RIAA and copyright owners. After successfully shutting down the original Napster and Audiogalaxy, RIAA is now pressing charges against individuals uploading and downloading music. Although this strategy seems to have made some progress (France, 2003), the unauthorized sharing of copyrighted material is still enormous. John Dvorak (2003) of PC Magazine argues that the RIAA strategy is going to fail because it is only concerned with protecting the profits of the record labels, and he blames the whole industry for not changing its business model to embrace the emergence of the MP3 format in the mid-1990s. Moreover, EMR startups are suffering for

other reasons. Licensing restrictions are stopping users outside the United States to download and pay for music files legally, forcing potential customers back to unauthorized P2P music file-sharing.

In addition to the mentioned retailers of digital music, new players are continuously emerging on the market. Napster has released a new version of its software, which is now a pay-per-download service.

Having recognized the potential of this new market, record labels, as well as companies such as [Sony](#), [Wal-Mart](#) and [Amazon](#), are launching their own initiatives for online music sales (Burrows, 2003).

The increased competition will present a definite challenge for EMRs and put their competitive strategies to the test. A sustainable competitive advantage will therefore be essential for the survival of EMRs.

## 5. CONCLUSION

The illegal file-sharing revolution poses a major challenge to the music recording industry in general and its digital mirror in particular. Digital music retailers are advised to adopt a differentiation strategy in order to effectively compete with the companies behind the free P2P networks. By creating brand loyalty through offering dimensions valued by buyers and accommodating for P2P network shortcomings, it is plausible that EMRs can achieve sustainable competitive advantage. This proposal, i.e. that greater differentiation leads to increased competitive advantage for EMRs, is well-grounded in literature and forwarded to be a sound framework for future empirical research.

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## APPENDIX 1 – MP3.com

Founded in 1997, MP3.com began as a site where Artists with an intense desire to share their music could gain immediate exposure to a fast-growing global audience of music fans. Slightly more than two years after MP3.com began, the company became the focal point of the exploding digital music scene.

MP3.com continues to serve our Artist community and help further its promotional efforts through the following tools:

Free Artist Page - Artists can add songs, images, event info and view detailed stats.

Platinum and Gold Services - A deluxe suite of promotional opportunities and support.

CD Program - Artists can create and sell CDs while earning 50% of net revenue.

Promo Auctions - Highly-visible Artist marketing opportunities. (MP3.com, 2003)

MP3.com is a slight variant of the subscription model dubbed the “music locker” model. This model allows the consumer to have access to a specific library of music that is determined by what music the consumer already owns and subsequently purchases. Companies like [MP3.com](http://MP3.com) and [MusicBank.com](http://MusicBank.com) are offering services where you would place your current CDs in your CD-ROM and their site would read the CD and confirm you own a physical copy. Once it is confirmed that you own the CD, you are given access to that music on their site and can stream it to your computer. In addition, whenever you buy new music from a partner site, that music is transferred to your music locker immediately so you can now listen to music instantly upon purchasing it, instead of waiting for your purchase to arrive through the mail. (Fischbeck, 2000, p.10)