



## Podcast: Online Music and Movies: Which of the New Digital Entertainment Models Offers the Best Value?

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It's been an exciting couple weeks for fans of digital downloads of music and movies. On September 14, Microsoft officially announced its Zune portable music player along with the Zune Marketplace download service intended to go head-to-head with Apple's iPod and iTunes.

Although pricing hasn't been announced, the Zune plans to introduce a number of clever features, including the ability to allow users to share music with friends by wirelessly sending tunes to each other for a limited number of plays.

Apple, of course, isn't standing still. Two days earlier, Apple announced several new models of its iPod music player but, perhaps more significantly, it also introduced the availability of movie downloads from iTunes -- which has now changed its name from the "iTunes Music Store" to simply the "iTunes Store" -- along with a planned device dubbed "iTV" to beam movies from your PC to your large-screen TV.

But that's not all. On September 7, Amazon.com announced its "Unbox" service offering downloads of TV shows and movies, with an option to either rent or own the digital movies. Apple, on the other hand, provides a "download to own" service only.

While it looks like the era of ubiquitous digital entertainment may finally be upon us, it's not clear that all of these models will prove to be successful. Knowledge@Wharton technology editor Kendall Whitehouse spoke with Wharton marketing professor [Peter Fader](#) and legal studies and business ethics professor [Kevin Werbach](#) to find out which of these approaches will deliver the best entertainment options to consumers and the most value for their companies' shareholders.

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**Knowledge@Wharton: Let's start with what's new in music downloads. One of the most noteworthy features of Microsoft's Zune will be the ability for users to wirelessly send songs to other Zune users, who can then listen to the tunes for up to three times, within a three-day period. Is this the killer feature for digital music that Microsoft hopes it will be?**

**Fader: That's not a killer feature. People have been finding ways to share music through authorized or unauthorized means for a long time and it's not clear that this is going to make their life any easier or better in that regard. The fact that it's a step beyond what the iPod offers is a nice indication. Of course, there are a lot of things that the iPod doesn't offer. I think it's increasingly clear that it's not the wonderful device that it was five years ago, but I think there's still a long way to go before people are holding in their hand a device that's going to meet all of their music needs.**

**Werbach: Yes, it's worth remembering that one of the killer features of the original iPod was that the version of digital rights management that it used allowed people to, not necessarily share music**



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**with other people, but share music themselves among multiple devices in a way that until then, the music industry hadn't permitted. I agree with Pete -- sharing is valuable. The ability to do it wirelessly, I don't think changes anything immediately, especially because it's only among Zune users, of which there are now approximately zero. Certainly, there will be more as Microsoft sells the devices but it's a proprietary system.**

I think though, that it's important as a signal that wireless is going to be an important piece of the digital distribution landscape. As we have companies like Microsoft and Apple involved who are playing this as software providers, hardware providers, systems and services providers and transaction platform providers potentially that wireless is going to be a significant part of the equation going forward -- but we're not all the way there yet.

**Knowledge@Wharton: Let's look at one other feature that the Zune as well as some of the SanDisk players will have that the iPod doesn't have. And, that's the ability to access content from a flat rate subscription service. Would Apple be smart to follow suit?**

**Fader: I think not only would Apple be smart to follow suit, I think they've been foolish for not following suit so far. It's very interesting that when they first announced the iTunes Music Store, it was one rant after another by Steve Jobs about how people don't want to rent their music, they want to own and so on. I think a lot of people disagree with that. But he hasn't made those kinds of statements, not nearly as frequently or as forcefully lately.**

So reading things into things, I think it's fair to guess that Apple will introduce something like that and when they do, two things will happen: It will be a huge success. I think Apple zealots will do whatever Steve Jobs tells them to do but this is something that will make their lives genuinely better.

Number two, it will legitimize the subscription model. Some of the new services, like Rhapsody and the new Napster and some of the Yahoo music services that have basically reached a plateau, will see new life when all of a sudden they can be viable choices to some of these newer services.

**Werbach: It's important to keep in mind that Apple's business here, and you look at it to a first approximation, Apple's whole business is selling iPods. They don't make any significant amount of money on iTunes. It's a leverage point to sell these devices, which have a very healthy profit margin.**

I think Pete's right that Subscriptions is an important piece of the business model puzzle that users want and therefore to the extent that not having that hurts Apple in selling iPods -- they'll go that way. But I don't think that they necessarily need to see it as a significant new revenue opportunity on its own.

**Knowledge@Wharton: What was interesting is that some of the new players like the Zune and the SanDisk are now apparently going to come preloaded with music that the user can listen to for some time and then later, after listening to it for a certain time, have an option to buy it. This reminds me a little bit of some of the security software that comes loaded on your computer when you buy it and then a few months down the road, you've got to start paying for it. Do you think that this is a clever idea when applied to music?**

**Werbach: I think it's only the lack of creativity of the music industry that's responsible for the fact that every PC you buy doesn't come preloaded with virtually every piece of commercial music ever recorded. The hard drives are there. That cuts out a huge piece of the distribution. It's easy enough to do rights management so that that wouldn't be widely available. I think we are going to see that as hard drive densities increase.**

We are going to see that for movies. If there's an opportunity to get any incremental revenue given that the cost is miniscule. Why doesn't every PC you buy come with 1,000 movies on the hard drive? So, we will see that. It's just that the music industry is so concerned about piracy. They're moving forward, I think, as they are being forced to by the market, but they're still not there.

**Fader: I also like the analogy you made to PC's that come loaded with software. People tend not to like those bundles. People tend to think, "This is cluttering it up". "I don't want it here". I think it is particularly true in the current case where they are putting on particular pieces of content, chosen out of million of alternatives, instead of giving people choices. I think it's kind of a lame**

**effort to give people value for their dollar and not only will it not create satisfaction, but it gives consumers the idea that these things are being forced on us, there's probably some kind of marketing deal. I think it raises skepticism more than it raises satisfaction.**

**Werbach: It is also, and I'm getting ahead as far as talking about movies, but it's going to be an important issue in terms of network capacity. Already, if you look at traffic on the internet, there are estimates that roughly a third of all traffic on the global internet is peer-to-peer file sharing. Most of that is video and not music, because the file sizes are so much bigger. But, as these services start to take off, especially as they go towards video, it's going to be a huge demand driver for network capacity. These alternatives that involve putting things on hard drives and not transferring them over the network each time are going to be important as ways to take some of that load off the network.**

**Knowledge@Wharton: Well, we may have been hinting at this, but let's take it head on. Pete, earlier you said, "It will be awhile before people hold in their hand a device that meets all of their needs." Let's spec that out. What would that be? What features would be the ultimate thing to play audio on?**

**Fader: It's going to be a device that has access to every song ever written, or at least every song that artists will allow to be transferred to users. It's not going to involve downloading. Downloading is not an enjoyable task. It is a necessary step that people have to go through to get access to their music. It will be much nicer to have access through a million, two million, and ten million songs, perhaps organized by genre or play list or whatever. When I'm walking down the street and I want to hear a certain artist, I don't have to say, "Darn, I forgot to download that this morning". So, it's going to be the "Celestial Jukebox" as Knowledge@Wharton has written about previously.**

It's also going to have other features as well. For instance, FM radio, because there are a lot of times when you don't want to choose, you just want to be listening to music in a more passive manor. A lot of current devices offer FM, but it's interesting that iPod doesn't for all the bells and whistles that is supposedly has. There are not the kinds of features that you might want to be holding in your hand for instance, recording capabilities -- whether it's recording the music, which is a controversial topic by itself, or even a voice recorder. So, there are a lot of simple features that can make this device more versatile, but they're not really on the table, at least as discussion points right now.

**Werbach: You know beauty is in the eye of the beholder. Everyone doesn't want the same device. I don't have an iPod. I don't have a music device. I have a four gigabyte memory card in my phone which is a Treo Smartphone, and I play music off of that. I download things off of Rhapsody on to that service. I don't want to carry two things in my pocket and I'm not going to go without my phone. That's just me. Obviously Apple's success shows that people will by iPods.**

People will make different sorts of trade-offs, but Pete is certainly right that even within the realm of music players, there's a way to go to get that full accessibility. Also, I think he's right, there are two modalities. One modality is that I want to hear this song or this artist. Another is that I want listen to the radio and that might not necessarily be FM. That could be streamed over the internet. There are services like Pandora and Last FM that have collaborative filtering engines to help people find new music. On the internet, getting those widely into mobile devices, I think will cause a great uptake of usage as well.

**Fader: I think the real battle isn't going to be over the specific features, and all that. It's going to be what will be the technology that brings it. Will it be Wi-Fi? That's what we're talking about a lot with Zune. Or can it be through the cellular networks that some people are starting to try, certainly in Korea and Japan, for instance. Or will it be through the satellite? There are a lot of different ways that it can happen. I think we should focus more on the technology that's going to bring it to us, rather than some of the bells and whistles that'll be sitting on top of that ultimate device.**

**Knowledge@Wharton: Well, that brings up the issue then of what are the constraints of getting there? Is it that there are still technology hurdles? Is it that the price point would be too high? Why don't we have that device now?**

**Fader: One reason why is the content providers, who have made it very difficult for hardware**

**manufacturers to develop and market this kind of device. You look at the controversy going on right now with the satellite radio that does allow you to record and the music industry trying to stop a device like that, that makes its customers happy. I think people are just much more hesitant about making those types of investments and to go to market risking loses before a device is even commercialized.**

**Knowledge@Wharton: Before we go on to the movie part of the discussion, I would just like to ask one question about Microsoft's strategy. Even though Kevin said that he doesn't have an iPod, clearly there are lots and lots of people who do, which is why Apple has a 75% market share. Seriously, do you think Microsoft is going to be able to take on Apple in this space?**

**Werbach: It's sort of funny to be asked a technology question about Microsoft, with the preface being, "Do you think they can possibly succeed"? Poor Microsoft! Can they take on Apple? Sure. Will they win? It's unclear. And it depends on what kind of market this is. Apple has succeeded wildly with the iPod and iTunes because it has great industrial design, a great user interface and a seamless experience connecting hardware and software. Lots of other people had the device and the service before and lots of other people are doing it; no one has done it so well. Microsoft is probably not going to beat Apple on design and user interface.**

On the other hand, Microsoft has a lot of pieces that Apple doesn't have, like a 95%-plus market share of Windows in the PC market, like the Windows PC platform, like the Xbox platform and relationships with content owners. Apple has a strong relationship with Disney because Steve Jobs is on the board of both, but Microsoft has all sorts of other relationships with content owners. So, you know, they each bring something to the table. The other piece is, to get back to what I said before, this is a piece of a larger battle for both of these companies.

I mean, for Apple it's more central because it's such a huge chunk now of their profitability. Microsoft, at the end of the day, could care less if they make money or not on selling a little handheld music device; it's a wedge into a huge business opportunity for all of their other products.

**Fader: It's interesting and perhaps sad, that we look at the players here and we're focusing strictly on hardware and that the content providers themselves are now kind of second-tier players, just providing stuff for these devices to play. It would be nice to see the industry shift, in a way, where the content providers have an equal say about the future of the industry, and I'm hoping that there will be a move in that direction.**

**Werbach: And where the innovation comes from the content providers--- I think that's a piece of it as well. I think the content providers resist the notion that content is this fungible thing, but that's partly because they've structured the market in such a way that they haven't been willing to come up with new models, to be open to mashups and various things people are doing with content, podcasts and so forth. That's innovation at the content level. Because it hasn't happened as much, the innovation has had to come from the hardware.**

**Fader: Of course, it's a good time to acknowledge the terrific news lately, the deal between YouTube and Warner Music, the deal about a week or so ago, about Universal making its songs available through a Spiral Frog service. So it's nice to see the content providers stepping up on their own, unilaterally, saying "Here's something that we think will make our customers happy", instead of all of them speaking with one voice, through lawyers. So there are signs of hope.**

**Knowledge@Wharton: Well let's switch now to what's new in downloads of Hollywood films. CinemaNow and MovieLink have offered downloads of films for quite a while now, with moderate success. Now Apple and Amazon.com have come into this space. So what's the secret to make this work?**

**Werbach: Well, there are a number of pieces to it. We're not at the end game yet. I think the market of people who want to access and download a full Hollywood film and sit there and watch it on their laptop screen, it's there, and it's something. It'll be something bigger but it's limited. The film experience is really and ultimately about getting it onto a TV -- you know one of those beautiful 40+inch, high-definition plasma TV's. But in order to get it there, you've got to get it into**

**your home to begin with, and that's where there's been this barrier--somewhat technological, somewhat industry-related and so forth. And each of these services is a move in that direction.**

The other thing is that Hollywood films -- whenever the discussion is about online video distribution, the talk always goes first to Hollywood films. It's a big industry, but the Hollywood film is a teeny piece of the potential video landscape and I think, with the kind of choice and possibility that's going to be out there, I actually don't think it's going to be the be-all and end-all of online video. It'll be sort of a nice teaser and people will pay a lot of money to see certain blockbusters right when they come out and own them and see them in super high-def. But most of the online video explosion is going to be other sorts of formats.

**Fader: It's interesting to see how people put Amazon and Apple, the new iTV service in the same sentence. They're very, very different from each other, especially when you look at the companies providing them. Amazon is a reseller of stuff. They make the sales process easy and they make a lot of things available. People don't necessarily hold them accountable for the stuff itself. That's great; so they can be in the movie distribution business, it's just another tab on the Amazon home page.**

Whereas Apple, for a variety of reasons, is more associated with the actual consumption and experience of the stuff and I think with iTV, they've gone a little bit too far, because this is a device and a service that lacks all the cachet of the iPod. It's a rather generic looking box; it's not something you carry around that will look cool and people will want to talk about. The service that it will deliver is going to be largely equivalent to the other services that exist and really no better--in fact, currently worse--than watching a DVD. And it's the first time that they've went into a fairly crowded market, against players not only like Amazon, but like Wal-Mart and I think it's going to be very hard for them to compete there.

**Werbach: On the other hand, I think they had to go there. I mean, Microsoft is in the living room with the Media PC and the Xbox. Apple needs to be there. I'd agree with you; the iTV device is not out yet, so all we've got are the tidbits that Steve Jobs has released and I agree with you, it's not clear that this is going to be a world leader device like the iPod was. But it's sort of, what took Apple so long to go into the living room?**

**Fader: But I'm not sure Apple needs to do that. I think Apple has survived being a niche player, picking its battles very carefully and doing them very well, in a world-class way. I think being just another "me too" player in a crowded market space--one where consumers are reasonably aware of the technology and aren't particularly satisfied with it--I don't think it's a place where they want to be.**

**Knowledge@Wharton: Speaking of Amazon and Apple, I wonder what you think of this rental model that Amazon has versus Apple's offer of letting you download a movie to play it and to own it indefinitely.**

**Fader: I have one word which is Netflix. There's a company that really embodies digital distribution, or non-digital distribution but contemporary distribution at its very, very best. I don't think anyone is dissatisfied with Netflix because they can't own. In fact, it's an enjoyable process to know that you can just dump the movie and get something else.**

I think the big deal about ownership -- again, a lot of that is attributable to Steve Jobs for obvious reasons -- is way overplayed. I think in a lot of situations, people would much rather rent and just have the option value that that kind of service provides.

**Werbach: Yes, I mean all these models are going to be there and it's sort of like saying with videotape rentals over the last 20 years, do people want to own or to buy? Well both, in different circumstances, depending on the price, depending on the movie. Companies like Disney have been very creative with DVD's in terms of offering different prices and formats and so forth and using multiple distribution channels. We'll see all of that. It's an artificial limitation, I would agree that rental is not a significant piece of this market opportunity but that will go away.**

**Knowledge@Wharton: Since you brought it up, let's talk about the price of downloading versus the price of buying the DVD. Reportedly, Wal-Mart, which sells a lot of DVDs, isn't pleased at the price point of the downloads. And they're actually pushing back to Hollywood, saying that their**

**wholesale price for DVD's has to come down, so they don't have to charge more for the DVD than other places charge for the download. Should Hollywood pay attention?**

**Fader:** That's another advantage to the rental, to the subscription model. It shields people from the price of each piece of content. It's very hard to look at a monthly fee and break it down to a per use basis. Again, you're just paying for option value at that point. That's one nice way to avoid the wrath of Wal-Mart because they're a difficult company to contend with.

**Werbach:** Yes. Hollywood originally wanted DVDs to be \$70, \$80, \$90 each for movies, which was what they were. Then Warner Bros. had some visionary people there who said, "There's this thing called the 'elasticity of demand'. You bring the cost down to \$20, \$25, \$30 -- people will buy DVDs who never would have thought of buying DVDs. The best thing that ever happened to Hollywood was this massive explosion of DVD rental because they dropped the price, which they didn't want to do early on.

Again, there are different models for pricing content. You think about what's television worth, broadcast television as we know it? Is it worth something? The television industry would say it's worth an awful lot. What do they charge for it? Well, nothing. It's free. It's a \$30, \$40, \$50 billion industry -- I don't know what the current numbers are - entirely based on advertising.

You could say, "Well, no one can compete against free." Sure you can compete against free. There's cable. Now, at the same time that people are giving away this valuable TV content, you have other subscribers paying \$100 a month for the same stuff that broadcast is giving away. Again, the market will find its price points and its models. There are multiple ones that are going to work. It just sort of takes a while for the industry players to be willing to go along with that.

**Fader:** One other point that I want to add to that is from the consumer perspective, not just from the supply side. Consumers don't mind paying money when they get a thing, not only something that they can experience but they can put on their shelf and have in their hands. If you look at people buying content over the internet, if you think about it, video on demand has not been nearly as successful as everyone projected five, ten years ago. What we're talking about these movies is just another version of video on demand. I think it's very important to sort out the way that people buy content, whether it's digital or hard copy. I think the price points need to be taken into account in that respect as well.

**Knowledge@Wharton:** I'm sure we could talk about this for another couple of hours but I wonder if I could have your views on one last question. Do you have any advice for Apple, Microsoft, Amazon, or anybody else who is trying to get into these two markets - digital movies or digital music? What's your advice?

**Fader:** Part of it is that I have a lot of respect for both those companies. They approach their businesses in very different ways and I think that that's ultimately good for consumers. And it's just fun to watch these different experiments play out. We keep talking about Microsoft and Apple when there are a lot of other players on the fringe, companies like MusicGremlin that's already come out with a wireless device.

So I think we just want to encourage innovation, we want to encourage consumers to go out there and try these things, we want to encourage markets to report accurately on how well all these devices are doing and I think then the world will be better for everybody.

**Werbach:** Long term, the content wants to be free and people want access to everything, however they want it, which means an interoperable world -- none of these things we're even close to with the proprietary nature of the platforms and digital rights management and so forth. Short term, that's not going to happen, long term, it's inevitable. So I think the question would be, how do you survive in this current world where there are all sorts of artificial constraints, some of which these companies put on themselves for business reasons.

I mean, look at Sony, which keeps shooting itself in the foot for being even more proprietary than anyone else. How do you not kill yourself over the long run in a situation where a lot of these things will be commoditized and it will just be a platform for new kinds of higher-level innovation, as we've seen with

basically everything else on the internet? It's the Google's that come around later and create innovation on top of the platform that ultimately generates the most value.

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