Which Online Music Service Will Have the Longest Playing Time?

Since May 2003, when Apple's online music service, iTunes, opened its digital doors, the drums announcing other online music services – new enterprises as well as existing music services spruced up and recharged – have been steadily beating.

MusicMatch. BuyMusic. Rhapsody. Listen.com. emusic.com. MusicNet.com. A new Napster, legitimized by Roxio, a vendor of multimedia programs. Wal-Mart. Even, it has been said, Microsoft and Virgin Entertainment Group.

Indications are strong that the companies behind the services have reason to think that profits can be made in online music. iTunes sold 20 million tracks in its first seven months of operation. Rhapsody's 250,000 subscribers paid to listen to 28 million songs in October, up from 11 million in June. Between June and November, music lovers bought 7.7 million songs online, but only 4 million single-song CDs at stores.

The future looks good, too. Jupiter Research expects online music sales to grow to $3.3 billion by 2008. Forrester Research, for its part, expects that within just four years online music will account for 33% of the music industry's sales.

But behind the vaunted successes and the optimistic predictions lurk at least two big questions: Which online music vendors, among the nearly one dozen operating today, have found the business model that will guarantee they will be around in 2008 to share the profits? Can the for-fee services make a dent in the billions of musical tracks exchanged, at no cost, on pirate networks?

The online music business models now being used include:

* The a la carte approach, favored by the likes of iTunes. Customers can buy individual tracks for 79 cents to $1.20 or albums for $9.99 and up, and buy as few or as many tracks as they want. They can, after downloading music to their hard drives, also burn it to CDs, copy it to portable music players or, if they have the right equipment, stream it around the house by way of their existing entertainment centers.

* The subscription model. Customers pay a monthly fee and then download a specified number of songs each month. For $9.99 a month, emusic lets its customers download 40 songs and use them in whatever way the buyers want. For $14.99, customers get 65 songs.

* The streaming model, such as the one used by RealNetwork's Rhapsody. Music lovers pay a monthly fee, then listen to as many songs a month as they can stand. Downloading is extra, usually under a dollar a track.

And the Winner Is ...
To some extent, all the models could fly. Larry Kenswil, president of eLabs, the media and technology division of Universal Music Group, suggests that music, like movies, should be able to thrive in a wide variety of channels: "People can watch a movie (at a theater), or on video, or on a pay-per-view channel. They have a dozen ways."

Some experts, though, are betting that the ranks of the online music vendors will thin out because technology, consumer preferences and costs will conspire to create a dominant business model. Wharton marketing professor Peter S. Fader says all the signs point to the eventual emergence of streaming as that model.

For the moment, though, the models based on selling tracks and albums will predominate because that is how most people have learned to obtain music online, Fader notes. Perhaps more important, downloaded music is portable. It can be burned to a CD for listening in the car. It can be put on an MP3 player for listening while jogging or flying. But, in the end, downloading is burdensome, Fader suggests. "Obtaining the songs is a nuisance. It's a pain to download them, to organize them, to back them up."

And when you come down to it, Fader adds, people really don't care much about having physical ownership of their music. What they really care about is having access to the music they like, when and where they want it.

Given that preference, financial and technological advantages will help the streaming model win out, Fader says. For downloading services the margin of profit is usually too thin. The download services pay music labels around 79 cents per track in royalties. Another 5 cents or more per track goes to credit card companies to cover transaction costs. Add in operating costs and the 99 cents or so in per-track revenue does not leave much room for profit.

By contrast, the streaming services pay the music industry less in copyright fees – as little as one cent or less each time a song is played – because the ownership of songs that are streamed but not downloaded does not pass to consumers. Perhaps more important, rapidly changing technology – including the spread of satellite radio, the development of phones that double as portable jukeboxes and the advent of MP3 players capable of receiving streamed music – will increasingly give consumers their music on demand while freeing them from downloads and all the attendant hassles, Fader says.

In fact, he adds, the future is already here. In November, Real Networks and cable provider Comcast struck a deal under which Rhapsody's streams will be offered to Comcast's broadband Internet service subscribers. "Just imagine when Rhapsody is available as a Comcast add-on, bundled into your bill. It is an incredibly efficient distribution network for Rhapsody," states Fader. "Streaming will win. It always [does]."

The Lure of Ownership

Not everyone, however, agrees. Apple's Steve Jobs recently told *Rolling Stone* magazine that music ownership is an ingrained habit, one that will always prevail: "People don't want to buy their music as a subscription. They bought 45s, then they bought LPs, they bought cassettes, they bought 8-tracks, then they bought CDs. They're going to want to buy downloads." Jobs, of course, is the mind behind iTunes and so could be somewhat partisan. But he may have a point because even with music it is important to remember that people – especially Americans – like to own things.

Moreover, the streaming model has inherent risks. Subscribers live with the possibility that their provider may go out of business, leaving them with nothing to show for months of subscription fees. The same is true for music lovers on a limited budget or those who have a limited tolerance for hikes in subscription fees. If, for financial reasons, these consumers are forced to end their music service, they are then permanently divorced from their music.

Even if personal finances don't come into the reckoning, this consideration exists, at least for now: Just about each of the online music services – whether it offers streamed or downloaded tracks – has glaring gaps in the genres of music that don't fit the top-40 mold, namely Latin music, gospel, jazz and classical, among other forms.

Music lovers who have eclectic tastes and who stick with downloads can flit from download site to download site to fulfill their varied tastes in music, one track or one album at a time. Consumers who buy into the streaming model and pay a monthly or annual fee are stuck with what their service offers them – or face paying additional fees at other sites that offer music their service does not.

Still, online music services which depend solely on selling downloadable tracks and albums may be bucking a marketing reality. The conviction that consumers will want to buy music for downloads depends a great deal on the notion that many people own large hard drives and portable MP3 players they would just love to fill with music.

Some experts think that is wishful thinking. Says Phil Leigh, an analyst who runs his own Tampa-Fla.-based firm, Inside Digital Media: "A 40-gigabyte iPod holds 10,000 songs. How many people will spend $10,000 to fill it up?" The fact that many people won't is one of the reasons Leigh thinks that the right business model for hawking music over the Internet is a hybrid that incorporates both streaming and downloading.

Leigh says his own experiences highlight the advantages of the hybrid model. "I recently had a weekend guest who loves Norah Jones. With a celestial jukebox such as Rhapsody, she could play all the Norah Jones she wanted while she was here. If I had wanted to satisfy my guest's appetite for Jones on iTunes I would have had to pay $10 to $20 for the tracks and I would have had no use for them after my guest left. But I also discovered Judy Garland on Rhapsody and then wound up burning three of her songs from 'Meet Me in St. Louis.'"

Looking for Repeat Business

The debate over business models ignores, in the eyes of some experts, other important steps online services will have to take if they are to survive and thrive. One of those steps will involve figuring out how to bring customers back, according to Mike McGuire, research director, media, at Gartner/G2. "It's the same problem the Samarian grain dealer faced 4,000 years ago. How do I get that guy to come in and buy my grain again next year?" Some sites try to bring in repeat business by having their staff recommend their own favorite songs. "Give me a break," McGuire says. "Who cares?"

The better approach, one that will most likely have to be part of a successful business model, is to create a sense of community among buyers or subscribers – not unlike the sense of community the original Napster as well as Kazaa and Morpheus have created among their users, McGuire says.

Within a music service's community, buyers would suggest songs to each other, exchange ideas about the music they buy and perhaps even offer each other snatches of songs. It is an approach with which Rhapsody and the new, legitimate Napster are already experimenting. Rhapsody allows subscribers who also have web logs, or blogs, to place a link to Rhapsody songs on their sites. When other Rhapsody members access the blog, they can read the bloggers' comments about the song and, if intrigued, use the blog link, which Rhapsody calls a RHAPlink, to hear the music themselves.

"Napster allows its subscribers to share playlists," says McGuire. "So if I like Stanley Clarke's 'School Days' I can click on a link and see what other people have the song and what their collections look like. If I find that some guy in Arkansas has Clarke I can look at his list and check it out" – and, of course, listen to samples of that music to expand his horizons.

The big unknown lurking behind any discussion of successful online music business models is whether any model can truly prosper as long as pirating networks continue to operate successfully on the Internet. New pirating networks crop up continually, including an increasingly popular one based in the Jenin Palestinian refugee camp. Kazaa, which replaced the old Napster when Napster came under legal fire, can boast that its file-sharing software has been downloaded more than 250 million times. All in all, according to some estimates, pirated-network users exchange some 5 *billion* tracks a day – a number that dwarfs iTunes' sales of 20 million tracks in six months.

But Leigh from Inside Digital Media, McGuire from Gartner/G2 and Fader are optimistic that, in time, the legitimate music sites will push back the tide of piracy and turn freeloaders into paying customers. "It is a misconception that (for-fee services) can't compete with free networks," says Leigh. "You and I can get free Internet access, but we don't do it because we don't want to put up with the limitations of free service."

Ultimately the limitations of pirate networks are significant. Songs obtained through them are often truncated, either at the beginning or at the end, because they were inexpertly transferred from a CD, tape or vinyl record to the hard drive by the person offering it up for copying. Despite the inroads cable and DSL modems are making into homes, the vast majority of private computers are still on conventional phone modems. Even if the sending computer's modem doesn't hang up in mid-transfer, downloading any more than a handful of songs through a 56L modem is a frustratingly long experience.

Perhaps more important, an increasing number of pirate network devotees are finding that while downloading music, especially through Kazaa, they are also downloading malicious code – perhaps a virus that destroys their data, a worm that uses their computer to launch itself to hundreds of other PCs, a Trojan horse that uses their machine to spawn spam, or spyware that subjects them to marketing pitches and interferes with the efficiency of their PCs.

Increasingly, the thinking goes, even teenagers will grow weary of the hassles and gratefully turn to paid services. Says McGuire: "You can compete (with the pirates) by offering music in a convenient way, providing reliable quality and making sure that (buyers) can manipulate it as they like within legal limits."

Fader puts it simply: "I was a big downloader of Kazaa, but when I tried Rhapsody, I felt I was a free man."
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