Couch Potato Famine: Prospering Through an Era of Disruptive Change in Media

Part II – Network Effects

From FTI Consulting—A Four Part Series on Media

By Bruce Benson

May 2007

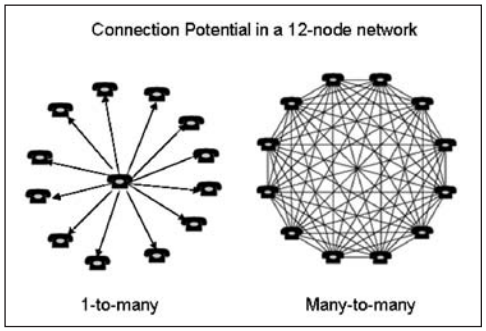
FTI®

Introduction

The goal of our four-part series is to help media and entertainment executives understand the underlying causes of the disruptive change afflicting their industry and to lay out broad strategies for adaptation.

In Part I of this series we discussed the three titanic forces that are disrupting the industry. They are the rise of open standards, the proliferation of broadband and the emergence of many-to-many networks like YouTube, peer-to-peer sites and MySpace. Because these many-to-many networks are a new form of content distribution, this second part of our series will focus on the economic behavior of these networks.

Many-to-many networks are now disrupting conventional broadcast and retail distribution. In Part I we described the power of these networks in terms of the speed in which content can be shared and the shear number of people who can interact. We also noted that they have some unique economic properties which we promised to explore in this part of our series. In this part of our series we will examine how these networks emerge, how they compete, and content owners' best strategies for co-existence with these networks.



Economists have been studying the behavior of networks for quite some time in a field they call *network economics*. By network economics they don't mean the financial mechanics of TV broadcasting[1]. Instead they mean the study of goods and services whose usefulness is determined, in whole or in part, by the number of other consumers that use it. They say such goods and services exhibit "network effects" or network externalities. A lot was written during the first dot com era about network economics. Several best sellers such as *Information Rules*[2] and other books brought the concept of network economics into the spotlight. However, these books did not anticipate the emergence of these many-to-many networks. Consequently the goal of this paper is to resuscitate some of these principles, bring in some of the newer thinking from economists, and describe a few principles of our own.

Rupert Murdoch understood the importance of network economics when he bought MySpace. MySpace is a very popular service with the tools to allow like-minded people to find and affiliate with each other semi-privately. Since buying this large and growing network, he has begun to systematically infuse it with media—first music, and now news and video. *Indeed, it is not too much to suggest that those media companies that master these new network effects are the ones most likely to prosper on the internet.*

In this paper we set out 10 principles that we believe are the foundations of competition and partnering with these large networks. We develop these principles throughout the first two sections which describe the special economic behavior of these networks and how they compete. In the third section we discuss some of the strategies available to the various segments of the media and entertainment industry in coping with these networks.

As we write this, two titans, Viacom and Google, are clashing. Viacom has sued Google's YouTube service for $1.5 billion for infringement. As much as anything, this struggle is about who has the power in a many-to-many networked world.

1 For readers interested in the financial characteristics of these industries, we recommend Harold Vogel's *Entertainment Industry Economics*, Cambridge University Press.

2 *Information Rules* by Carl Shapiro and Hal Varian, Harvard Business School Press, 1999

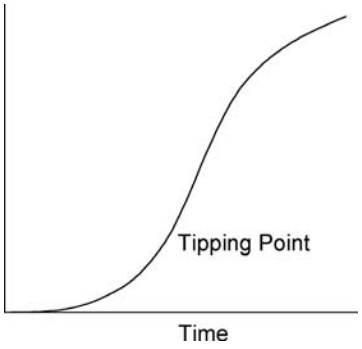
The Behavior of Network Goods

A Definition. We will coin the terms *network goods* or *network-dependent goods* to mean a product or service whose usefulness is determined by the size of its network of members. Skype, eBay, faxes, telephones, and MySpace are network-dependent goods. If their users couldn't interact, they'd be useless, and the more members the more useful they become. This paper focuses primarily on this class of network-dependent products and services. Note that all these types of services require a many-to-many network between their users since they have to interact. This network can be physical, like the phone company's, or virtual like eBay's.

It's important to stress that just because a service is delivered through a network doesn't always mean it's a network good. Portals like Yahoo! are not network goods. Their usefulness is not dependent on the size of their network. This is because the users all come and pull information from a central Yahoo! site, the members don't interact. This is true for TV networks as well. They are not network goods because their utility to a viewer is not a function of how many other viewers there are. In theory, viewers would receive the same broadcast whether there were 200 or 2 million viewers. These types of networks rely on one-to-many (broadcast) networks for delivery.

With these preliminaries out of the way, let's look more closely at the behavior of network goods.

Network size and tipping points. Network goods have an adoption pattern shaped like an S curve. Historically, network goods have taken a long time to incubate in the market before they hit a tipping point that ignites rapid adoption. As we noted earlier, this happened with fax machines. Faxes had a small market niche in filing flight plans of all things, but they only caught on for general business use when there was a sufficient number of them in the workplace.



Some network goods, of course, don't survive long enough to reach a tipping point. Video phones are a good example. Consumers didn't buy them because none of their friends and family had them, so they were not very useful. Unable to find a market niche where they could hang on until their penetration grew to spark a tipping point, they died still-born. The concept has been resurrected anew with Skype Video. However, Skype first achieved network size in voice calls between computers, then began offering video after their network of consumers was built.

When two similar services are launched in the market and are network-dependent, a battle ensues to build the underlying size of their network. This is because a service's value to the customer is determined by the very size of the network it offers. The more members, the more useful it is. When AIM launched in May of 1997 it wasn't useful until a sufficient number of people joined. MSN's Messenger service was launched several months later. But once AIM's network reached sufficient size, new customers, facing a choice of which program to use, naturally opted for AIM because it had the largest network. This leads us to our first principle of network goods:

PRINCIPLE 1: Consumers are usually compelled to use the service with the biggest network.

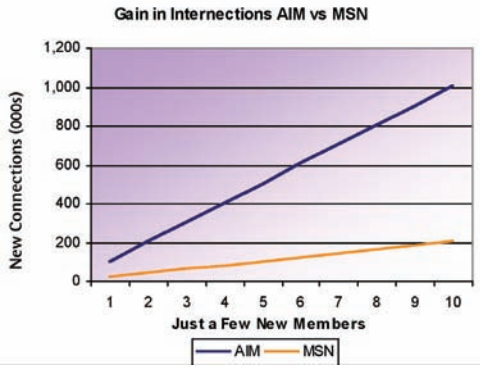
We use the word compelled in this principle to indicate something far more powerful than the mere size advantage of the network. Size, like the number of retail stores in the WalMart chain, is a passive advantage. It's a measure of convenience for the consumer. But a big network is different. Its size advantage makes it exponentially more useful and usually dominates the consumers decision making process. This is because the

network with the most members enables more interactivity which is what the consumers are seeking. In eBay's case this means more buyers and sellers, in YouTube's case it means more amateur video is contributed and shared, and in Skype's case it means users can call more people.

A tipping point is ignited when the network good hits a critical mass of users and it moves from having niche utility to mass utility. Because the value of the network increases with its size, a positive feedback loop ensues—more people join, it becomes more useful, and even more people join. This leads us to our second principle:

PRINCIPLE 2: Being first to market is an even bigger advantage for network goods.

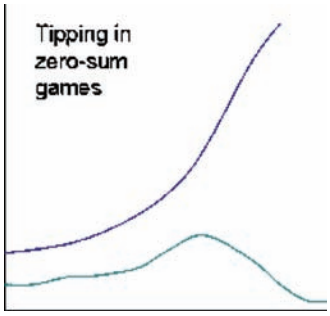
The original service that starts up in a market initially has the bigger size, and Principle 1 says this is where new members will gravitate. Since the service gets more valuable with size, it follows that the first network will usually grow faster and reach a tipping point sooner than later arrivals.



This disproportionate advantage also shows up in the mathematics. Say AIM initially had 50,000 members versus MSN's 10,000. If they each add just one new member, then AIM will gain 100,000 new connections while MSN only gains 20,000[3]. The chart at right shows the growth in connections as both add 10 new members. Of course, consumers don't do this math, they simply join the one that is more likely to connect them to people they want to reach.

We feel compelled to warn that being first to market isn't a guarantee of success or popularity even for network goods. The features of the service have to be the right ones. (For an excellent elaboration on this subject, see the book *Fast Second* by Constantinos Markides and Paul Geroski[4].)

Network goods and zero-sum games. Networks are often incompatible, meaning that members of one can't interact with members of another. When networks are incompatible, the race for consumers is often a zero-sum game, meaning that a gain of a particular member by one service is a loss to the other. In such cases, when a tipping point is reached, one service will enjoy a positive tipping point while the other can suffer a negative one.



3 Metcalf's Law: An interconnected network with N members enables N2 connections. With one additional member, AIM would enable $50{,}001^2 - 50{,}000^2$ or 100,000 new connections.

4 Josse Boss Press, Copyright Wiley and Songs, 2005.

This has played itself out in the zero-sum competition between MySpace and Friendster. Both were early social networking sites for teens. However, MySpace has proven far more popular. Since teens don't need two such services, every gain by MySpace has been a loss for Friendster, and its future looks bleak. (See chart to below.) This gives us our third principle:

PRINCIPLE 3: In a zero-sum competition between network goods, the winner takes all.

Facebook, another social network, would probably suffer the same fate as Friendster, except that it initially found safe harbor with the College and High School crowd who want to interact privately with other students but not with the world at large. We'll discuss this notion of safe-harbor later.

Not all network goods are zero-sum. Today there are several P2P services for sharing music and people often use several of them. They are network goods because they depend on their members to share their music and videos. Yet because not all services have the same content, consumers will join several.

MySpace vs. Friendster

Market Share of US Internet Visits to Top 20 Social Networking Sites February 2007

Rank	Name	Domain	Market Share
1	MySpace	www.myspace.com	80.74%
2	Facebook	www.facebook.com	10.32%
3	Bebo	www.bebo.com	1.16%
4	BlackPlanet.com	www.blackplanet.com	0.88%
5	Xanga	www.xanga.com	0.87%
6	iMeem	www.imeem.com	0.73%
7	Yahoo! 360	360.yahoo.com	0.72%
8	Classmates	www.classmates.com	0.72%
9	hi5	www.hi5.com	0.69%
10	Tagged	www.tagged.com	0.67%
11	LiveJournal	www.livejournal.com	0.49%
12	Gaiaonline.com	www.gaiaonline.com	0.48%
13	Friendster	www.friendster.com	0.34%
14	Orkut	www.orkut.com	0.26%
15	Windows Live Spaces	spaces.live.com	0.18%
16	HoverSpot	www.hoverspot.com	0.18%
17	Buzznet	www.buzznet.com	0.18%
18	Sconex	www.sconex.com	0.14%
19	MiGente.com	www.migente.com	0.11%
20	myYearbook	www.myyearbook.com	0.11%

Note - data is based on custom category of 20 of the leading social networking websites ranked by market share of visits, which is the percentage of traffic to the site, based on Hitwise sample of 10 million US Internet users. The percentages represent the market share of visits among the websites within the custom category.

Source: Hitwise

Negative tipping points occur with non-network goods as well. Owning an iPod has become "cool" and the resulting bandwagon effect has made it the product of choice. Since a consumer doesn't need two such devices, the MP3 market is a zero-sum game. Consequently sales of rival products suffered declines as the iPod exploded in popularity. However, the iPod is not a network good. The faddish popularity it enjoys can eventually be overcome by rivals who strive to imitate its sleek design and features. This eventually happened with the Sony Walkman. But in the case of network goods, network size itself is often the dominant and most valued feature and is much harder for rivals to overcome. *Network size cannot be imitated in a factory; it must be hard-won in the marketplace.*

Lock-in and Compatibility. This brings us to the issue of consumer lock-in and switching costs. Just as people will join the bigger network, they will be unwilling to leave the bigger network for a smaller one. The network's size creates a switching cost, and the consumer is locked in. If Skype has a network with 14 million members and if Verizon had a similar service with 2 million members, most Skype members would not be tempted to join Verizon. If some Skype consumers did switch to Verizon, they would loose 12 million connections (14 million – 2 million). This is their switching cost. Hence our fourth principle:

PRINCIPLE 4: In incompatible networks goods, the bigger the network the greater the lock-in.

It may seem that based on the foregoing four principles the largest network wins, and there is nothing the smaller players can do. Fortunately this isn't true, and we'll explore the general subject of network competition later. However, one key tactic in minimizing the leader's network size advantage is to become compatible with his service. Once two services are compatible, consumers are no longer locked in due to network size. For instance, in the example above, if Verizon and Skype made their services compatible, a Verizon member could call a Skype member without changing services. They would also gain access to a total of 16 million people, increasing the utility of both services. This leads to principle five:

PRINCIPLE 5: The leader's network size advantage is neutralized and consumer utility is increased when networks become compatible.

The two services will still compete for market share in terms of quality of service, ease of use and price, but no longer on network size. When do two competitors decide to become compatible and why? Again, we'll discuss this in the next section.

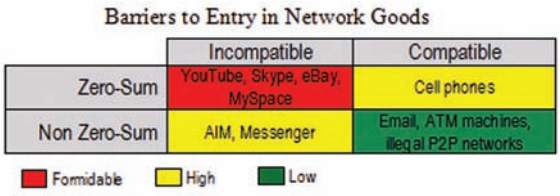
Only One? It is very interesting to note that many of the network goods we have been discussing completely dominate their category: Skype for free computer-to-computer phone service, eBay for internet auctions, MySpace for social networking and YouTube for amateur video. This gives rise to a final principle, which we have to caution is more of a conjecture, but is supported by our observations:

PRINCIPLE 6: For some network-dependent services, the market only wants one.

In the case of eBay, the consumer is better off with the largest auction marketplace possible. Sellers are better off because they can reach a huge number of bidders and they only have to put their items up for bid in one place. Equally, buyers are better off because they are more likely to find items they're looking for at the price they want in a huge market place with lots of sellers. YouTube is another example. People wanting to share their amateur creations with others find it very convenient to put their videos on one service that reaches millions rather than several smaller services. Similarly, people wanting to watch amateur video would rather go to one place where the videos have been viewed and rated by many other people. In short, consumer utility is maximized when there is a single service. This is very rare in conventional economics. In conventional economics, competitors slug it out until two or three winners are left standing. Since consumers want competitors—at least to ensure there is a check on monopolistic pricing and continued innovation—there is always room and a need for a second or third supplier.

These "market spaces" are very hard to dislodge by competitors. Before Google bought YouTube, it tried to launch its own video sharing site, as did Yahoo and MSN. It got no takers. The market only wanted one.

This chart summarizes the competitive barriers to entry that new services face as they try to enter the incumbent's many-to-many market.



The first row shows zero-sum markets, in which the consumer typically doesn't need or want to belong to two services. Naturally, barriers to entry for a new entrant are high because he must get consumers to switch. The top left cell is where the zero-sum and incompatible networks live. These are the most formidable for new entrants, as we noted just now in Principle 6, the market may not need two of them. Barriers are less so in zero-sum markets when the leader's network is compatible (top right cell) because the consumer can easily switch between the leader and the new entrant. Cell phones are an example.

The second row of the chart shows non-zero-sum markets, where the consumer is willing to belong to two services or own two products. Things are a little easier for new entrants, but network incompatibility is still a high hurdle. Not surprisingly, network goods that are both non-zero-sum and compatible (shown in green) have the lowest barriers to entry, like a new email program. Media companies should keep this chart in mind as they develop their strategies. We'll discuss this extensively later in this paper.

Competition and *Co-opitition* in Network Goods

Barry Nalebuff from Yale and Adam Brandenburger from Harvard wrote the book Co-opitition in 1996[5]. Using results from game theory they brought to light how competitors can often maximize their position through strategic cooperation with competitors—a concept they called "co-opitition". We'll first discuss competition among network goods then look at co-opitition in terms of network compatibility.

Competition. In terms of competition between networks, we want to focus on when consumers switch from one network good or service to another. In conventional economics, competition rages around benefits and price. Consumers are looking for the product with the most benefits and least price. In addition, for some goods and services, there are switching costs that make it harder to switch brands or services. Conventional economics has boiled all this down to the following relationship: Consumers switch to a new product when its

BENEFITS › PRICE + SWITCHING COSTS

This means that when the perceived benefits of the product or service exceed its costs and the consumer's other hassles of switching, the consumer is susceptible to switching. (This doesn't guarantee they will, humans are extremely inert. In this sense the role of marketing is to overcome their inertia.) As an example, a consumer may switch to a Mac from a PC when the perceived benefits of a Mac (such as better graphics and slicker design) exceed the price of the Mac and the hassle of switching all of their files from their old PC.

Network economists have added an additional variable to this switching relationship, which is the gain in network size when switching. So in network economies, consumers switch when:

BENEFITS + NETWORK SIZE GAIN › PRICE + SWITCHING COSTS[6]

In our previous example of Skype vs. Verizon, a person who originally joined Verizon with 2 million members might soon realize that they'd be better off joining Skype with its 14 million members, a network size gain of 12 million. Since the services are both free, there's no price issue, and because they are both very intuitive there are no switching costs. Hence the Verizon members will always switch to Skype. Note that if Skpe's voice quality was worse (a switching cost) or Skype wasn't free, then the consumer might forestall switching.

The relationship above is more profound than it may seem. If Rupert Murdock's purchase of MySpace turns out to be a winning bet, the battle that other companies will wage to switch consumers away from MySpace will be fought over the variables in this switching equation.

Often on the Web, the price of both the leader's and the competitor's service is zero, and switching costs are minimal, so the battle is all about benefits vs. network size. Since consumers won't switch from a big network to a smaller one without a very good reason, the benefits of the smaller competitor's service will have to be very significant in order to entice the consumer to switch.

This discussion about competition and switching can be summed up as a single principle:

5 Published by Currency Doubleday, 1996

6 Derived from Oz Shy's The Economics of *Network Industries*, Cambridge University Press, 2001.

PRINCIPLE 7: To switch consumers away from the network size leader, competitors must significantly exceed them in benefits while minimizing price and switching costs.

This principle demonstrates why defeating illegal P2P networks is so difficult. P2P services are the network size leader in music. The number of illegal downloads per month far exceeds paid downloads. But legal competitors who want illegal consumers to switch to their service have fewer benefits to offer because legal services have fewer songs and awkward copy protection schemes. Of course prices are higher on legal networks, and so are switching costs because the consumer has to buy and download their entire library. In short, there is no dimension in the switching equation above in which the legal network can trump the illegal network. The requirements of Principle 7 cannot be achieved.

The best way for smaller competitors to neutralize the network size advantage of the incumbent is through compatibility, let's now turn to coopitition.

Co-opitition. When and why does a market leader decide to co-operate with competitors and make their network or product compatible?

The key thing to observe about incompatibility is that it's more expensive than compatibility. There are four main reasons for this:

1. When a service is incompatible it has to develop and maintain its own compliments. For example, in the case of iTunes it has to maintain its own proprietary song store, its own song format and security system (DRM). This is far more expensive than relying on open standards.
2. Incompatibility limits the size of the market for each competitor. The fact that AIM users can't converse with Windows Messenger users limits the size of AIM's network. Today, new users have to pick the one that lets them chat with the most friends or co-workers (or use both).
3. The marketing costs to explain to consumers the virtues of your incompatible system are higher, which reduces profits.
4. When services are incompatible, the underdog will undercut the prices of the leader. This forces the leader to react in kind, driving prices and profits downward. But when services are compatible there is less competition around pricing. ATM machines are an example. Banks used to have incompatible ATM networks, but rival banks would cut their fees to attract customers. It eventually became clear to the banks that fees would be higher and their customers would be happier if they made their networks compatible, and so they did.

CASE STUDY: iTUNES

In February of this year, Steve Job's wrote an open letter to the music industry suggestion that the industry move away from copy-protected and propriety song formats to the open standard, MP3. This is a case of the market leader arguing for compatibility. But this isn't egalitarianism on Mr. Job's part. Based on the foregoing discussion of compatibility, we can surmise that Apple has concluded that profits would be higher if they didn't have to maintain a proprietary DRM and song format, that the market would be larger because consumers are no longer confused by different DRM standards, and they would get a disproportionate share of device and song sales as the market leader.

This is a move that most of the record labels are resisting. They feel selling unprotected songs will provoke more piracy. It's interesting to observe that Apple's other option to achieve compatibility would be to license its Fairplay DRM and song format to its competitors. This too would create compatibility while driving license revenue to Apple. Since it is unlikely that the music industry will give up on DRM, Apple may take this course of action.

Since the cost of incompatibility is high, profits are lower for all competitors than they might be under compatibility. Consequently there often comes a point in the market leader's progression when they have gained as much market share as possible under incompatibility and will shift to compatibility. In doing so, they pick up probably more than their fair share of the fence-sitting customers while lowering costs and improving profits. In addition, the leader can often create this compatibility by licensing access to their dominant

technology or network and thereby also gain new revenue from their competitors. This gives us an eighth principle:

PRINCIPLE 8: Since compatibility is more profitable, the market leader will usually shift to compatibility after capturing his market share under incompatibility.

This observation about compatibility applies to network compatibility or to compatibility around other proprietary standards such as song formats or reservation systems for airlines. See insert above regarding Apples' proprietary iTunes song format.

The Logic of Compliments. When content is distributed on a many-to-many network, the network and the content shared on it are compliments. They are both required to deliver the content to the consumer, and the service cannot exist without both. While co-dependent, the network distributor and the content provider are rarely equal. A large network like MySpace has significant pricing leverage over content owners, but with smaller networks the content owner has pricing power.

One important way to gain a price advantage when the players are complimentary is to commoditize your partners by finding several suppliers of the needed compliment. This is easy to see in the case of Yahoo News, who can commoditize its national news suppliers by making deals with Reuters, AP and even have its own journalists. This creates price competition among Yahoo's news suppliers and weakens the suppliers' pricing leverage. Equally, content owners will seek many distribution partners so that no one of them has much power over the content owner. This gives us our ninth principle:

PRINCIPLE 9: Complimentary partners in a network will attempt to commoditize each other.

A special case arises when there is only one source of content or only one significant distribution partner. Owners of unique content like a hit movie know its distribution partners can't get it anywhere else and so they can't be commoditized. This leads to their favorite axiom that *content is king*. But this is really only true when there are multiple distribution outlets. When there's only one major distributor, content isn't king. In the case of iTunes, who owns 90% of the digital music download market, iTunes has set a uniform and low price for all songs of 99 cents. They have virtually commoditized the music labels' content. Consequently when content owners with desirable content come up against a dominant distributor, things can get fractious. We've already mentioned the lawsuit between Viacom and YouTube. Another example is TV studios and distribution on iTunes. Many of the TV studios don't want to be commoditized by iTunes the way the music labels have been, and most are being tepid in their commitment to Apple.

This leads to our last principle:

PRINCIPLE 10: Complimentary networks exist only when the participants' revenue models are aligned.

This is not quite as obvious as it sounds. Of course, the participants in a delivery network won't do business with each other if they can't make money, but it's how they each make their money that makes the partnership possible. For example, MTV distributes its content nationally through various cable companies. The two parties have found alignment: the cable companies make money through subscription fees to the consumer, while MTV makes money through advertising within the content. (MTV also get some licensing fees from the cable operator.) This is not the case with YouTube. Both the content owners and YouTube's parent, Google, want to make money from advertising *in the content*. To date, they can't agree on a revenue sharing arrangement or who owns the customer relationship. Their business models are out of alignment.

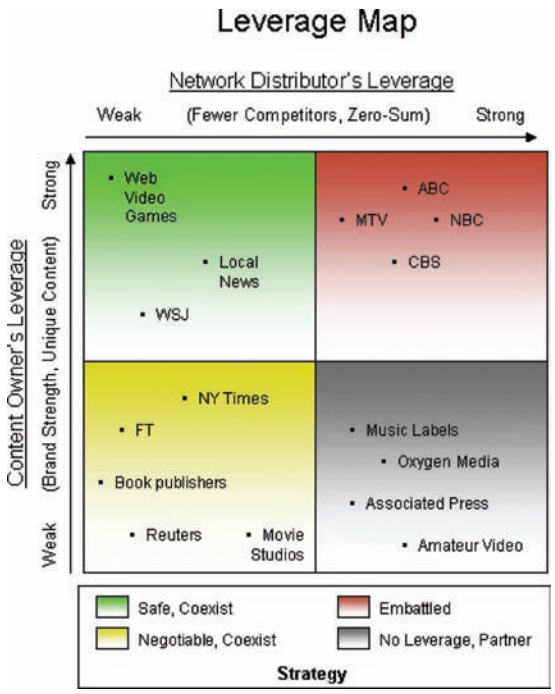
What it all means for Big Media—Resisting Commoditization

There is a titanic battle raging at the moment over who has the power in a networked world. Is it the network owner or the content provider? When content is sold on the network, who sets prices? When it's ad-supported, who owns the consumer relationship, who owns the advertiser relationship, and how is the ad revenue divided up? In essence, who commoditizes who?

This battle has broken out now in video because of the emergence of very large internet networks. YouTube and MySpace, P2P networks, and to some extent iTunes, since it's the dominant online retailer, all control access to consumers. While video content owners are just beginning this battle, newspapers and the music companies have been in the fray for a long time, and are losing at the moment. National newspapers are being commoditized by the portals while the music companies are losing to both P2P and iTunes.

In this last section we will briefly examine the prevailing media types on the web, look at their existing positioning, and discuss whether it can be improved.

The general situation is depicted in the *Leverage Map* at right. This map pits content owners on the left side of the chart against network distributors along the top. We've organized the chart so that content owner's leverage gets stronger as you go up the chart. Networks get stronger going left to right. By leverage we mean the strength of each player's negotiating position. The quadrants show examples of various companies and their positioning on the map. The red area on the map is where both the content owner and the network distributor have strong leverage. This is the area with the most conflict. The green area is safest for the content owners, where they have strong brands and unique products, and the network distributors are fragmented. The yellow area is where both parties are weak. The grey area is the worst for content owners—where they have weak brands or undifferentiated products, but the network distributors are powerful.



In terms of the content owner's negotiating leverage, two aspects matter most: brand strength and proprietary (unique) content. By brand strength we mean whether or not the brand is esteemed and tightly identified with its products. For example, The *Wall Street Journal* is a well-regarded brand strongly associated with its quality business news. ABC is a well known brand and is strongly identified with its hit shows like *Grey's Anatomy*. This is true of most major TV networks. The music labels by contrast do not have strong brands and links to their products. Consumers don't know who produces Justin Timberlake or Yo Yo Ma. Movie studios are in the same boat.

Brand association matters because weak brands need aggregators, strong brands often don't. For example, music consumers who want to download Justin Timberlake's new album are unwilling to troll through the various music label's websites trying to figure out who his distributor is. They want to go to one place to get their music. So they go to iTunes or P2P networks, both of which are aggregators. However, business news consumers are willing to go directly to WSJ.com and Grey's Anatomy lovers will go straight to ABC.com.

Because the consumer knows where to find the content without the help of an aggregator, the content owner is less dependent on a third party for distribution. The other important strength that some content owners possess is unique content. We discussed this earlier. When you own unique content, you have more negotiating leverage against a strong network. Content owner's with strong brands and unique content are at the top of the Leverage Map.

The network distributor's strength comes from their size relative to competitors, and whether consumers are willing to join multiple services or want to belong to just one (zero-sum). We've talked about this at length in the first two sections of this paper. We also noted that networks can be compatible or incompatible, but we've left this dimension off the chart because none of the web distribution networks are currently compatible with any others, although iTunes has proposed it. In the chart, the network distributor's leverage gets stronger from left to right as size and the tendency toward zero-sum increases. iTunes and YouTube would be on the far right. MySpace would be in the middle because, while large, it isn't zero-sum. Friendster would be to the left in the weakest position because it is neither large nor zero-sum.

Content owners have different strategic choices based on the area they occupy in the leverage map. We'll end this paper with a discussion of the choices that the different content owners face and the zones they occupy.

The Grey Zone: This is the worst position to be in for a content company. These companies have weak brand linkage with their content, their content is often undifferentiated, and they face strong distributors. Their only choice currently is to partner with the network distributors. Partnering means that the content owner shouldn't try to do their own distribution, or it isn't the main route to the consumer, and they should let Web partners do their distribution for them. This doesn't mean they won't have their own websites, but they won't get much distribution from them.

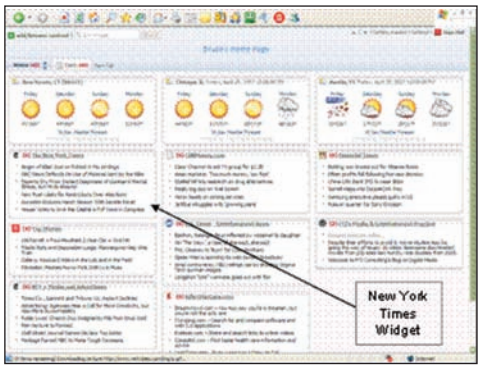
Companies in this position can try to improve their lot by developing higher brand esteem, or if it's their product that is undifferentiated, trying to develop some categories of differentiated content. Alternatively, rather than getting stronger themselves they can also try to weaken the prevailing network distributors. They can do this by encouraging the growth of competitive distributors or seeking compatibility between weak and strong distributors. As stated in Principle 7, the distributor's size advantage can be neutralized and the consumer's utility improved via compatibility. Also the leading distributor may be willing to move to compatibility because it's more profitable (Principle 8). If they can weaken the distributors they will shift into the yellow zone. Not great, but better than living in the grey zone. The music companies may yet achieve this by shifting their distributors into the green zone if a standard DRM is developed or open MP3 distribution is adopted.

The Yellow Zone: This is the region in the leverage map where content owners have either a weak brand or undifferentiated content, but the network distributors don't have much power either. This can happen when there are many mid-size distributors or when consumers are willing to use several services. Content owners in this region will either partner or coexist. Movie studios with weak brand linkages to their unique content will partner because they require aggregators. Companies with strong brands like the *New York Times* will coexist with network distributors. This means they'll have their own distribution website which will get significant traffic, but will also distribute through partner sites.

Some of the companies in the yellow zone, like movie studios, risk being forced into the grey zone if a dominant distributor is established. If iTunes for movies becomes dominant for paid content, or a YouTube emerges for movies in a free ad-supported model, than the studios would loose much of their negotiating leverage. The best hedge against this outcome is to be as accessible to new entrants as established distributors, and keep contract terms reasonable so startups can partner, not just the super-rich distributors.

Content companies in the yellow zone also want to move into the green zone. This is very hard for companies like Reuters with undifferentiated content, but may be possible for companies with weak brand linkages but unique content. For example, the movie studio Lions Gate is well known for its horror films. Conceivably, it could launch an online horror channel of its own and inch its way into the green zone. The trick is to strengthen the brand linkage with consumers. This can be done through a combination of marketing and withholding some content so consumer must go to the content owner's site to get it.

For some brands, we also see a significant opportunity emerging to bypass distributors with a relatively new technology called "widgets"[7]. These are small web-based applications that consumers can use to snap together and make their own homepages. By creating news widgets, the *New York Times* is able to supply news feeds directly to the consumer without always having a relationship to a network distributor. The example at left from NetVibes shows the *New York Times* widget. The headlines are clickable and the *Times* controls the advertising displayed in the article when the viewer clicks on it. This gives newspapers a "portal bypass" strategy. Of course the portals are entering the widget game as well. If this widget paradigm takes off, it could significantly shift the leverage toward the newspapers.



The Green Zone. This is the best position for content owners because they have strong brands and well differentiated content, and there is no dominant distributor. They enjoy significant negotiating leverage with their distribution partners. Companies in this space will usually choose a coexistence strategy. They will distribute primarily from their own site while providing their content to several distributors and get favorable terms.

One interesting outlier in the green zone is internet based video games. Most notable is a type called massively multiplayer online games (MMOGs), where people all over the web play against each other simultaneously within the game. These games are actually self-contained many-to-many networks. One of the biggest games on the web today is *World of Warcraft* which has a network of millions of simultaneous users. Obviously they employ a go-it-alone strategy because they have no dependence on a third party network distributor.

The Red Zone. The red zone is the most embattled. This is because strong brands with unique content are facing dominant network distributors, and both have significant negotiating leverage. The TV and cable networks are all struggling in their relationship with the web. Some are negotiating with You Tube. Others, like Fox and NBC, are forming distribution consortiums. Viacom is filing lawsuits and CBS is going it alone.

From many of the economic principles described earlier, we do not believe that TV networks will be able to successfully launch sites that directly compete with YouTube or MySpace. Coexistence is the best strategy, but going-it-alone may be necessary if the parties' business models cannot be brought into alignment. Coexistence and go-it-alone strategies in the red zone have pluses and minus:

- Coexistence – The TV networks have already launched their own websites and are streaming ad-supported content while seeking favorable distribution deals with the network distributors. TV networks have high demands: they want to preserve their brand identity, own the advertising within their content, and hopefully retain the relationship with the viewer. Smaller distribution networks like Joost will concede to these terms, while Google and YouTube may not. Even if they do, TV networks need to be wary of brand dilution and a shift in negotiating power over time if the large distributors end up providing most of their viewers. TV content owners could end up in the grey zone on our map. Consumers who originally

7 Widgets are the latest embodiment of RSS (Really Simple Syndication) wherein consumers can sign up for feeds directly from the news supplier.

associated Lost with ABC may eventually associate it with the distributor they use, like YouTube. This issue of brand doesn't exist in conventional TV because the TV network has its own channel on the cable dial. But the channel paradigm doesn't hold up well in a many-to-many network. Consumers search based on ratings and send video links to their friends. Channels are not a major entry point on internet networks.

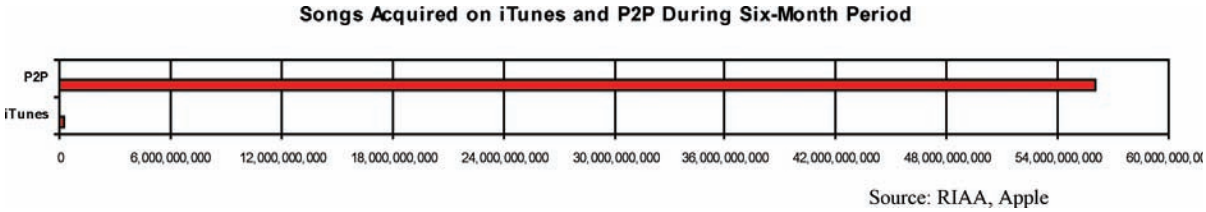
At the moment, NBC and Fox have announced a consortium to distribute their content through a gaggle of network distributors like MySpace, AOL and Yahoo. While some tout it as an anti-YouTube strategy, it's really a coexistence strategy. They intend to leave amateur content to YouTube while the consortium distributes professional content. As we said earlier, it's wise not to go head-to-head with YouTube. By teaming with several network distributors, they essentially commoditize them and ensure that no one of them ends up with too much power. This keeps the content owners safely in the green zone. Still, this consortium of content owners runs the risk that leverage will shift over time to the network distributors because they "own the eyeballs", and they also risk brand dilution.

- Going-it-alone – This is an interesting strategy for major TV networks. In this model they partner with no one, and consumers are forced to get their TV episodes from the TV networks' websites. Under this strategy the TV networks have complete control over everything: they retain the consumer relationship, the advertiser relationship and all of the ad placements. They also synergistically re-enforce the program and brand relationship—consumers that missed Grey's Anatomy on ABC can stream it on ABC.com. By going it alone, TV broadcasters also construct a cable bypass on the internet around their current cable distributors. This can avoid replicating a dependency on distribution partners as viewers move to the Web. Under this model we also see an unprecedented opportunity for major networks to actually own the end consumer relationship. They have never enjoyed this in the past. Conventional over-the-air broadcasting doesn't allow interactivity between the broadcaster and consumer, and in cable, the cable companies own the relationship with the cable subscriber. While TV networks must learn new skills in managing customer relationships and data, the revenue and marketing opportunities are vast, and it's important to preserve it as they negotiate with distributors.

  Hits vs. Catalog is an important consideration in go it alone strategies. While everyone may know to go to NBC.com for episodes of *Heroes*, they don't know whose streaming old *Star Trek* episodes. Consequently, When the brand relationship is weak, it may be best to distribute catalog titles through aggregators while distributing the current lineup only through the TV network's own website. (This mimics the TV syndication model of today, but does not have to be exclusive.)

  A final consideration in a go it alone strategy is whether small community networks could be built up around the show itself. Tools now exist to easily create MySpace like features around a show. These microcommunities provide enormous promotional and advertising opportunities. In this sense the show would behave like the massive multiplayer game and form its own many-to-many network. Note that while we've been discussing television, this observation might equally apply, say to the *New York Times* who might set up and host a community site around the 2008 presidential race, or the Iraq war.

Pirated Content. The final point we'll make in this paper about content owners and their network strategies is that infringing P2P networks must be eradicated, or made as scarce as possible. We don't say this out of sympathy for content owners, even though we are believers in the need for strong infringement protections. We say this because it is an economic necessity. There are some people that think that piracy has always been a fact of life in the media industry and companies just have to buck up. The supposition is that despite the piracy there is still big money to be made. However, the types of piracy that exist in the physical world are very different than internet piracy. In the physical world copy quality is often poor, pirates have to operate out in the open to sell their goods, and goods are not free. But on the internet, copies are perfect, free, anonymous and in infinite supply. No market for intellectual property can ultimately operate profitably under such conditions.



In the music industry, infringing P2P networks are the market leader in digital distribution. These networks illegally distribute over a billion songs per month, the equivalent of 91 million albums. That's 24 times as many songs per month as iTunes sells legally. Here the only strategy is eradication. As we discussed earlier under Principle 7, it is impossible for the music companies to compete. There is no benefit to legal music that trump illegal networks, they also can't offer a lower price than free, and they impose high switching costs. The only benefit that trumps free music over paid music it seems is the benefit of not going to jail. Consequently content owners have no choice but to pursue legal remedies and enforcement aggressively—probably even more aggressively than they are doing now.

Conclusion

In this paper we have tried to consolidate into one place the economic rules that govern the competitive behavior between the new distribution networks and the content owners. Because these networks are free for consumers to join, and much of the content is free or ad-supported, conventional economics with its focus on price takes a back seat. Instead the *economics of attention* dominate: who owns the eyeballs watching the YouTube ads? Who can get the most kids to congregate in an online social network? How do you compete for consumer's attention? We have tried to show that while it seems chaotic, there are rules, and these are the rules of network economics.

Based on the 10 principles outlined above, we've also tried to briefly describe the strategic choices available to most types of media companies. However in the space of this paper we can only highlight the strategic options. FTI will be happy to meet with companies individually to discuss these strategies in more depth.

It is our belief that entertainment is only 20% invented. As the walled gardens of the broadcast paradigm crumble and content is let loose over the web, the tyranny of the 30-minute and one hour broadcast schedule in television and the album structure in music is dismantling. Consumers are showing enormous appetite for place shifting and time shifting, as well as great elasticity in interest regarding content length, quality and degree of interactivity. They also enjoy creating or mashing up their own content and sharing these creations.

In Part III of FTI's four-part series on media we will explore what we and others have called the "mass-niche" duality of media. We will discuss the notion of the "long tail" as coined by Chris Anderson, and investigate how long tails coexist with a hits-driven business model. In Part IV we will bring all of the topics of this series together and lay out broad strategies for adaptation for media companies.

Readers should feel free to contact us at:

Bruce Benson
Senior Managing Director
Entertainment & Media
203.606.3854
bruce.benson@fticonsulting.com

FTI Consulting
3 Times Square, 11th floor
New York, NY 10036
203.606.3854
Blog: ftimedia.wordpress.com