



iTunes Europe: A Preliminary Analysis

I. Introduction

On June 15, 2004, Apple announced the launch of its iTunes Music Store (iTMS) in the United Kingdom, France, and Germany. In its first week, the store sold 800,000 songs and outsold its nearest competitor, OD2, by a margin of sixteen to one.¹ With the new incarnations of the iTMS, Apple has preserved the business model that has been so successful in the U.S. compared to previous legal music download services. In terms of features, the European stores are virtually identical to the U.S. original, as users enjoy the same ease of use, deep catalogue,² and key innovative functions such as “iMix” and “Party Shuffle.”³ One notable difference is the pricing—songs sell for 79 pence (\$1.43) in the UK and 99 euro cents (\$1.19) in France and Germany.⁴ Although the iTunes business model⁵ has been successful thus far, Apple faces a new set of challenges as it expands further into Europe and beyond. In addition to variations in the substance of laws regarding such areas as anti-circumvention, fair use, and consumer protection (discussed in the iTunes Case Study Summary⁶), the international long-term success of the iTMS ultimately depends on how well it can manage and adapt to variations in user expectations and cultural differences across Europe.⁷

When assessing the implications of iTunes’ arrival in Europe, it is useful to think in terms of the regulatory environment, markets, and policy. An analysis of the regulatory environment identifies both legal conditions and social/cultural norms which may serve as obstacles to, or facilitators of, the development of the iTMS service. A market analysis focuses on the potential impact of the iTMS on consumers, producers, and the industry as a whole. As the iTMS has just arrived in Europe and as of yet data is limited, our assessment of

¹ See <http://www.apple.com/pr/library/2004/jun/23itunes.html>.

² For issues related to depth of catalogue see below at note 4. See also the discussion of Apple’s negotiations with independent artists in Section III.

³ <http://www.apple.com/pr/library/2004/jun/15itunes.html>.

⁴ <http://www.reuters.co.uk/newsArticle.ihtml?type=topNews&storyID=54253751>.

⁵ In our “iTunes Case Study,” we posit that Apple is concerned with maximizing overall profits and is even willing to accept minor losses from the iTMS store so long as iPod sales make up for this. Thus, the business model is “successful” in that Apple has over 50% of the portable music player market. Additionally, it controls 70% of the market in digital music distribution and managed an impressive 70 million downloads during its first year, regardless of the financial success of the iTMS itself. Of course, in the future Apple may become more concerned with profitability within the digital music distribution business. “iTunes: How Copyright, Contract, and Technology Shape the Business of Digital Media: A Case Study” (hereinafter “iTunes Case Study”), at <http://cyber.law.harvard.edu/media/uploads/81/iTunesWhitePaper0604.pdf>.

⁶ <http://cyber.law.harvard.edu/media/uploads/72/6/iTunesSummary061404.pdf>.

⁷ <http://www.technewsworld.com/story/technology/34535.html>.

its impact is necessarily tentative. Finally, a policy analysis explores the potential influence of the launch on policy formation.

II. Regulatory Environment: The Interplay between Law and Social Norms

On the whole, the legal conditions in Europe create a hospitable environment for the iTunes service. Differences in the implementation of the European Union Copyright Directive (EUCD) are significant to the extent that they reflect underlying social norms and impose greater transaction costs; however, they are unlikely to function as a major obstacle to a pan-European expansion of the iTunes for several reasons. First, the iTunes relies on basic principles of copyright law⁸ that are accepted across Europe. Second, Apple can use contract law to enforce the iTunes terms of service, thereby leveling differences in national laws by entering into agreements with individual consumers. The practice of using contracts to enforce licensing agreements is also widely accepted across Europe.⁹ Finally, Apple uses Digital Rights Management (DRM) to constrain consumer behavior, and the EUCD reinforces such technological protections by requiring Member States to make it illegal to circumvent them.¹⁰ Specifically, the EUCD prohibits both the act of circumvention, and trafficking in anti-circumvention devices.¹¹ A key feature of the iTunes business model is the iPod-iTunes tie, whereby Apple uses DRM to restrict interoperability, effectively create barriers to entry in both the portable player and music download markets, and increase the value of its own offerings by presenting them as an integrated whole.¹² Notably, the EUCD does not grant clear reverse engineering or interoperability exceptions to the anti-circumvention provision, meaning that Apple can attempt to transplant its business model without facing a legal obstacle (explicit permission for competitors to reverse engineer) that could have been deadly.

Variations in the law among Member States could nevertheless impact the iTunes's long-term viability. The EUCD aims to harmonize the law, not to make laws identical in all Member States.¹³ For the iTunes to succeed throughout Europe, complete unity in the law is neither necessary, since Apple can use contracts and DRM to support its business model, nor sufficient, since many other challenges persist. Ultimately, however, differences in laws may reflect underlying variations in social norms and consumer expectations. The essential question is whether the iTunes will be able to adapt to these variations, which, as they interact with the law to shape the regulatory environment, could create two important effects. First, differences in law and norms can raise transaction costs for Apple or consumers. Second, social and cultural values might influence the popularity of the service and thus its long-term sustainability.

Social norms not only influence the formulation and enforcement of the law, but they also underlie consumer behavior. For example, when drafting laws to comply with the anti-circumvention provisions of the EUCD, issues such as reverse engineering to create compatibility (i.e., for DVD players) have been especially important to legislators. Such sensitive issues may be partly responsible for the delay in implementation in

⁸ For an elaboration see iTunes Case Study, Part I., at 19-23.

⁹ *Id.*

¹⁰ *Id.*, Part II., at 37.

¹¹ *Id.*

¹² See *id.*, Part II., at 44-47.

¹³ For a discussion of the harmonization of the EUCD in the context of iTunes, see *id.*, Part I., at 19.

some countries.¹⁴ The enforcement of the law also reflects cultural norms, including attitudes about file sharing.¹⁵ The Netherlands, for instance, is relatively lenient with respect to its legal actions against file sharing. Germany, by contrast, is more stringent. Indeed, the IFPI recently reported the first conviction of a file sharer by a German criminal court.¹⁶ Finally, expectations of fair use or fair dealing may differ substantially from country to country. A country with no expectations of fair use would be an ideal target for the expansion of digital media stores such as the iTunes, while countries accustomed to more permissive use could be problematic, especially if there were indications that DRM might be compromised (particularly if reverse engineering allowed competitors to create portable players that could play content from the iTunes),¹⁷ or that licensors were unwilling to provide music.

The fact that the arrival of the iTunes in Europe took longer than expected suggests that the higher transaction costs associated with complex, multi-player negotiations can be a hindrance to expansion. Sources speculated that depth of the catalogue was probably the real issue behind any setback in the launch.¹⁸ In fact, when the iTunes launched in Europe, the Association of Independent Music (AIM) confirmed that Apple and the independent labels had been unable to reach a licensing agreement. In a statement, AIM, which has signed collective deals with iTunes competitors Napster, OD2, Sony, and others, remained hopeful that the iTunes would soon be able to offer a more complete selection of European music (independents account for 22% of the market at retail).¹⁹ In May 2004, rumors abounded that the major labels were trying to force Apple to raise prices on singles in the US.²⁰ Because the terms of the negotiations between Apple Europe and the labels were not disclosed, sources cited known agreements, such as the restrictive licensing agreement between BMG and UK-based service Wippit, as evidence that the labels might be driving harder bargains in Europe.²¹ Interestingly, the prices of songs in Europe, 99 euro cents (\$1.19) correspond roughly to the amount mentioned in the rumors. Nevertheless, it is unclear whether the higher prices relative to the US are a result of pressure from the labels, an independent decision by Apple, economic conditions that make selling music both on and offline more expensive in Europe generally (such as the value-added tax), or some combination of these factors.

As Apple attempts a pan-European expansion, the transaction costs of dealing with the region's numerous collecting societies—organizations that issue copyright licenses and collect fees when it is impractical to do so on an individual basis—may also function as a further, though minor, obstacle. Depending on the specific business model, an online music provider must clear an array of rights, including the right to reproduce (mechanical rights), the right of making available to the public (performance rights), and the right to distribute. These rights are held by “authors,” in this case the songwriter, and “performers,” meaning the performing artists as well as producers. Thus, after Apple successfully negotiates with the record labels—or their representatives—regarding the rights of producers and performers, it must negotiate with the collecting

¹⁴ <http://grep.law.harvard.edu/article.pl?sid=04/06/18/0445250&mode=thread>.

¹⁵ See <http://www.ifpi.org/site-content/press/20040330f.html>.

¹⁶ See <http://cyber.law.harvard.edu/media/home?wid=25&func=viewSubmission&sid=35>.

¹⁷ See iTunes Case Study, *supra* note 5, at 47.

¹⁸ http://www.theregister.co.uk/2004/04/19/apple_itunes-euro/print.html.

¹⁹ <http://www.macworld.co.uk/news/index.cfm?NewsID=8910&Page=1&pagePos=3>

²⁰ “Apple Denies Report of Price Increase,” Reuters (May 10, 2004) at <http://www.macminute.com/2004/05/07/itunes>.

²¹ http://www.theregister.co.uk/2004/04/19/apple_itunes-euro/print.html.

societies who represent the “authors.” Notably, these collecting societies sought to create a “one-stop-shop” for copyright licenses by entering into the Santiago Agreement.²² However, the agreement stipulates that online music providers must obtain a separate, Europe-wide license from the collecting society that represents each Member state in which the provider does business. Thus, there can be no competition between societies, and inefficiency in the form of higher prices may result. Not only does a provider such as Apple have to pay a price that may not be optimal, but it also must pay multiple times, once for each country in which it operates. Currently, the European Commission is investigating the legality of the agreement under European competition law.²³

In sum, it remains to be seen whether Apple can stimulate a market for online music the way it did in the US, where the iTunes sold over 70 million songs in its first year, compared to the one million downloads that all prior services combined managed in the first two years of their existence.²⁴ Recently, the Official UK Chart Company announced that a half million songs had been downloaded legally in the UK during the first half of 2004.²⁵ This finding, coupled with the iTunes’s impressive performance during its first week,²⁶ might be evidence of a demand for legal online music that Apple and others can further nurture.²⁷ Finally, Europe is an important market for the company’s entire product line. In its SEC filings for the fiscal second quarter 2004, the region accounted for US \$449 million of Apple’s net sales, approximately a 33 percent increase over the same period in 2003.²⁸ With the arrival of the iTunes, Apple can raise the visibility of all its offerings.

III. Markets Perspective

In this section we turn our attention to the implications of the iTunes expansion into Europe both for European consumers and on the recording industry in general. The expansion has indicated that a technology firm formerly in the business of selling hardware and software can influence the music industry both in terms of how music is priced and distributed, and what music is available to consumers. This development represents an interesting departure from the traditional music industry business model, in which conventional wisdom²⁹ holds that the music studios and copyright holders are “the largest players,” and therefore often able to set the music industry’s terms.

Remarkably, Apple seems to have been able to change certain longstanding business practices of the recording industry. Traditionally, the recording industry used staggered release dates, in which an album would be released in one region on a certain date and in another region on a different date.³⁰ In addition to

²² See <http://www.mofo.com/news/general.cfm?MCatID=7968&concentrationID=&ID=1040&Type=5>.

²³ See

<http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/586&format=HTML&aged=0&language=%20EN&guiLanguage=en>.

²⁴ <http://www.pro-music.org/viewpoints/billboard.htm>.

²⁵ http://www.theregister.co.uk/2004/06/03/download_legal/.

²⁶ See <http://www.apple.com/pr/library/2004/jun/23itunes.html>.

²⁷ The extent of this demand is unknown. It would require analysis of the market share of legal online music versus P2P.

²⁸ See http://www.sec.gov/Archives/edgar/data/320193/000110465904013021/a04-5089_110q.htm; see also

<http://www.linuxinsider.com/story/34207.html>.

²⁹ See http://en.wikipedia.org/wiki/Record_industry.

³⁰ For example, such a practice would allow the recording industry to time an album release according to the dates on which the artist would be on tour in that region. For a discussion of staggered release dates please see iTunes Case Study, *supra* note 5 at 88.

releasing albums on different dates, it was possible for the recording industry to charge different prices in different regions once albums were released. This price discrimination allowed the music industry to boost sales by tailoring prices to demand.³¹ By providing a single store accessible across Europe, the iTunes will likely make it difficult for the recording industry to charge different prices to consumers in different parts of Europe or to release in one European country but not another.

Although Apple is the most popular Internet-based music service, its sales constitute at most 2% of total recording industry sales.³² At the same time, the record industry's apparent willingness to give up the staggered release dates and price discrimination practices in their sales through Apple's iTunes is a striking reflection of the power that an end distributor like Apple has managed to garner in the music business.³³ Apple's iTunes Europe launch may very well have marked a change in how power and control are distributed in the music industry.

Perhaps even more substantially, the iTunes Europe expansion highlights the fact that Apple is able to offer the most liberal DRM scheme of any of its competitors.³⁴ Two interpretations naturally emerge: either Apple is better than its competitors at negotiating with certain music industry labels, or Apple places a higher premium on providing more liberal rights to its users. The first would provide a testament to Apple's power as a distributor to exert influence over its supplier; the second might imply that Apple was adopting a different revenue source (i.e., iPods) than its competitors were.

Examining the consumer perspective, one might conclude that consumers ought to be pleased simply because the iTunes Europe launch provides them an additional choice. Since consumers can vote with their feet (or mouse) by not shopping at the iTunes, it would seem that they endure no loss as the result of iTunes' Europe launch.³⁵ However, such an appraisal would ignore the possibility that consumers may pay a new type of cost by accepting the restrictions on consumer behavior that the iTunes employs to function as a successful business. Such constraints on behavior might include: provisions that prevent users from circumventing Apple's DRM even when such circumvention is solely for the sake of fair use, file incompatibility that makes it impossible for users to transfer their iTunes songs to any portable device except

³¹ For a discussion of price discrimination in the music industry in the context of iTunes see iTunes Case Study, *supra* note 5 at 9.

³² Walter S. Mossberg, "The Music Man," The Wall Street Journal (June 18, 2004) available at <http://online.wsj.com/article/0..SB108716565680435835.00.html> (paid subscription).

³³ Another interpretation might claim that the industry was willing to give up these practices because regional releases would mean that peer-to-peer theft would be the only source available for those anxious to get their hands on a new song or album in a region where that song or album had yet to be released.

³⁴ It is especially interesting that Sony Connect, which potentially has available the resources of Sony music, offers what might seem to some a less competitive option than iTunes, by offering more restrictive DRM. Apple allows users to share with more computers than its leading competitors. Apple allows users to share with 5 computers whereas Sony Connect allows only three computers as does Napster 2.0. Apple allows users to burn seven copies of a playlist Napster allows only five burns of a playlist, Sony is the most restrictive allowing only 5 CD burns of a track + 5 content protected burns of a track. Hypothetically iTunes is unlimited with respect to burns of a single track. All three services allow unlimited transfers to complaint portable devices. Sony is the most restrictive in this category by differentiating rights for transfers between different music labels. Apple is slightly more restrictive in that it restricts an iPod to have only music on it that has been obtained from five different user's accounts.

³⁵ Generally, one potentially negative impact inflicted upon consumers by the expansion of a traditional retail business takes the form of an opportunity cost; consumers lose the goods or services which would be offered by a desirable retailer located in whatever location is now held by an undesirable retailer. It seems as though this cost is nearly absent from the iTunes expansion, since iTunes does not have to locate in attractive retail space, and thus does not deprive consumers of any other option.

the iPod, and a sales schema that for all practical purposes eliminates users' rights under the first sale doctrine.

IV. Policy Implications

Apple's willingness to expand iTunes to the UK, France and Germany, reports of strong early sales in those nations,³⁶ and Apple's plans for a pan-European launch attest to the efficacy of the legal regimes that allowed for the expansion. Just as the law influences and facilitates new business opportunities, industry has its own reciprocal effect on the law. Specifically, the iTunes expansion confirms the basic structure of relevant contract, copyright, and anti-circumvention law in Europe. This feedback effect will probably bolster the EUCD and existing implementations, and dilute any calls for overhaul in the near future.

In turn, EU member states that are still debating how to implement the EUCD³⁷ may experience distorting effects from this feedback loop if it unduly influences the balancing of policies affected by EUCD implementation. At a time when the very laws that will govern iTunes are being decided, the limited effects evident from the iTunes expansion may not be indicative of future developments. For example, corporate discretion would enable Apple to alter terms of use as business circumstances dictate, thereby limiting users' fair use rights in ways it does not today. There is precedent for such a development, in the form of Apple's decision to decrease the number of burns allowed per playlist one year after launching in the U.S.³⁸ In thus restricting iTunes' functionality, Apple explicitly identified the balance between discouraging music theft and preserving fair use rights.³⁹ Whether policymakers see such decisions as legitimate business activities, or undesirable legislation by corporate board, may impact pending EUCD implementations as well as future policy formation.

The influence on policymaking could be amplified by iTunes' selective launch in three European states. Whereas all EU Internet users will eventually be subject to some EUCD implementation, not all users will have an equal choice of legal media downloading services. For example, in Italy, P2P file sharing is criminal and subject to up to three years in prison.⁴⁰ Whereas iTunes' recent launch provided a legal downloading alternative in the UK, France and Germany, it left Italian users without that same choice.⁴¹ Additionally, as complementary markets such as portable player devices⁴² emerge from the growing legal media downloading market,⁴³ fears of losing economic opportunities must not unduly influence the judgments surrounding EUCD implementation.

³⁶ See "iTunes shows strong early sales in Europe," at http://news.com.com/iTunes+shows+strong+early+sales+in+Europe/2100-1027_3-5245090.html.

³⁷ Only six of the original 15 EU nations have implemented the EUCD. France is not one of the six, yet the iTMS is available there.

³⁸ "iTunes Celebrates Its First Anniversary; Over 70 Million Songs Purchased", at <http://www.apple.com/pr/library/2004/apr/28itunes.html>.

³⁹ Id.

⁴⁰ See "Italy approves 'jail for P2P users' law," http://www.theregister.co.uk/2004/05/20/italy_p2p_law/.

⁴¹ Italian users are not entirely without legal downloading choices; see, e.g., Tiscali Music Club Italy, <http://musica.tiscali.it/>.

⁴² For now, the only portable player capable of playing iTunes tracks is Apple's own iPod player. However, tracks from other services such as Napster UK will play on multiple devices.

⁴³ GartnerG2 estimates that the number of online music subscribers in the U.S. will increase from half a million in 2002, to almost 9 million in 2007. "Copyright and Digital Media in a Post-Napster World" at 16, available at <http://cyber.law.harvard.edu/home/uploads/254/2003-05.pdf>.

Finally, the iTunes expansion and related developments may attract attention from policymakers who observe markets for signs of market-leader behavior. Apple's recent expansion, in conjunction with such business strategies as the iTunes-iPod tie,⁴⁴ as well as iTunes' 70% market share of legal media downloads in the U.S.,⁴⁵ may ultimately attract attention from regulators in Europe or elsewhere. Alternatively, a market leader in legal media downloading could emerge from other quarters, for example if major record companies unite behind some other online entertainment marketplace. Such concerns reportedly animated Apple's recent objections to a Sony-BMG merger, which may be approved by the EU this summer.⁴⁶ EU Commissioners have already expressed concerns about ensuring openness and interoperability in the digital media space;⁴⁷ their current target for scrutiny in this area is Microsoft, whose bundling of proprietary DRM within Windows Media Player (WMP), with the Windows operating system, has garnered attention from regulators.⁴⁸

V. Conclusion

The recent iTunes launch in the UK, France, and Germany, and the announcement of a pan-European launch, demonstrate that the legal conditions in Europe are relatively favorable to the iTunes business model. Complex, multi-player negotiations and differences in laws raise transaction costs; this constitutes a significant short-term challenge. However, variations in social norms and consumer expectations throughout Europe pose a greater, long-term challenge for Apple. The expansion has also indicated that a technology firm formerly in the business of selling hardware and software can influence the music industry. This and other effects of the expansion reach back to the law that allowed for the expansion; the feedback effects both affirm the basic structure of underlying law in Europe and could influence future policymaking. Possible future policy targets include those related to EUCD implementation, and those governing the openness of the nascent digital media industry. In the more immediate term, a more relevant question is likely to be how enthusiastically consumers will warm up to the legal download option for purchasing music.

⁴⁴ Apple's nonparticipation in a prominent DMCA reform coalition may reveal the strategic importance of the tie.

http://www.theregister.co.uk/2004/06/23/ms_apple_snuub_boucher/.

⁴⁵ "The Music Man," The Wall Street Journal, *supra* note 32.

⁴⁶ See "EU's Monti to recommend Sony BMG merger," *at*

<http://www.reuters.co.uk/newsPackageArticle.jhtml?type=businessNews&storyID=531678§ion=finance>.

⁴⁷ An April 16, 2004 communication from the European Commission states that "a global and interoperable technical infrastructure on DRM systems based on consensus among the stakeholders appears to be a necessary corollary to the existing legal framework..."

http://europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0261en01.pdf at 11.

⁴⁸ In its March 24, 2004 press release announcing the conclusion of the five-year-long Microsoft antitrust investigation, the Commission warned: "Absent intervention from the Commission, the tying of WMP with Windows is likely to make the market 'tip' definitively in Microsoft's favour. This would allow Microsoft to control related markets in the digital media sector..."

<http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/382&format=HTML&aged=0&language=EN&guiLanguage=en>.