

Strategic Management and Competitive Advantage

Concepts and Cases



Jay B. Barney
William S. Hesterly

Strategic Management and Competitive Advantage

Concepts and Cases

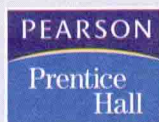


Jay B. Barney

The Ohio State University

William S. Hesterly

The University of Utah



Upper Saddle River, New Jersey 07458

Library of Congress Cataloging-in-Publication Data

Barney, Jay B.

Strategic management and competitive advantage: concepts and cases / Jay B. Barney, William S. Hesterly.

p. cm.

Includes bibliographical references and index.

ISBN 0-13-154274-5

1. Strategic planning. 2. Business planning. 3. Industrial management.

4. Competition. I. Hesterly, William S. II. Title.

HD30.28.B36834 2006

658.4' 012—dc22

2005045936

Senior Acquisitions Editor: Michael Ablassmeir

VP/Editorial Director: Jeff Shelstad

Associate Editor: Melissa Yu

Editorial Assistant: Richard Gomes

Developmental Editor: Erika Rusnak

Media Project Manager: Ashley Santora

VP/Director, Market Development: Annie Todd

Marketing Manager: Anke Braun

Marketing Assistant: Patrick Danzuso

Associate Director Production Editorial: Judy Leale

Production Editor: Mary Ellen Morrell

Permissions Supervisor: Charles Morris

Associate Director, Manufacturing: Vincent Scelta

Production Manager: Arnold Vila

Manufacturing Buyer: Diane Peirano

Design Manager: Maria Lange

Art Director: Janet Slowik

Interior Design: Raven Design

Cover Design: Maria Lange

Cover Illustration: Gary Hovland

Illustrator (Interior): P.J. Loughran, Gary Hovland

Illustrator (Figure Art): ElectraGraphics, Inc.

Director, Image Resource Center: Melinda Reo

Manager, Rights and Permissions: Zina Arabia

Manager, Visual Research: Beth Brenzel

Manager, Cover Visual Research & Permissions: Karen Sanatar

Image Permission Coordinator: Craig A. Jones

Manager, Print Production: Christy Mahon

Composition/Full-Service Project Management: Preparé, Inc.

Printer/Binder: Courier-Kendallville

Credits and acknowledgments borrowed from other sources and reproduced, with permission, in this textbook appear on appropriate page within text.

Copyright © 2006 Pearson Education, Inc., Upper Saddle River, New Jersey, 07458.

Pearson Prentice Hall. All rights reserved. Printed in the United States of America. This publication is protected by Copyright and permission should be obtained from the publisher prior to any prohibited reproduction, storage in a retrieval system, or transmission in any form or by any means, electronic, mechanical, photocopying, recording, or likewise. For information regarding permission(s), write to: Rights and Permissions Department.

Pearson Prentice Hall™ is a trademark of Pearson Education, Inc.

Pearson® is a registered trademark of Pearson plc

Prentice Hall® is a registered trademark of Pearson Education, Inc.

Pearson Education LTD.

Pearson Education Singapore, Pte. Ltd

Pearson Education, Canada, Ltd

Pearson Education-Japan

Pearson Education Australia PTY, Limited

Pearson Education North Asia Ltd

Pearson Educación de México, S.A. de C.V.

Pearson Education Malaysia, Pte. Ltd



10 9 8 7 6 5 4 3 2
ISBN 0-13-154274-5

Strategic Management and Competitive Advantage

C o n c e p t s a n d C a s e s



This book is dedicated to my expanding family: my wife, Kim; our children, Lindsay, Kristian, and Erin; their spouses, Ryan, Amy, and Dave; and most of all, our four grandchildren, Isaac, Dylanie, Audrey, and Chloe. They all help me remember that no success could compensate for failure in the home.

Jay B. Barney
Columbus, Ohio

This book is for my family who has taught me life's greatest lessons about what matters most. To my wife, Denise; my sons, Drew, Ian, Austin, and Alex; my daughters, Lindsay and Jessica (and their husbands, Matt and John); and grandchildren, Ellie and Owen.

William Hesterly
Salt Lake City, Utah

A c k n o w l e d g m e n t s



Obviously, a book like this is not written in isolation. We owe a debt of gratitude to all those at Prentice Hall who have supported its development. In particular, we want to thank Jeff Shelstad, VP/Editorial Director; Eric Frank, Director of Marketing; Michael Ablassmeir, Senior Acquisitions Editor; Annie Todd, VP/Director of Market Development; Kathleen McLellan, Market Development Manager; Mary Ellen Morrell, Production Editor; Janet Slowik, Art Director; Judy Leale, Associate Director Production Editorial; Melissa Yu, Associate Editor and Erika Rusnak, Development Editor. We are also grateful to our friend and colleague, Mark Hansen, for his important work on the Instructor's Manual and PowerPoints. Louis Marino helped with the test bank, and Deborah Gilliard has helped with the development of the web site. All these people were instrumental in creating this new approach to teaching strategic management.

Many people were involved in reviewing early drafts of this manuscript. Their efforts undoubtedly improved the manuscript dramatically. Their efforts are largely unsung, but very much appreciated.

Thank you to these professors who participated in early manuscript reviews:

Mainuddin Afza—*Bloomsburg University*
Peter Antoniou—*California State University-San Marcos*
Kendall Artz—*Baylor University*
Susan Barnes—*Washington State University*
Steven Congden—*University of Hartford*
Jim Davis—*University Notre Dame*
David Deeds—*Case Western Reserve University*
Tom Douglas—*Clemson University*
Jon Down—*Oregon State University*
Alan Ellstrand—*University of Arkansas*
James Fiet—*University of Louisville*
Jeff Furman—*Boston University*
Carole Jacobson—*Purdue University*
Joseph Mahoney—*University of Illinois*
Rick Martinez—*Baylor University*
Sharon Matusik—*University of Colorado at Boulder*
Gerry McNamara—*University of California-Riverside*
Elaine Mosakowski—*University of Colorado at Boulder*
Jeffrey Parker—*Jacksonville State University*

Pamela Pommerenke—*Michigan State University*

Peter Ring—*Loyola Marymount University*

Jiten Ruparel—*Otterbein College*

Rhetta Standifer—*University of Missouri*

Edward Ward—*Saint Cloud State University*

Thank you to the following professors who participated in multiple review activities:

Todd Alessandri—*Syracuse University*

Vikas Anand—*University of Arkansas*

Barry Dean Baysinger—*University of Kansas*

James Bloodgood—*Kansas State University*

Brian Boyd—*Arizona State University*

Trevis Certo—*Texas A&M University*

Rebecca Guidice—*University of Nevada-Las Vegas*

Mark Hansen—*Brigham Young University*

Andrew Inkpen—*Thunderbird University*

Constance James—*Pepperdine University*

Janice Joplin—*University of Texas at El Paso*

Franz Kellermanns—*Mississippi State University*

Laura Poppo Lockwood—*Virginia Polytechnic Institute and State University*

Denise Luethge—*University of Michigan-Flint*

Ram Mudambi—*Temple University*

Michael Pitts—*Virginia Commonwealth University*

David Sirmon—*Clemson University*

Jim Thurman—*George Washington University*

Marta White—*Georgia State University*

Thank you to these professors who participated in the Strategic Management Society Focus Groups in 2003 and 2004:

Todd Alessandri—*Syracuse University*

Brian Boyd—*Arizona State University*

Clay Dibrell—*Oregon State University*

Michael Fern—*University of North Carolina*

Marta Geletkanycz—*Boston College*

Amy Hillman—*Arizona State University*

Constance James—*Pepperdine University*

Franz Kellermanns—*Mississippi State*

Ram Mudambi—*Temple University*

Laura Poppo Lockwood—*Virginia Polytechnic Institute and State University*

David Sirmon—*Clemson University*

Jim Thurman—*George Washington University*

Brief Contents

Part 1: THE TOOLS OF STRATEGIC ANALYSIS



Chapter 1: What Is Strategy and the Strategic Management Process?	2
Chapter 2: Evaluating a Firm's External Environment	32
Chapter 3: Evaluating a Firm's Internal Capabilities	74
End-of-Part Cases	PC 1-1

Part 2: BUSINESS LEVEL STRATEGIES



Chapter 4: Cost Leadership	114
Chapter 5: Product Differentiation	144
End-of-Part Cases	PC 2-1

Part 3: CORPORATE STRATEGIES



Chapter 6: Vertical Integration	178
Chapter 7: Corporate Diversification	206
Chapter 8: Organizing to Implement Corporate Diversification	244
Chapter 9: Strategic Alliances	276
Chapter 10: Mergers and Acquisitions	308
End-of-Part Cases	PC 3-1
Appendix: Analyzing Cases and Preparing for Class Discussions	343
Illustration/Photo Credits	347
Glossary	349
Company Index	357
Name Index	359
Subject Index	363

Contents

Part 1: THE TOOLS OF STRATEGIC ANALYSIS



Chapter 1: What Is Strategy and the Strategic Management Process? 2

Opening Case: What Has Napster Wrought? 2

Strategy and the Strategic Management Process 5

Defining Strategy 5

The Strategic Management Process 5

What Is Competitive Advantage? 12

Research Made Relevant: How Sustainable Are Competitive Advantages? 14

The Strategic Management Process, Revisited 14

Measuring Competitive Advantage 15

Accounting Measures of Competitive Advantage 15

Global Perspectives: Accounting Around the World 16

Economic Measures of Competitive Advantage 19

Strategy in Depth: Estimating a Firm's Weighted Average Cost of Capital 21

The Relationship Between Economic and Accounting Performance Measures 22

Emergent Versus Intended Strategies 22

Ethics and Strategy: Stockholders Versus Stakeholders 23

Why You Need to Know About Strategy 25

Strategy in the Emerging Enterprise: Emergent Strategies and Entrepreneurship 26

The Strategic Management Process in an International Context 27

Summary 28

Challenge Questions 30

Problem Set 30

End Notes 31

Chapter 2: Evaluating a Firm's External Environment 32

Opening Case: Can TiVo Change the Way You Watch TV? 32

Understanding a Firm's General Environment 34

Global Perspectives: Pokémon Invades Louis Vuitton 37

The Structure-Conduct-Performance Model of Firm Performance 39

Ethics and Strategy: Is a Firm Gaining a Competitive Advantage Good for Society? 40

The Five Forces Model of Environmental Threats 41

Strategy in Depth: The S-C-P Model and the Five Forces Framework 42

The Threat of Entry 43

The Threat of Rivalry 48

The Threat of Substitutes 49

The Threat of Suppliers 49

The Threat of Buyers 51

The Five Forces Model and Average Industry Performance 52

Another Environmental Force: Complementors 53

Research Made Relevant: The Impact of Industry and Firm Characteristics on Firm Performance 54

Industry Structure and Environmental Opportunities 55

Opportunities in Fragmented Industries: Consolidation 56

Opportunities in Emerging Industries: First-Mover Advantages 56

Opportunities in Mature Industries: Product Refinement, Service, and Process Innovation 59

Strategy in the Emerging Enterprise: Microsoft Grows Up 60

Opportunities in Declining Industries: Leadership, Niche, Harvest, and Divestment 62

Threat and Opportunity Analysis in an International Context 64

Analysis of Environmental Threats in an International Context 64

Analysis of Opportunities in an International Context 66

Summary 68

Challenge Questions 70

Problem Set 70

End Notes 71

Chapter 3: Evaluating a Firm's Internal Capabilities 74

Opening Case: Electronic Arts—They're in the Game 74

The Resource-Based View of the Firm 76

What Are Resources and Capabilities? 76

Critical Assumptions of the Resource-Based View 77

Strategy in Depth: Ricardian Economics and the Resource-Based View 78

The VRIO Framework 78

The Question of Value 79

Global Perspectives: Does It Pay to Be an American Beer in Europe? 81

Strategy in the Emerging Enterprise: Who Is Yahoo!? 82

Ethics and Strategy: Externalities and the Broader Consequences of Profit Maximization 84

The Question of Rarity 86

The Question of Imitability 87

Research Made Relevant: Strategic Human Resource Management Research 92

The Question of Organization 93

Applying the VRIO Framework 94

Applying the VRIO Framework to Dell Computer 96

Imitation and Competitive Dynamics in an Industry 98

Not Responding to Another Firm's Competitive Advantage 98

Changing Tactics in Response to Another Firm's Competitive Advantage 100

Changing Strategies in Response to Another Firm's Competitive Advantage 101

Implications of the Resource-Based View 102

Where Does the Responsibility for Competitive Advantage in a Firm Reside? 102

Competitive Parity and Competitive Advantage 103

Difficult-to-Implement Strategies 104

Socially Complex Resources 105

The Role of Organization 105

Internal Analysis in an International Context 106

Exploiting Current Resource Advantages in New Markets 106

Developing New Resources and Capabilities in New Markets 107

Summary 108

Challenge Questions 110

Problem Set 110

End Notes 111

End-of-Part 1 Cases

Case 1-1: Roadway Express, Inc. PC 1-1

Case 1-2: Michelin and the Global Tire Industry in 1999 PC 1-9

Case 1-3: Apple's iTunes: Changing the Face of Online Music Retailing PC 1-29

Case 1-4: Wal-Mart Stores, Inc. PC 1-40

Case 1-5: Harlequin Enterprises: The Mira Decision PC 1-56

Part 2: BUSINESS LEVEL STRATEGIES



Chapter 4: Cost Leadership 114

Opening Case: Can Wal-Mart Keep It Going? 114

What Is Business Level Strategy? 116

What Is Cost Leadership? 116

Sources of Cost Advantages 117

Research Made Relevant: The Consolidation of the U.S. Beer Market—Did Bud Pay Too Much? 123

Ethics and Strategy: The Race to the Bottom 125

The Value of Cost Leadership 126

Cost Leadership and the Threat of Entry 126

Cost Leadership and the Threat of Rivalry 126

Strategy in Depth: The Economics of Cost Leadership 127

Cost Leadership and the Threat of Substitutes 128

Cost Leadership and the Threat of Suppliers 128

Cost Leadership and the Threat of Buyers 129

Cost Leadership and Sustained Competitive Advantage 129

The Rarity of Sources of Cost Advantage 129

The Imitability of Sources of Cost Advantage 131

Strategy in the Emerging Enterprise: The Oakland A's: Inventing a New Way to Play Competitive Baseball 132**Organizing to Implement Cost Leadership 135**

Organizational Structure in Implementing Cost Leadership 135

Management Controls in Implementing Cost Leadership 138

Compensation Policies and Implementing Cost Leadership Strategies 139

Cost Leadership in an International Context 139*Global Perspectives: The Rise of the Maquiladora* 140**Summary 141**

Challenge Questions 142

Problem Set 142

End Notes 143

Chapter 5: Product Differentiation 144*Opening Case: Who Is Victoria, and What Is Her Secret?* 146**What Is Product Differentiation? 146**

Bases of Product Differentiation 147

Research Made Relevant: Discovering the Bases of Product Differentiation 148

Product Differentiation and Creativity 153

The Value of Product Differentiation 153

Product Differentiation and Environmental Threats 153

Strategy in Depth: The Economics of Product Differentiation 154

Product Differentiation and Environmental Opportunities 156

Ethics and Strategy: Product Claims and the Ethical Dilemmas in Health Care 157**Product Differentiation and Sustained Competitive Advantage 158**

Rare Bases for Product Differentiation 158

The Imitability of Product Differentiation 158

Organizing to Implement Product Differentiation 164

Organizational Structure and Implementing Product Differentiation 165

Management Controls and Implementing Product Differentiation 165

Strategy in the Emerging Enterprise: Can Only Small Firms Be Innovative? 168

Compensation Policies and Implementing Product Differentiation Strategies 168

Can Firms Implement Product Differentiation and Cost Leadership Simultaneously? 169

No: These Strategies Cannot Be Implemented Simultaneously 169

Yes: These Strategies Can Be Implemented Simultaneously 170

Product Differentiation in an International Context 171*Global Perspectives: International Marketing Blunders* 172**Summary 174**

Challenge Questions 175

Problem Set 175

End Notes 176

End-of-Part 2 Cases

Case 2-1: The British Motorcycle Industry at a Crossroads PC 2-1

Case 2-2: JetBlue Airways: Neeleman's Future Bet PC 2-10

Case 2-3: The Levi's Personal Pair Proposal PC 2-27

Case 2-4: Kodak: Betting on Digital Imaging PC 2-36

Case 2-5: Nike, Inc. in 1998 PC 2-52

Part 3: CORPORATE STRATEGIES



Chapter 6: Vertical Integration 178

Opening Case: Who Am I Calling? 178

What Is Corporate Strategy? 180

What Is Vertical Integration? 180

Strategy in Depth: Measuring Vertical Integration 182

The Value of Vertical Integration 183

Vertical Integration and the Threat of Opportunism 183

Vertical Integration and Firm Capabilities 185

Vertical Integration and Flexibility 186

Research Made Relevant: Empirical Tests of Theories of Vertical Integration 188

Applying the Theories to the Management of Call Centers 188

Integrating Different Theories of Vertical Integration 190

Vertical Integration and Sustained Competitive Advantage 190

Ethics and Strategy: The Ethics of Outsourcing 191

The Rarity of Vertical Integration 191

Global Perspectives: Producing a Hindi Version of The Osbournes 193

The Imitability of Vertical Integration 194

Organizing to Implement Vertical Integration 195

Organizational Structure and Implementing Vertical Integration 195

Strategy in the Emerging Enterprise: Oprah, Inc. 196

Management Controls and Implementing Vertical Integration 197

Compensation in Implementing Vertical Integration Strategies 198

Vertical Integration in an International Context 200

Summary 202

Challenge Questions 204

Problem Set 204

End Notes 205

Chapter 7: Corporate Diversification 206

Opening Case: X-Box Is Coming 206

What Is Corporate Diversification? 208

Types of Corporate Diversification 209

Global Perspectives: How Global Are Globally Diversified Firms? 210

Limited Corporate Diversification 210

Related Corporate Diversification 211

Unrelated Corporate Diversification 213

The Value of Corporate Diversification 213

What Are Valuable Economies of Scope? 213

Research Made Relevant: How Valuable Are Economies of Scope, on Average? 214

Strategy in the Emerging Enterprise: Gore-Tex and Guitar Strings 220

Can Equity Holders Realize These Economies of Scope on Their Own? 228

Ethics and Strategy: Globalization and the Threat of the Multinational Firm 229

Corporate Diversification and Sustained Competitive Advantage 231

The Rarity of Diversification 231

The Imitability of Diversification 231

Strategy in Depth: Risk-Reducing Diversification and a Firm's Other Stakeholders 232

Corporate Diversification in an International Context 234

Financial Risks and International Diversification 235

Political Risks and International Diversification 235

Global Perspectives: Using International Strategies to Avoid Taxes 236

Summary 239

Challenge Questions 240

Problem Set 240

End Notes 241

Chapter 8: Organizing to Implement Corporate Diversification 244

Opening Case: Corporate Crooks 244

Organizational Structure and Implementing Corporate Diversification 246

Strategy in Depth: Agency Conflicts Between Managers and Equity Holders 248

The Board of Directors 249

Research Made Relevant: The Effectiveness of Boards of Directors 250

Global Perspectives: The Family Firm in the United States and the World 252

Institutional Owners 252

The Senior Executive 254

Corporate Staff 255

Division General Manager 257

Shared Activity Managers 257

Management Controls and Implementing Corporate Diversification 259

Evaluating Divisional Performance 259

Allocating Corporate Capital 262

Transferring Intermediate Products 263

Compensation Policies and Implementing Corporate Diversification 266

Strategy in the Emerging Enterprise: Transforming Big Business into Entrepreneurship 267

Organizing to Implement Corporate Diversification in an International Context 268

Ethics and Strategy: When Is Enough Too Much? 269

Summary 272

Challenge Questions 273

Problem Set 273

End Notes 274

Chapter 9: Strategic Alliances 276

Opening Case: Original Programming at HBO 276

What Is a Strategic Alliance? 278

How Do Strategic Alliances Create Value? 279

Strategic Alliance Opportunities 279

Strategy in Depth: Winning Learning Races 282

Global Perspectives: Can You Hear Me Now? 284

Research Made Relevant: Do Strategic Alliances Facilitate Tacit Collusion? 286

Alliance Threats: Incentives to Cheat on Strategic Alliances 288

Adverse Selection 288

Moral Hazard 289

Strategy in the Emerging Enterprise: Disney and Pixar Have a Falling Out 290

Holdup 291

Strategic Alliances and Sustained Competitive Advantage 292

The Rarity of Strategic Alliances 292

Ethics and Strategy: When It Comes to Alliances, Do "Cheaters Never Prosper?" 293

The Imitability of Strategic Alliances 294

Organizing to Implement Strategic Alliances 297

Explicit Contracts and Legal Sanctions 297

Equity Investments 300

Firm Reputations 300

Joint Ventures 301

Trust 302

Strategic Alliances in an International Context 303

Summary 304

Challenge Questions 305

Problem Set 305

End Notes 306

Chapter 10: Mergers and Acquisitions 308

Opening Case: The Case of the Twin Mergers 308

What Are Mergers and Acquisitions? 311

The Value of Mergers and Acquisitions 312

Mergers and Acquisitions: The Unrelated Case 313

Mergers and Acquisitions: The Related Case 314

Strategy in the Emerging Enterprise: Cashing Out 318

What Does Research Say About Returns to Mergers and Acquisitions? 319

Why Are There So Many Mergers and Acquisitions? 319

Strategy in Depth: Evaluating the Performance Effects of Acquisitions 320

Mergers and Acquisitions and Sustained Competitive Advantage 323

Valuable, Rare, and Private Economies of Scope 323

Valuable, Rare, and Costly-to-Imitate Economies of Scope 324

Unexpected Valuable Economies of Scope Between Bidding and Target Firms 325

Implications for Bidding Firm Managers 326

Global Perspectives: Ford's Acquisition of Jaguar 330

Implications for Target Firm Managers 332
Research Made Relevant:

The Wealth Effects of Management Responses to Takeover Attempts 333

Organizing to Implement a Merger or Acquisition 336

Mergers and Acquisitions in an International Context 338

Summary 340

Challenge Questions 341

Problem Set 341

End Notes 342

End-of-Part 3 Cases

Case 3-1: eBay: To Drop-Off or Not? PC 3-1

Case 3-2: Nucleon, Inc. PC 3-15

Case 3-3: Saatchi & Saatchi (A): Pioneers of Globalization in Advertising PC 3-25

Case 3-4: Extending the "easy" Business Model: What Should easyGroup Do Next? PC 3-37

Case 3-5: LEGO (A) PC 3-53

Case 3-6: LVMH: Managing the Multi-Brand Conglomerate PC 3-57

Case 3-7: Swissair and the Qualiflyer Alliance PC 3-72

Case 3-8: Ben & Jerry's—Japan PC 3-78

Case 3-9: The Tale of Eloise and Abelard or Tough Love for HP-Compaq PC 3-90

Case 3-10: Newell Company: The Rubbermaid Opportunity PC 3-105

Case 3-11: Cooper Industries' Corporate Strategy (A) PC 3-111

Appendix: Analyzing Cases and Preparing for Class Discussions 343

Illustration/Photo Credits 347

Glossary 349

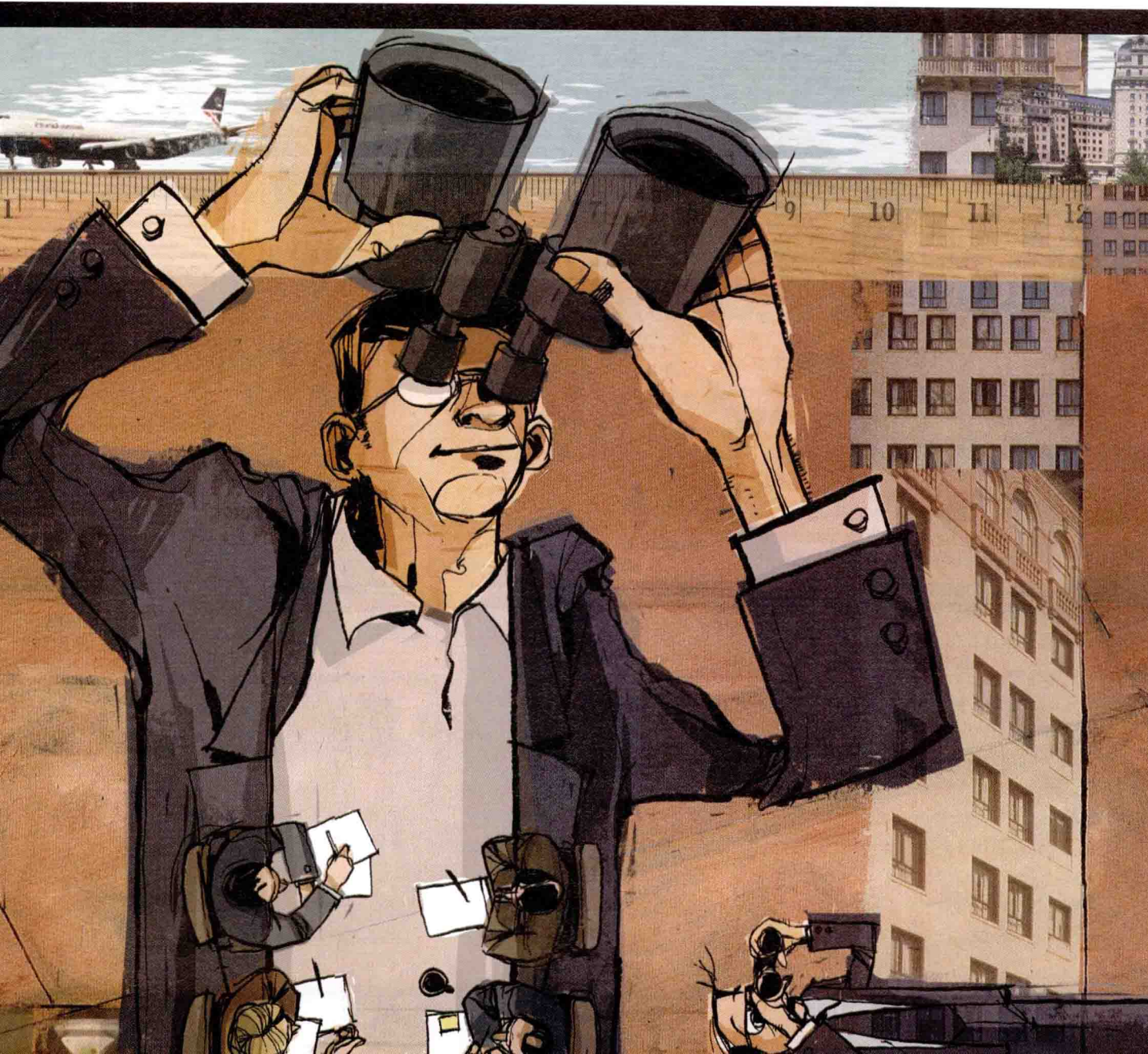
Company Index 357

Name Index 359

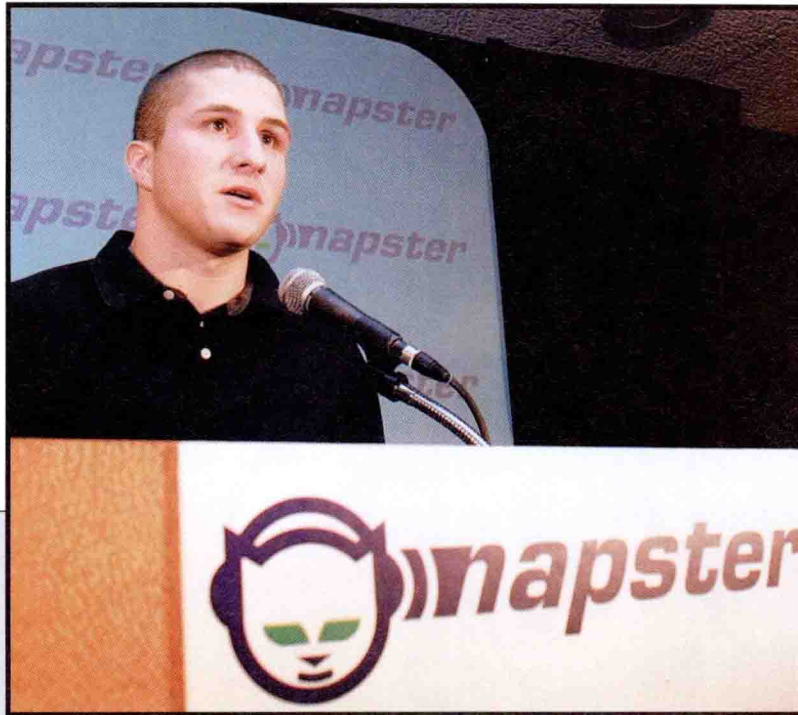
Subject Index 363

1

THE TOOLS OF STRATEGIC ANALYSIS



What Is Strategy and the Strategic Management Process?



The music business is a mess. U.S. music sales were down 8.2 percent in 2002. Most major record labels have seen their profit margins fall from 15 to 20 percent in the late 1980s to below 5 percent currently. In 2003, many of these labels—including BMG, EMI, and Sony Music—laid off thousands of employees. Even artists like Metallica and Dr. Dre have complained that the structure of the music industry is fundamentally flawed and needs to be redesigned.

Singer-songwriter Sheryl Crow recently observed: "This industry

What Has Napster Wrought?

has been in such a funk. It really needs something . . . to get it going again." In fact, everyone associated with the music business is unhappy—except consumers. Consumers have never been happier.

Of course, it all began with Napster. A Web site where consumers could trade digital music

with each other, Napster opened up the possibility that people could download an

entire music library to their hard drive and burn CDs, all for free. Not surprisingly, Napster's founder, Shawn Fanning, got a louder reception than any of the bands when he was introduced at the MTV Music Video Awards.

And while the original Napster was found to violate U.S. copyright laws and was forced out of business, free online downloading continues. Indeed, some researchers suggest that there was a

Learning Objectives

After reading this chapter, you should be able to:

1. Define the concept of strategy.
2. Describe the strategic management process.
3. Define competitive advantage and its relationship to economic value creation.
4. Describe two different measures of competitive advantage.
5. Explain the difference between emergent and intended strategies.
6. Discuss the importance of understanding a firm's strategy even if you are not a senior manager in a firm.
7. Describe how the strategic management process can be extended to include international business activities.

35 percent increase in free downloaded music from 2002 to 2003, despite several well-publicized prosecutions of individual file swappers.

Current free music download Web sites—like KaZaA, eDonkey, and Bit Torrent—operate on the margin of the law. However, since these Web sites do not reside on a single server, their proprietors are difficult to identify and prosecute.

The great irony is that, historically, the creation of new music formats has always enhanced the profitability of record labels. From the 78-rpm single of the 1930s and 1940s, to the 33-rpm long-playing

record of the 1950s and 1960s, to the cassette tapes of the 1970s and 1980s, and the compact discs of the 1990s, every time a new recording format has been introduced, record company profits have soared. This has been the case even though some of these formats—including cassette tapes and burnable CDs—were not copy protected. But, so far, no record company has figured out how to make a profit from downloading music off the Internet.



Now, iTunes, Rhapsody, Sony Connect, and Wal-Mart Music Downloads have all recently entered the fee-based Internet music download market. These companies contract with various record companies to make music available to consumers over the Web for a fee. That way, record companies (and artists) are compensated for producing music, these Web sites earn a profit, and consumers have the opportunity to legally download music—albeit for a fee.

These and other fee-based music download firms have adopted two distinct strategies.