

STRUCTURED VIRAL COMMUNICATIONS: THE POLITICAL ECONOMY AND SOCIAL ORGANIZATION OF DIGITAL DISINTERMEDIATION

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INTRODUCTION

This paper applies a new institutional economic analysis of what I call “structured viral communications” to two of the most interesting stories of cyberspace: (1) digital disintermediation in the music business; and (2) the 2008 Obama campaign. The paper positions the analysis between two extreme views of the digital revolution’s impact on traditional business models. At one extreme is the Internet fairytale of “free everything”;¹ on the other end are the copyright-holder sob stories of pirates “stealing everything.”² While there is a certain amount of truth in each view, both overstate their case and, consequently, offer a fundamentally flawed account that provides a faulty basis for policymaking.

The “Internet fairytale” dramatically overestimates the ease of cost recovery in a world of low marginal costs. Moreover, it underestimates the challenge of organizing the economic relationships needed to recover substantial average costs and achieve long-term viability. The Internet fairytale also violates the first principle of the free software movement: “[F]ree’ as in ‘free speech,’ not as in ‘free beer.’”³ The failure to carefully define what “free” is endangers the achievement of what it is and could be. Failing to deal with long run recovery of real costs gives excessive credence to the sob story of the copyright holders, who, of course, demand far more control over free speech than is needed to cover their costs. However, the “copyright-holder sob story” vastly overestimates the role of piracy in the decline of revenues and underestimates the benefits of economic efficiency. What could be a reasonable argument in support of incentivizing content creation quickly deteriorates into a legitimization of the abuse of market power and the defense of efforts to capture economic rents made available by technological innovation. By overreaching on the claim of piracy, proponents of this view undermine

1. *See, e.g.*, CHRIS ANDERSON, FREE: THE FUTURE OF A RADICAL PRICE 3, 13 (2009).

2. *See, e.g.*, Preston R. Padden, EVP, Worldwide Gov’t Relations, Walt Disney Co., Building a Framework for Efficient Enforcement, Remarks at the Silicon Flatirons Conference: The Digital Broadband Migration: Information Policy for the Next Administration (Feb. 11, 2008).

3. GNU Operating System, <http://www.gnu.org> (last visited Oct. 12, 2010).

the case for copyright.

The new institutional economic framework is ideally suited to combine these two accounts and extract valid organizational insights. It integrates the economics of production costs and transaction costs by stressing the challenges of institutionalizing social and economic relations in durable, resource-generating organizations. Douglass C. North, a Nobel laureate and leading practitioner of new institutional economics, summarizes the framework as follows:

Institutions provide the basic structure by which human beings throughout history have created order and attempted to reduce uncertainty in exchange. Together with the technology employed, they determine transaction and transformation costs and hence the profitability and feasibility of engaging in economic activity.

. . . .

. . . It concerns the endless struggle of human beings to solve the problems of cooperation so that they may reap the advantages not only of technology, but also of all the other facets of human endeavor that constitute civilization.⁴

The problem of cooperation is dramatically affected by new communications technologies because they transform the logic of collective action.⁵ The need for cooperation and organization, however, does not disappear, but the ability to achieve cooperation and organization is transformed.

The framework of analysis for the organizational challenges of structured viral communications is taken from the work of Elinor Ostrom, another Nobel laureate in economics, whose work is founded on a critique of neoclassical economics. Ostrom has identified the critical challenges in organization/institution building and has shown that communications are critical to building durable institutions to solve the problem of managing “common pool resources” (“CPR”).

In CPR dilemmas where individuals do not know one another, cannot communicate effectively, and thus cannot develop agreements, norms, and sanctions, aggregate predictions derived from models of rational individuals in a noncooperative game receive substantial support. These are sparse environments

4. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 118, 133 (1990).

5. Arthur Lupia & Gisela Sin, *Which Public Goods are Endangered?: How Evolving Communication Technologies Affect the Logic of Collective Action*, 117 PUB. CHOICE 315, 329 (2003).

....

... In richer environments that vary from the institutionally sparse homeland of noncooperative game theory... [s]imply allowing individuals to talk with one another is a sufficient change in the decision environment to make a substantial difference in behavior....⁶

The recognition of shared interest—the collective payoff that flows from cooperation—also plays a key role in the analysis of social organization to cooperatively exploit the CPR.

When substantial benefits can be gained by arriving at a joint plan of action for a series of future interactions, individuals may have in their repertoire of heuristics simple sharing rules to propose, backed up by a presumption that others will use something like a measured response. If in addition, individuals have learned how a monitoring and sanctioning system enhances the likelihood that agreements will be sustained, they are capable of setting up and operating their own enforcement mechanism.⁷

[A]ppropriators of a common resource might take into account more than the individual benefits and costs they receive from following or breaking the rules that coordinate resource use. If they include the opportunity costs of foregone joint benefits and the expected costs of developing new rules if defecting behavior leads to the breakdown of existing arrangements, appropriators may recognize incentives to maintain those arrangements by adopting a cooperative strategy over numerous iterations.⁸

Digital disintermediation breaks down incumbent social and economic relations of production, but establishing durable new relations requires institution building. This paper is organized as follows: Part I presents an overview of the argument, relying on graphic presentations and a critique of the “Internet fairytale.” Part II is a study of the music sector, the first major example of digital disintermediation. This part provides an analysis that highlights the economic aspects of a sector that resisted the transformation. It also provides context for a critique of the “copyright-holder sob story.” Part III examines the Obama campaign as an example of structured viral communications that voluntarily embraced a powerful new approach to organization in order to achieve a goal in a

6. ELINOR OSTROM ET AL., RULES, GAMES, & COMMON-POOL RESOURCES 319-20 (1994).

7. *Id.* at 220.

8. *Id.* at 296.

non-economic context. Finally, the conclusion summarizes three broad points to be gleaned from the institutional economic analysis.

I. THE TRANSFORMATIVE POWER OF STRUCTURED VIRAL COMMUNICATIONS

A. Viral Communications Overwhelms Centralized Communications

As shown in the top graphs of Figure I-1, Chris Anderson first argued that, in cyberspace, the long tail of the distribution of commercial activity is where the action would be because the declining costs of search, storage and distribution meant that less popular products would have more shelf space and a longer shelf life.⁹ He later argued that *Free* would be the basic model of digital transactions.¹⁰ He failed, however, to appreciate the impact of the explosion of communications that would inundate the transactions on which his formulation focused (the bottom graph of Figure I-1).

The problem with Anderson's initial long tail argument is that it was still essentially a one-to-many formulation (as shown in the top left graphic of Figure I-2). While technology made it cheaper and easier to execute communications, transactions still involved a central source transacting with individual customers. In reality, lowering the cost of transactions between a centralized source and consumers on the edge of the network is much less important than the ability of people at the edge to engage directly in transactions or conversations with one another, i.e. the many-to-many essence of Internet communications (the top right graph of Figure I-2).

Consequently, the ability of individuals to communicate overwhelms any linear effects of cost reduction. David Reed has called this the "sneaky exponential."¹¹ Reed's formulation of the sneaky exponential pointed out that with even modest numbers of people connected, potential conversations increased dramatically. He was criticized by some who argued that the number of potential conversations overwhelmed the capacity of individuals to engage in communications.¹²

9. See CHRIS ANDERSON, *THE LONG TAIL: WHY THE FUTURE OF BUSINESS IS SELLING LESS OF MORE* 6, 9-10 (2006).

10. ANDERSON, *supra* note 1, at 3, 5.

11. David P. Reed, *That Sneaky Exponential – Beyond Metcalfe's Law to the Power of Community Building*, <http://www.reed.com/dpr/locus/gfn/reedslaw.html> (last visited Oct. 12, 2010); see also David P. Reed, *Exponents of Change: How Scale Creates Value in Network Communities*, <http://www.reed.com/dpr> (last visited Oct. 12, 2010); see also David P. Reed, *The Law of the Pack*, HARV. BUS. REV., Feb. 1, 2001, at 23-24.

12. Bob Briscoe, Andrew Odlyzko & Benjamin Tilly, *Metcalfe's Law is Wrong*, IEEE Spectrum, July 2006, at 34.

The central point of his argument, though, was that the freedom to communicate maximizes individual, and therefore social, value. Individuals choose more valuable conversations and have more of them.

The explosion of viral communications provides an opportunity for organization because the conversations need not be random (the bottom graph in Figure II-2). From a network perspective, chaotic viral communications may not be efficient. Carefully structured communications allow more and higher value communications to take place.¹³ Robust, multi-scale networks achieve significantly greater efficiencies in the use of communications resources than a purely many-to-many network, while allowing more communications to take place at much lower resource cost than in a one-to-many network. I call this hybrid, structured viral communications. The ease of communications alters the logic of collective action, while structure renders the network more efficient.

The exponential explosion of viral, many-to-many communications on the edge quickly overwhelms the dominance of the firms at the center of the one-to-many network. First, the freedom to communicate changes the terms of trade and undermines the ability of the center to control resource flows. A simple count of transactions may continue to show a long tail structure, but the nature and value of the transactions shifts. Having a large market share as depicted by the power curve rule¹⁴—80 percent of the transactions are accounted for by 20 percent of the firms—is less meaningful when the consumer can easily switch suppliers. Under these circumstances, the transaction is not one of extracting surplus from consumers; it is one of capturing transactions by making them attractive. In the music case, for example, one can argue that the largest labels still account for a high percentage of the transactions, although it has declined, but more importantly, the value of those transactions has been cut by two-thirds because they have lost control over communications.

The key for the Obama campaign was to first train people, secure their commitment and then reward them with access to centralized tools and resources that allowed them to be more effective in performing the activities *they* wanted to conduct. The volunteers were self-selected and self-motivated, while the center gave encouragement and support rather than orders. The support was not random but given to specific individuals, identified on a decentralized basis, who appeared to be reliable and potentially productive agents. These identified agents then

13. See Mark N. Cooper, *Making the Network Connection*, in OPEN ARCHITECTURE AS COMMUNICATIONS POLICY, 131-32 (Mark N. Cooper ed., 2004).

14. See generally *Power Law*, WIKIPEDIA, http://en.wikipedia.org/wiki/Power_law (last visited Oct. 12, 2010) (reference article includes an example power law graph demonstrating the 80-20 rule).

had the autonomy to engage in activities at the edge. It was a light hand of hierarchy and organization that channeled the viral energy toward a goal.

B. The Challenges and Advantages of Structured Viral Organizations

Structured viral communications captured for organizational purposes convey a general set of advantages in the form of transaction cost reductions and demand side value creation (see Table I-1). Using local knowledge and allowing consumers to be producers who self-organize on the network, structured viral communications achieve a better fit between consumer needs and output at a lower cost with increased option value. Additionally, there is a supply-side component: The general transaction cost processes can be brought to bear on the exploitation of specific resources. Individuals engage in a productive process to exploit a resource, using the more powerful communications to achieve a benefit. Table I-1 applies the general framework to four examples, each of which is grounded more heavily in one of the primary aspects of social order. For example, an open mesh network is a technology-centered solution that uses embedded coordination in devices to occupy the local spectrum dynamically, thereby utilizing it more intensively. Open source software uses embedded knowledge to share code and exploit the rich information available in a community of programmers. The two detailed studies presented in this article expand on examples that emphasize the economic (music) and political (Obama campaign) realms of society.

Overcoming organizational challenges is the key to success (see Table I-2). Table I-2 is based on Elinor Ostrom's characterization of the ways in which groups organize themselves to effectively exploit common pool resources. In order to form an effective organization to exploit a common pool resource on a sustainable basis, she argues that each of the challenges must be overcome in a coherent manner. Communication is the key to successful organization.

The ability to communicate and exchange information is central to the ability to organize around shared interests and take collective action. Positions (roles) with identifiable permitted activities (rights and obligations) are filled according to boundary (entry) conditions where rewards induce participation and enforcement maintains appropriate behavior. The life blood of the organization is a continuous flow of information to members about the status of the organization and behaviors to alert the members and those charged with maintaining the integrity of the organization.¹⁵

15. It may well be that the literature on collective action was always too pessimistic. The

This is where Anderson's second analysis goes wrong as a guide to institutionalizing economic organization. It is a mistake to claim that things are free or that there need be no organization. In fact, he knows otherwise. While the title of the book is "Free," it turns out that the whole book is a discussion of the shell game of cost recovery engaged in by clever capitalists (see Table I-3). They shift cost recovery across time, space and products to give the illusion of *free*. They cannot succeed without covering their costs and they cannot cover their costs without establishing durable economic relations. Those relations require the parties to the transaction to know what has been conveyed and, where cost recovery is shifted, commitment and enforcement. Each cost recovery scheme has problems from the firm's point of view and, in several respects, from the societal point of view.

By skipping over or downplaying the hard organizational challenges, Anderson creates a false dichotomy between scarcity and abundance (see Table I-4). While scarcity is certainly the wrong model, imaginary abundance based on a "don't worry, be happy" or "we'll figure it out" approach is not likely to elicit a sustainable outcome. New institutional economics and the analysis of common pool resources indicate it is vital to achieve the cooperation necessary to exploit technology.

While the new institutional economics is grounded in criticism of neoclassical economics, it recognizes the contribution that neoclassical analysis can make in the study of efficiency in production costs. This paper does so too, basing the analysis of the transformation in the music sector on a traditional economic analysis.¹⁶ The study of the music sector shows how digital disintermediation can break down incumbent economic institutions. The study of the Obama campaign shows how digital disintermediation can be used to create a powerful organization by tapping into the power of viral communications.

II. DIGITAL DISINTERMEDIATION IN THE MUSIC SECTOR

In April 2006, *The Journal of Law & Economics* published a symposium on "Piracy and File Sharing"¹⁷ that outlined many of the major analyses that had played a role in the intense file sharing policy debate following the famous peer-to-peer file-sharing case, *MGM Studios, Inc. v. Grokster, Ltd.*¹⁸ After another half-decade of further

study of common-pool resources is rich with examples from physical space. The recognition of shared interest—the collective payoff that flows from cooperation—also plays a key role. See OSTROM ET AL., *supra* note 6, at 148.

16. See generally F.M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 4-14 (3d ed. 1990).

17. Symposium, *Piracy and File Sharing*, 49 J. LAW & ECON. 1 (2006).

18. 545 U.S. 913 (2005).

developments, it has become clear that there was a lot more going on than “piracy.”

Early studies on the impact of peer-to-peer file-sharing were all over the map. Some studies found increases in sales as a result of stimulation in certain population segments (e.g. older consumers) that offset losses in others (e.g. younger users).¹⁹ Other studies found that file-sharing had little or no effect.²⁰ Still others found losses that were not large.²¹ Some concluded that because of recording industry pricing practices, even where recording industry revenue declined as a result of file sharing, consumer welfare may have increased.²² One econometric study of downloading found that the increase in consumer surplus was almost 200 percent larger than the loss of industry revenue.²³

This ambiguous empirical outcome from an analytic point of view is perfectly predictable from a theoretical point of view. Several potentially positive impacts of file-sharing have been suggested, including sampling and networking.²⁴ These impacts are especially prominent, where, as here, the industry previously had not been vigorously competitive,²⁵ and new technologies both dramatically reduced costs and enhanced the consumer experience. Accordingly, every downloaded song need not represent a lost sale. As shown below, there are many songs that would not have been purchased if their cost were not bundled into CDs.

19. Eric S. Boorstin, *Music Sales in the Age of File Sharing* (April 3, 2004) (unpublished thesis, Princeton Univ.) (on file with Princeton Univ., Dep’t of Computer Sci.).

20. Martin Peitz & Patrick Waelbroeck, *The Effect of Internet Piracy on CD Sales: Cross-Section Evidence* 13-14 (CESifo, Working Paper No. 1122, 2004); *see also* Martin Peitz & Patrick Waelbroeck, *An Economist’s Guide to Digital Music* 31 (CESifo, Working Paper No. 1333, 2004) [hereinafter Peitz & Waelbroeck, *Guide*]; *see also* Alejandro Zentner, *Measuring the Effect of Online Piracy of Music Sales* 16-17 (June 28, 2003) (unpublished manuscript) (on file with Univ. of Chicago Dep’t of Econ.); *contra* Stan J. Liebowitz, *Pitfalls in Measuring the Impact of File-Sharing on the Sound Recording Market*, 51 CESIFO ECON. STUDIES 439, 475-76 (2005) [hereinafter *Pitfalls*].

21. Zentner, *supra* note 20, at 4, 17; *see also* Stan Liebowitz, *Will MP3 Downloads Annihilate the Record Industry? The Evidence so Far*, in 15 *ADVANCES IN THE STUDY OF ENTREPRENEURSHIP, INNOVATION, AND ECONOMIC GROWTH INTELLECTUAL PROPERTY AND ENTREPRENEURSHIP* (Gary D. Libecap ed., 2004).

22. Rafael Rob & Joel Waldfogel, *Piracy on the High C’s: Music Downloading, Sales Displacement, and Social Welfare in a Sample of College Students* 3, 27 (Nat’l Bureau of Econ. Research, Working Paper No. 10874, 2004).

23. Mark Cooper, Dir. of Research, Consumer Fed’n of Am., Ctr. for Internet and Soc’y, *Remarks at the Telecommunications Policy Research Conference: Round #1 of the Digital Intellectual Property Wars: Economic Fundamentals, Not Piracy, Explain How Consumers and Artists Won in the Music Sector* (Sept. 26-28, 2008).

24. Ram D. Gopal et al., *Do Artists Benefit From Online Music Sharing?*, 79 *J. BUS.* 1503, 1524, 1529 (2006); *see also* Michael X. Zhang, *A Review of Economic Properties of Music Distribution* 14 (Nov. 15, 2002) (unpublished manuscript) (on file with Mass. Inst. of Tech.); *see also* Peitz & Waelbroeck, *Guide*, *supra* note 20, at 12, 29-30.

25. *See* Peter J. Alexander, *Market Structure of the Domestic Music Recording Industry, 1890-1988*, 35 *HIST. METHODS* 129, 129 (2002).

Sampling of individual songs through downloads allows consumers to experience new music and discover its value and could thus actually increase sales of CDs. Further, there is evidence that lower value songs are more likely to be downloaded than higher value songs.²⁶ Accordingly, some downloads would never have been purchased and thus do not represent lost sales. There is evidence that downloaders in high purchase groups may purchase a CD after downloading some songs, and that downloading increases purchases in those demographic groups least likely to purchase (i.e. respondent above the age of 25 compared to those below the age of 25).²⁷ Downloading may also stimulate purchases of complementary and related goods and services, and thus may ultimately expand the market for legitimate purchases of content for newly acquired equipment (such as an MP3 player) or for goods and services related to albums (such as live concerts). Because these revenue streams have not traditionally been the focus of the major record labels, artists may become the primary beneficiaries, those directly receiving revenues, rather than record companies.²⁸

The public policy problem is rendered complex by the fact that the ultimate issue is not whether some revenues have been lost as a result of peer-to-peer communications networks, but whether the losses have been enough to threaten the viability of the industry²⁹ and whether any new business models or industry structure might better serve the public and the promotion of progress.³⁰

After studying repeated historical examples of technological changes that lead to outbreaks of competition in the recording industry, Peter J. Alexander offered an analysis of the potential cost savings and the “exponential” increase in product creativity afforded by new digital technology that was still a decade away.

A distribution network of this type may potentially attenuate the effects of the significant barriers to entry in the music business. First, it could give firms (particularly fringe firms and new entrants) the

26. See Rob & Waldfogel, *supra* note 22, at 15-16, 22-25; see also Brief for Felix Oberholzer-Gee & Koleman Strumpf as Amici Curiae Supporting Respondents at 7, *MGM Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913 (2005) (No. 04-480).

27. Boorstin, *supra* note 19, at 60-62; *Pitfalls*, *supra* note 20, at 465 (disagreeing with some of the specifications used in Boorstin’s statistical study, but nonetheless finding that Boorstin’s conclusion would have remained the same).

28. See Amit Gayer & Oz Shy, *Publishers, Artists and Copyright Enforcement*, 18 INFO. ECON. & POLICY 374, 380-82 (2006).

29. Liebowitz, *supra* note 21, at 253 (even Liebowitz recognizes that this “[h]arm is not the same as fatal harm . . .”).

30. Mark S. Nadel, *How Current Copyright Law Discourages Creative Output: The Overlooked Impact of Marketing*, 19 BERKELEY TECH. L.J. 785, 855-56 (2004); Raymond Shih Ray Ku, *The Creative Destruction of Copyright: Napster and the New Economics of Digital Technology*, 69 U. CHI. L. REV. 263, 322-24 (2002).

opportunity to have their products distributed in a less costly and non-exclusionary fashion. By providing product samples to consumers, the new distribution network would also transmit information relating to product specifications. This would lessen the need for more traditional and less efficient techniques, such as radio airplay and other costly promotional activities, to inform consumers of the existence of new products. Given the modest marginal costs of adding a new product line to a digital delivery system, it is conceivable that the number of product offerings could increase exponentially. The costs of distribution should decline dramatically, as physical distribution at national or international levels has significant scale features. A competitive digital delivery system would reduce substantially the minimum efficient scale of distribution, and likely stimulate a highly competitive producer market.³¹

Alexander was able to predict the development in the industry once it was forced to embrace digital distribution. The key word is “forced.” The industry did not willingly make these changes.

A. The Tight Oligopoly in the Physical Music Business

1. Collusion on Price

Any analysis of the economic impact of digital distribution on the recording industry must start by understanding the structure and conduct of the industry in the years just prior to the digital revolution. The picture was not pretty—a tight oligopoly able to engage in the exercise of market power.³² This collusive power was verified by two lawsuits, one by the Federal Trade Commission³³ and one by state Attorneys General,³⁴ both of which were settled in 2000 and 2002 respectively. The complaint filed by forty-one state Attorneys General made the following

31. Peter J. Alexander, *New Technology and Market Structure: Evidence from the Music Recording Industry*, 18 J. CULTURAL ECON. 113, 121 (1994) [hereinafter *Evidence*].

32. Peter J. Alexander, *Peer-to-Peer File Sharing: The Case of the Music Recording Industry*, 20 REV. OF INDUS. ORG. 151, 151 (2002) (“The music recording industry is a highly-concentrated five firm oligopoly. Much of the dominance achieved by large firms in the industry results from control over the distribution and promotion of the [products] of the industry.”). Hollywood major movie studios and recording companies have long understood that their profits are directly tied to their ability to monopolize distribution. After all, they are not the creators of the copyrighted works at issue; they are simply the assignees and licensees of copyrighted works. As such, they have but a single means for deriving revenue: control of distribution. Note that a subsequent merger rendered the industry a four firm oligopoly.

33. See Statement of Chairman Robert Pitofsky and Commissioners, In the Matter of *Time Warner Inc. et. cetera*, (File No. 971-0070, May 10, 2000), available at <http://www.ftc.gov/os/2000/05/cdstatement.htm>.

34. See *In re Compact Disc Minimum Advertised Price Antitrust Litig.*, 2001 U.S. Dist. LEXIS 25817 (D. Me. Jan. 26, 2001).

allegations that the music labels had colluded to raise prices.

3. The purpose of the illegal agreements was to raise prices and reduce retail price competition that threatened the high and stable profit margins for CDs enjoyed by both the defendant labels and distributors and many music retailers.

....

. . . 4. This competitive threat arose with the entry into music retailing of several discount retailers (for example, Best Buy, Circuit City and Target), which could profitably undercut the prevailing retail prices charged for CDs by traditional retailers. Consumers flocked to the discount retailers that rapidly gained market share at the expense of traditional retailers.

....

. . . 5. The traditional retailers reacted by pressuring defendant distributors to impose minimum advertised pricing (“MAP”) policies which established the retail price levels at which CDs were sold, thereby effectively reducing and/or eliminating retail price competition for CDs. . . .

....

. . . 7. The effect of these anticompetitive agreements has been twofold. First, retail CD prices, which had been dropping, were stabilized and then raised industry-wide. Second, the oligopoly of defendant distributors was able to maintain high wholesale prices and margins for CDs. As a result of both effects, consumers have paid higher prices for CDs than they would have absent the illegal agreements. . . .

....

. . . 51. [T]he defendant distributors transformed their MAP programs into blunt and effective instruments for putting an end to price competition”³⁵

This collusion was a response to competition. The compact disc entered the market in the mid-1980s, constituted a quarter of total sales by 1990, and three-quarters by 1995.³⁶ Competition arrived in the early

35. Complaint at ¶¶ 3-5, ¶ 7, ¶ 51, *In re Compact Disc Minimum Advertised Price Antitrust Litigation*, 2002 WL 32947273 (D. Me. Oct. 15, 2002) (No. 1361).

36. Cooper, *supra* note 23, at 7.

1990s as the CD format became more popular; it was a new technology of distribution that had lower cost and was easier to store and handle. As shown in Figure II-1, this competition drove prices down “from \$15 to \$10 in a short period of time.”³⁷ As a result, “[d]iscount retailers’ sales grew dramatically”³⁸ The list prices in Figure II-1 do not reflect the significant discounting that was going on prior to the mid-1990s just before the industry engaged in its price fixing scheme to stop the practice. Nevertheless, total sales grew dramatically. In fact, this pre-mid-1990s period of price competition saw a faster rate of sales growth than any other time over the prior thirty years.³⁹ Prices fell by forty percent and sales more than doubled (see Figure II-2).

The biggest gains in sales came in the early 1990s when list prices were at their low and the big discount outlets were slashing prices even further. In addition to the price competition that had broken out, the expansion of sales was also the result a shift in technology, which stimulated library replacement as consumers switched from vinyl or tape cassette to CD. The expansion affirms the importance of the price elasticity of demand in the music sector: “All major labels report that moving albums to mid- or budget-pricing increases sales significantly.”⁴⁰ Consequently, the failure to recognize the price elasticity of demand has distorted the analysis of the digital transition in the music sector.

When collusive discipline was applied as a result of the recording industry’s control over physical distribution, “retail and wholesale price increases occurred despite the fact that, as the records of one music company reveal[ed], per-CD unit costs had decreased sharply during the 1990s.”⁴¹ The benefits of economies of scale and falling costs that should have been passed through to consumers in a competitive market were instead redirected to suppliers through price-fixing. The the anti-competitive behavior of the industry as it sought to control discounting had an immediate and substantial effect on prices.

. . . By June 1996 *Billboard* reported, “Thanks to the majors’ new-found resolve on MAP [Minimum Advertised Prices], prices of hit CDs at discount chains rose by \$2 to \$11.99 over the last month.” In the meantime, NARM [the National Association of Recording Merchandisers] reported that the average price paid by their SoundData Consumer panel during the period of December 1995 through February 1996 was \$13.64, up from \$12.71 in the previous

37. *Id.* at ¶ 39.

38. *Id.* at ¶ 40.

39. *Pitfalls*, *supra* note 20, at 458.

40. GEOFFREY P. HULL, *THE RECORDING INDUSTRY* 179 (2nd ed. 2004).

41. Complaint, *supra* note 35, at ¶ 75.

survey.⁴²

While these particular anticompetitive practices were enjoined both in 2000 by the Federal Trade Commission and in 2002 by the state Attorneys General, today the industry still remains a tight oligopoly with suspect business practices.⁴³

2. Anti-Consumer Bundling

The manipulation of CD prices was combined with a second strategy to further exploit consumers. Throughout the 1990s, even though production costs were falling, the recording industry all but eliminated the sale of singles. In effect, consumers were forced into paying too much for CDs that contained extra content they did not actually want. In the 1980s, sales of singles had been in the hundreds of millions and, with declining production costs, could have remained high. The industry, however, sought to increase its profits by restricting the availability of singles. Implementing this strategy caused sales volumes of singles to fall by 90 percent, as shown in Figure II-2

Prior to the 1990s, the single allowed consumers to cost-effectively meet their needs while stimulating sales through the purchase of individual songs which consumers could use to “try out” an artist.

At one time, singles made up a hefty part of the recording industry’s income. . . . But things have changed. Record companies want consumers to buy full length CDs when they fall in love with a song. So they’ve shut off the spigot when it comes to releasing less expensive commercial singles to retail.

The debate rages. Labels insist they simply cannot make a big enough return if fans are buying \$3 singles instead of \$16 albums. Retailers, though, fume that they are suffering without singles, which have historically increased foot traffic in stores, especially among younger shoppers.

Labels like the single when it suits their purposes; during parts of the overheated 1990s, labels released them in floods at deeply discounted prices to help promote blockbuster albums and claim fanciful new

42. HULL, *supra* note 40, at 183 (citation omitted).

43. See ELI NOAM, *MEDIA OWNERSHIP AND CONCENTRATION IN AMERICA* 129 (Oxford Univ. Press, 2009); see also Bill Werde, *Major-Label Payola Probe*, ROLLINGSTONE, Nov. 25, 2004, at 15-17; Peter J. Alexander, *Entry Barriers, Release Behavior, and Multi-Product Firms in the Music Recording Industry*, 9 REV. OF INDUS. ORG. 85, 92-93 (1994) (where the importance of promotion and radio play is emphasized).

sales records

. . . .

. . . But that was then, this is now, and the music fans are the losers.⁴⁴

A look at the long-term trend in single sales easily supports the conclusion that a large part of “piracy” is the result of demand that was suppressed by the exercise of market power to eliminate singles (see Figure II-3). Singles had already gone through two transitions (i.e. vinyl to cassette and cassette to CD), but the industry had all but eliminated them by the late 1990s, creating a pent-up demand that exploded once the digital distribution model took hold. Single sales had been well above 150 million in the late 1980s and above 200 million in the 1970s.⁴⁵ Digital distribution amplified the attractiveness of the singles through convenience, portability, and consumer control. With the decline in the price of CDs, sales of singles to the tune of 400 million could well have been achieved, suggested by Figure II-3.⁴⁶

The combination of high prices due to anticompetitive collusion and the elimination of the single in order for the new full-album CD format to thrive created a windfall for the record labels. “The record companies minted money,’ one major-label exec told [reporter Seth Mnookin]. ‘We made huge margins off CDs. We’ll never have those margins again.’”⁴⁷

A survey of consumers at the time of the consent decree signed with the Federal Trade Commission in 2000 revealed significant consumer dissatisfaction with recording industry pricing.⁴⁸ Three-quarters of respondents felt that pricing levels were unreasonable and almost as many felt they were excessive compared to other forms of entertainment.⁴⁹ The respondents said they would increase their purchases of music if prices fell substantially and almost all respondents said they would be unwilling to buy digital downloads at the same price as CDs. The public was clearly not satisfied.

Because it relied on a series of erroneous assumptions, the recording

44. Eric Boehlert, *Why the Record Industry is Killing the Single*, SALON.COM, Dec. 19, 2001, http://dir.salon.com/ent/music/feature/2001/12/19/music_industry_sidebar/index.html.

45. Cooper, *supra* note 23, at 25.

46. This represents one-third of units shipped, which is the level of sale of singles in the mid-1980s.

47. Seth Mnookin, *Universal’s CEO Once Called iPod Users Thieves. Now He’s Giving Songs Away*, WIRED, Dec. 2007, at 209.

48. Michele Wilson-Morris, *28 States Sue Major Labels and Retailers Over Alleged Price Fixing Conspiracy*, MUSIC DISH (Aug. 8, 2000), <http://www.musicdish.com/mag/?id=1411>.

49. *Id.*

industry put forward vastly overblown claims of piracy and revenue loss (see the industry aspiration line in Figure II-2, above). First, the industry assumed that the bubble of sales created in the early 1990s by library replacement would continue. At the same time, the industry intended to preserve its anticompetitive pricing structure to maintain the jacked up price of CDs despite the dramatic reduction in costs made possible by digital production and distribution. Further, the industry hoped its policy of forcing consumers to buy bundles of songs rather than singles could be maintained despite the dramatically-altered economics of music distribution in favor of digital singles.

B. The Emergence of a Digital Music Business

1. The Transaction Cost Transformation

The world of physical distribution is still characterized by high fixed costs and near-zero marginal cost. Therefore it is still good business to put as much content as one can on each CD, even accounting for the fact that the CD's cost of distribution has declined. With the advent of digital distribution, however, fixed costs of distribution all but disappear, physical infrastructure is no longer necessary, and transaction costs are significantly slashed. Accordingly, the compelling economic logic of bundling disappears. The result is that revenue per unit shipped plummeted (See Exhibit III-4). Although the total number of units purchased by the public has increased sharply, the vast majority of units sold are now singles and the average price per unit sold has declined by seventy percent.

The digital transformation also goes beyond the impact of cost reduction and the elimination of the exercise of market power. Demand shifts as a result of both production and transaction changes. Flexible new consumer-friendly formats expand demand and take the experience of music consumption to another level.

The rise of the compact disc (like the rise of cassette tapes before them) demonstrated the market appeal of flexibility and convenience. CDs weren't a hit because they had the best audio fidelity; that honor still belongs to vinyl records. Rather, they gave consumers more control over the listening experience. If you wanted to replay your favorite song (or skip a crappy one), you didn't have to bother with delicately moving a phonograph arm or engaging in a frustrating rewind-stop-play-stop-rewind tango with your tape player. Everyone

came out a winner.⁵⁰

With the ability to choose singles, consumers can spend a lot less to get the music they want. In 2009, according to the RIAA, consumers spent about \$1.2 billion on singles, \$1 billion for subscription and mobile services and about \$4.3 billion on albums.⁵¹ In other words, consumers are meeting their music needs in a much more convenient way at less than half the cost. The recording industry would have liked to force them to spend as much as \$13 billion more for three times as many albums, along the high growth line in Figure II-2, which is the future the industry claimed absent downloading. Of course, we do not know how many albums consumers would have actually purchased if the recording industry had won its war against digital distribution. However, the industry's hope for very high rates of growth in album sales with inflated prices was likely too optimistic.

We do not know precisely how many singles that consumers buy per album; although, we do know the number is small (one to three). If we assume consumers buy albums for two favorite songs, consumer savings from the availability of singles would be as high as \$9 billion. If we assume three songs per album, consumer savings would be about \$5.6 billion. While there are uncertainties due to different assumptions about growth patterns and the number of songs consumers would purchase per album in a non-digital world, there is no doubt that the consumer savings are quite large. These figures represent substantial savings in an industry with total sales of about \$7 billion.

2. The Artists' View

It is a frequent lament in the music industry that few albums and almost no artists ever make any money on the sale of records. The income gap between the handful of "stars" and the remaining vast body of artists is huge. The range of works that are widely played and circulated is narrow. Under the music industry's traditional model, a handful of companies selected a small number of releases and promoted them heavily, marketing them through expensive distribution channels.

The costs of the distribution system that the recording companies controlled placed a huge drag on the market (see Figure III-5). The average price per CD in 2001 was about \$17.99, while the cost of producing a CD in quantity was \$0.50.⁵² The average amount an artist

50. Mnookin, *supra* note 47.

51. RECORDING INDUSTRY ASS'N OF AMERICA, 2009 YEAR-END SHIPMENT STATISTICS, *available at* <http://76.74.24.142/A200B8A7-6BBF-EF15-3038-582014919F78.pdf>.

52. Cooper, *supra* 23, at 12.

receives per unit sold is \$0.12.⁵³ Some sources put the artist share somewhat higher, but not much more than a dollar, net of costs.⁵⁴ Factoring in the composer, performer and producer shares of the CD price, an artist will ultimately get between twelve to sixteen cents of every dollar the consumer paid. Thus, the intermediaries that stand between the musician and the audience account for about eighty-five percent of the final price.

Manufacturing, distribution and retail account for over half of the final price of the CD. These costs are all but eliminated with digital distribution. Another quarter of the cost—record company overhead, marketing and profits—are vulnerable to sharp reductions in an environment that emphasizes horizontal structure and peer-to-peer communications. Thus, three-quarters of the costs and the central point of control are eliminated, signaling the end of the highly skewed traditional star system.

The recording companies that control distribution have an incentive to maximize profits by focusing on a few blockbuster albums and stars.⁵⁵ Those who have control of music distribution have incentive to sell the music that can bring them the most revenue. They consequently distort the market by extensive and disproportional promotions in favor of a small number of works. The overwhelming advertising campaign may further skew the consumers' preferences and lead to distorted demand.

In essence, music consumers do not have accurate information on the quality of the music because the music is an experience good. Music publishers, because of the delay in obtaining market information for all of their music, may overinvest in certain music genres and underinvest in others. A typical strategy to overcome the inefficiencies and uncertainties in the market is to focus on the superstars.⁵⁶

The brunt of these inefficiencies falls on the artists. High costs and the incentive to focus on a narrow range of output reduces demand for the product overall and narrows the prospects for most artists.⁵⁷

53. Bill Wittur, *Selling Minor Chords in Exchange for a Happy Tune*, MUSIC DISH, Dec. 12, 2004, <http://www.musicdish.com/mag/index.php?id=4859>.

54. WILLIAM FISHER, PROMISES TO KEEP: TECHNOLOGY, LAW AND THE FUTURE OF ENTERTAINMENT 259 (2004); DEREK SLATER ET AL., BERKMAN CTR. FOR INTERNET & SOCIETY AT HARV. LAW SCH., CONTENT AND CONTROL: ASSESSING THE IMPACT OF POLICY CHOICES ON POTENTIAL ONLINE BUSINESS MODELS IN THE MUSIC AND FILM INDUSTRIES AI-4 (2005).

55. Michael X. Zhang, *A Review of Economic Properties of Music Distribution*, at 5 (Sloan Sch. of Mgmt., MIT, Working Paper No. L82, 2002).

56. Gopal et al., *supra* note 24, at 1507.

57. See Evidence, *supra* note 31, at 121.

Figure III-5 also includes an estimate of the recording company take on digital distribution in its early days. The companies did not give up their rents easily. While the hard costs of distribution declined, the companies pushed up their share of the total delivered price, seeking to turn the eliminated costs of manufacturing, distribution and retail into record company rents. The large increase in record company take shown in Figure III-5 may even be too low because the companies may take charges against artist royalties. While these charges against artist royalties have always been a bone of contention, the advent of digital technology has rendered many of these charges utterly fictitious in the online environment.⁵⁸

From the artists' point of view, the benefits of the transformation are also readily explained in classic welfare economic analysis. In the oligopoly environment, producer surplus is inflated by high cost products and results in the large surplus earned by a small number of recording companies that produce "high value" blockbuster albums. In the digital environment, producer surplus is much smaller per unit, but made up of the much larger low cost output earned by less well-known artists. Using the midpoint estimate of fourteen percent of the retail price of a CD going to the artists (composers and performers), we estimate that about \$1.1 billion of the revenue from CDs went to artists in 2007. Apple, contrarily, takes about thirty percent of the digital sales revenue, returning seventy percent to artists, representing just under \$2 billion for artists in 2007.⁵⁹ Some of that must go toward administrative and other costs, so the artists end up with about \$0.50 per track or about \$1.4 billion on digital singles. The big difference on the supply side is the much broader range of artists to whom the surplus goes. If the oligopoly model had prevailed by expanding the sales of CDs, the artists' share of the producer surplus would have been larger, but much more narrowly distributed.

[British hip-hop artist Taio Cruz]'s latest album, "Rokstarr," has sold just 93,000 copies in 12 weeks, according to Nielsen SoundScan, and this week sits at No. 54 on the Billboard 200 chart.

58. HULL, *supra* note 40, at 259-260 ("[L]abels typically deduct a packaging charge, twenty-five percent for CDs, even from digital files where there is no packaging. Labels also typically pay a rate for singles that is lower than the album base rate, often seventy-five to eighty percent of the album rate. Labels also pay a lower rate on "new technologies"; also often seventy-five to eighty percent of the base album rate. If all of those deductions were taken, the artist's and producer's combined royalty would shrink to about 4.2 cents per download. Some major artists objected to this small portion of the small pie.").

59. Cooper, *supra* 23, at 22.

But while he has sold relatively few albums, he has sold 4.9 million copies of two singles from the album, “Break Your Heart” and “Dynamite,” and videos for those singles have been viewed more than 49 million times online. For his label, Mercury Records, that means he is a commercial success.⁶⁰

For the artist today, as seen in the above example, commercial success rests on sales of singles (for which consumers paid about \$5 million, instead of over the \$35 million they would have had to pay to purchase full albums) and video views (from which advertising revenues may be garnered).

Album sales were never the primary way most artists earn their living. Rather, artists earn their living by getting play time, which makes it possible to sell more songs, perform more shows and sell more merchandise (see Figure II-6). The mechanism through which the vast majority of artists became beneficiaries of the new market structure is easily explained by the reduction of transaction costs. Digital distribution expands the opportunity to engage in each of these activities. Collaboration between artists and contact with fans is increased, and the ability to be heard expands through easier promotion, viral communications and sharing. Playtime, which used to be largely restricted to radio (and hemmed in by repeated payola scandals), has exploded on the Internet. Online plays represent a new distribution channel that opens up the opportunity for direct sales from artists to consumers. Figure II-6 shows the percentage of respondents to a recent Pew Internet and American Life Project poll on the use of the Internet in regard to acquisition of music and conduct of music related activities. The behavior has become pervasive. Consequently, “If the demand for, say, live performances is enhanced by the “popularity” of the artists generated from the number of distributed recordings (legal and illegal copies combined), then we obtain the conditions under which publishers of recorded media may lose from piracy, whereas artists may gain from piracy.”⁶¹

Moreover, entirely new avenues for revenues have opened up for artists.

The singer-songwriter Dave Barnes, an artist signed to Razor and Tie, has never broken the top 50 in the Billboard 200. But Mr. Barnes found success on Christian radio and landed a deal with SongFreedom.com, a site that provides music to wedding photographers and videographers.

60. Joseph Plambeck, *Platinum Is So Passé. In iTunes Era, the Singles Count*, N.Y. TIMES, Aug. 30, 2010, at B1.

61. Gayer & Shy, *supra* note 28, at 375-76.

The commercial success of that deal, according to Mr. Chenfeld, is not reflected on the Billboard 200, even though its revenue is “considerable, and opportunities like that are viral.”

“The reliance on album sales is very 20th century,” he said.⁶²

The dramatic improvement in the discovery and information function of the market expands sales as well. This is a process that needs to be given more credit in the transformation. We tend to think about the digital revolution as inherently technical, a change in the means of production, i.e. the tools that are used to produce content and the form of the end product. However, the transformation of transactions and transaction costs is just as important. The digitization of content, which has captured so much attention in the intellectual property wars because of the ability to copy perfectly and infinitely, is not all that matters.

At the same time as this the new technology has changed the relationship between artists and recording companies, it weakens the star system because “there is a greater probability of discovering other high quality music items by lesser known artists with the new technology.”⁶³

The ultimate cost savings in marketing and distribution come from both the supply side and the demand side. On the demand side, the ability to sample “is an information-pull technology” and “a substitute to marketing and promotion, an information-push technology.”⁶⁴ As the cost structure of the industry changes through the adoption of digital technologies, performance improves since “variable costs relative to fixed costs are more important for music downloads than for CDs. This suggests that acts with a smaller audience can succeed in the digital music market. As a consequence, we could observe more music diversity and less skewed distribution of sales among artists.”⁶⁵

In fact, we do observe this pattern. The payoff for artists and society is increased diversity. Although the examples above are geared more toward the starving artists, those who may never get onto the charts, the impact has been documented even at the top of the charts.

. . . We find strong evidence that over the last decade, the number of unique artists and albums that have appeared on the Billboard Top 200 album charts is statistically related to the number of Internet

62. Plambeck, *supra* note 60, at B1.

63. Gopal et al., *supra* note 24, at 1530.

64. Martin Peitz & Partick Waelbroeck, *File-Sharing, Sampling, and Music Distribution 5* (Int'l Univ. in Germany, Sch. of Bus. Admin., Working Paper 26/2004, 2004).

65. MARTIN PEITZ & PATRICK WAELBROECK, AN ECONOMIST'S GUIDE TO DIGITAL MUSIC 396 (2005).

users. The implication is that with lowering of information sampling costs, consumers become aware of more new albums they like, leading to more artists and albums being ranked on the charts.

....

. . . The implication is that as sampling becomes less expensive, the superstar effect is eroded overall, and more users purchase music items based on their actual, not perceived, valuations.⁶⁶

The effects of the change in the business model driven by digital distribution have become clear.

[T]he multiple ways to make money provide hope to a struggling industry and are also changing the kind of music that gets made and promoted. Album sales are often driven by older listeners who typically favor country and soft-rock artists like Taylor Swift and Susan Boyle.

Pop and hip-hop artists like Taio Cruz and Rihanna are sometimes underrepresented on the album chart, as younger fans in particular have moved to buying singles and streaming music online.⁶⁷

On the date of submission of this article (August 30, 2010), analysis of the Top 50 in the charts supports this conclusion. There were forty-eight artists represented among the Top 50 albums and another twenty-seven without a Top 50 album had a Top 50 single.⁶⁸ An additional seven artists, who had neither a Top 50 album nor a Top 50 single, were listed as a being in the Top 50 when other digital distribution is taken into account (Ultimate Chart).⁶⁹ Of the thirty-four artists who did not have a “hit” album, only one had more than one single in the Top 50.⁷⁰ In fact, only six of the eighty-two artists in these top 50 lists had more than one single in the Top 50.⁷¹ Consumers are clearly able to meet their music needs in a more efficient manner and save a great deal of money.

An analysis of artists’ revenue streams from Norway, shown in Exhibit III-7, finds that total artist income has increased substantially in spite of declining revenues from record sales because the other sources of

66. Gopal et al., *supra* note 24, at 1526-1528.

67. Plambeck, *supra* note 60.

68. See *The Billboard 200*, BILLBOARD, Aug. 28, 2010, at 34; *Hot 100*, BILLBOARD, Aug. 28, 2010, at 38.

69. See *id.*; see also THE ULTIMATE CHART, <http://www.ultimatechart.com> (last visited Dec. 8, 2010).

70. *The Billboard 200*, *supra* note 68; *Hot 100*, *supra* note 68.

71. *Id.*

income have increased even more rapidly.

3. The Welfare Economics of the New Industry

This transformation is perfectly consistent with economic theory and can be explained in the classic terms of welfare economics. Figure II-8 shows the welfare economics. It includes both the supply and demand side shifts (falling costs, rising demand) and a shift from oligopoly pricing to competitive pricing. The recording industry had very high margins due to the exercise of market power over product and price in the distribution oligopoly. The digital revolution changed the picture: (1) there was a dramatic shift in the cost curve; (2) there was a shift in the demand curve; and (3) the market power of the industry was undermined by consumer sovereignty, shifting pricing power from producers to consumers.

Referring to Figure II-8, record labels were fat and happy living at point A, fixing prices and bundling songs onto albums, experiencing supra-normal profits. In the digital economy, record labels would like to live at point B because rents would increase if they could capture a disproportionate share of the cost savings. The technology allows consumers to engage in some self-help and forces record labels to build new business models, located at point C. Rents are thin here, but the industry can achieve a stable equilibrium with normal profits. Most importantly, content producers can survive. Some analysts make the mistake of suggesting that the industry can survive at point D, but it cannot. The costs at point C are real and they must be recovered. Neither the fat and happy copyright-holder world of oligopoly rents (point B), nor Internet fairy tale world of “free everything” (point D) could survive long in a dynamic capitalist economy. In the former, entry will compete the ill-gotten gains away, returning them to consumers; in the latter, exit will cause the rents, and the products, to disappear.

In conclusion, based on a series of assumptions that this paper argues were erroneous, the industry put forward vastly overblown claims of piracy and revenue loss. At the end of the 1990s, the industry assumed that the bubble of sales created by the previous change in formats would continue and it could preserve its anticompetitive pricing structure in spite of the dramatic reduction in costs made possible by digital production and distribution. It also hoped its policy of forcing consumers to buy bundles of songs rather than singles could be maintained despite the dramatically altered economics of music distribution in favor of digital singles. Both of these assumptions were incorrect. It was not piracy that delivered benefits to consumers, it was economic efficiency.

C. Extensions of Digital Economics to Other Sectors

1. Newspapers

These same powerful economic forces have been visible in other sectors. The audience-creating aspect of digital disintermediation is most evident in the newspaper sector. As shown in Figure II-9, the primary source of lost revenue in the past decade was in classified advertising, accounting for about 60 percent of the loss. Classified advertising is an appendage to the newspaper—usually contained in a separate section—and advertisers pay to be there because they think there will be an audience. Once the Internet became ubiquitous, specialized classified service providers (e.g. Craigslist), employment lists (Monster.com), and electronic two-sided markets providers (e.g. E-bay) became more attractive. The ability to target advertising is also important. The success of local cable and local weekly newspaper advertising has probably accounted for a part of the revenue loss in the retail category because they allow local advertisers to target adds better than dailies that serve a very broad geographic area. Since these losses are based on efficiency and competition, there is no reason to believe that they will ever be restored, nor is there any reason to support an economic proposition that policies should be implemented to “save” the commercial mass media enterprises. Digital distribution is not succeeding because it is stealing the content of the commercial mass media; it is succeeding because it is a much more efficient mechanism for aggregating audiences and distributing information. Because it is so efficient, the future media will not support the massive commercial enterprises that came to dominate mass media in the 20th century.

2. Book publishing

The economic impact of digital disintermediation in the distribution of books parallels the impact on music and newspapers, characterized by fierce battles over capturing rents made possible by more efficient production and distribution. As shown in Exhibit III-10, the cost of production and distribution of books declined from about \$17 per book to less than \$4 per book. Publishers defend high prices for digital books in the name of preserving bookstores,⁷² but there is a widespread

72. Another reason publishers want to avoid lower e-book prices is that print booksellers like Barnes & Noble, Borders and independents across the country would be unable to compete. Consumers, however, are buying electronic readers and becoming comfortable with reading digitally. If e-books are priced much lower than the print editions, no one but the aficionados and collectors will want to buy paper books. Motoko Rich, *Math of Publishing Meets the E-Book*, N.Y. TIMES, Mar. 1, 2010, at B1 (“If you want bookstores to stay alive, then

belief that they are also seeking to avoid downward pressure on the pricing of physical books.⁷³

The empowerment of content creators is evident in book publishing space, as it was in the music space. The dramatic improvement in the discovery and information function of the market expands sales. Examples from book publishing, where digitization of distribution is just beginning, highlight the importance of the transformation of the relationship between the creator and the audience.

Readings have long been a way for authors to reach audiences. This is part of the discovery function. Podcasts change the arithmetic.

Horror writer Scott Sigler, one of the pioneers in this area, began regularly posting readings of his first book in March 2005. “EarthCore,” broken up into 45-minute chunks that he posted on a weekly basis, won an audience of 10,000 listeners. His second book, “Ancestor,” did even better, scoring 30,000 subscribers. . . .

This month, Sigler’s fourth book debuted in a hardcover release for the first time, from Crown Publishing Group, an imprint of Random House. Crown has printed an initial run of 100,000 copies That’s a high figure for the book industry, where mostly unknown authors usually get an initial print run of only a few thousand.⁷⁴

Sigler is an unsigned artist who has used the new distribution medium to break into the system. The new medium not only makes it possible to reach fans, but it involves elements of viral communications. “Sigler’s editors say the company has been impressed that Sigler fans have requested promotional materials about the book to try to spread the word about the new hardcover edition⁷⁵

Another author, J.C. Hutchins, utilizes “a ‘minister of propaganda’ [on his website to] routinely [send] his readers on missions that vary from burning CDs and passing them along to printing out promotional postcards and slipping them onto shelves at the local bookstore.”⁷⁶ Direct

you want to slow down this movement to e-books,” said Mike Shatzkin, chief executive of the Idea Logical Company, a consultant to publishers. “The simplest way to slow down e-books is not to make them too cheap.”)

73. The argument involves shifting cost recovery between hardbacks and paperback. *Id.* (“Moreover, in the current print model, publishers can recoup many of their costs, and start to make higher profits, on paperback editions. If publishers start a new e-book’s life at a price similar to that of a paperback book, and reduce the price later, it may be more difficult to cover costs and support new authors.”).

74. Mike Musgrove, *Breakthrough of the Podcast Authors*, WASH. POST, Apr. 13, 2008, at F01.

75. *Id.*

76. *Id.*

involvement and collaboration are also possible. “To further build reader interest and loyalty, Hutchins recently opened up his fictional world to fans and invited them to add their own stories.”⁷⁷

Giving content away for free, the center of the recording industry’s concern, is one of the many strategies that artists can use to stimulate future sales.

Tor Teen books is publishing the dead-tree version, and it will also be available . . . as a free download in formats that will be easy to read on, say, the screen of a PDA. As with podcasts, the idea is to win over potential converts with free content in the hopes that readers or listeners buy something down the road.⁷⁸

3. Video

Digital disintermediation is in its early stages in the video space, but, given its impact in the music and newspaper product spaces, it has already attracted a great deal of attention. Wall Street analysts who have been examining the growing competition between Internet video and traditional video distribution⁷⁹ frequently begin by discussing the impact of digital distribution on the music labels and the determination of video content producers to avoid that fate.⁸⁰ Or, as Comcast puts it, they need to make “sure that we get ahead of the steamroller that is the Internet.”⁸¹ The time frame in which this steamroller is projected to arrive is relatively short and the extent of the potential competition is pervasive.⁸²

77. *Id.*

78. *Id.*

79. PIPER JAFFRAY, INTERNET VIDEO: FIELD OF DREAMS OR NIGHTMARE ON ELM STREET? 5 (2009).

80. For example, the opening section of the Piper Jaffray analysis is entitled “Music v. Video: Why These Markets are Traveling Down Different Paths.” Similarly, the title page of Michael Nathanson’s book *Web Video: Friend or Foe...And to Whom?* starts with an observation about the difference between music and video and links that difference to the proactive behavior of Comcast. MICHAEL NATHANSON ET AL., WEB VIDEO: FRIEND OR FOE...AND TO WHOM? (Bernstein Research 2009); *see also* Tim Arango, *Cable TV’s Big Worry: Taming the Web*, N.Y. TIMES, June 24, 2009, at B1 [hereinafter *Big Worry*] (“What is at stake is perhaps the last remaining pillar of the old media business that has not been severely affected by the Internet: cable television. Aware of how print, music and broadcast television have suffered severe business erosion, the chief executives of the major media conglomerates . . . have made protecting cable TV from the ravages of the Internet perhaps their top priority.”).

81. Jeff Baumgartner, *Comcast Nears ‘TV Everywhere’ Launch*, LIGHT READING (Sept. 9, 2009) http://www.lightreading.com/document.asp?doc_id=181548&site=lr_cable.

82. UBS INVESTMENT RESEARCH, Q-SERIES: GLOBAL MEDIA THEME - CAN PAY TV BENEFIT FROM ONLINE VIDEO? 9 (2009); NBC recently stated that “[t]he Internet as a distributor of high-quality video programming has reached the tipping point” Reply Comments of NBC Universal, Inc., in Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, MB Dkt. No. 07-269, 2 (August 28, 2009),

The music labels have suffered a major reduction in their revenues and margins as a result of digital distribution, and Wall Street analysts are concerned with the ability of the video content producers to maintain their rate of profit. This paramount Wall Street concern is only part of a proper economic analysis. Rather, the following key elements (which are given short shrift in these analyses) must also be considered:

- **Consumer Welfare:** In the Wall Street analyses, the question of how consumers have fared is, at best, given cursory treatment. While the convenience of digital distribution is frequently noted, the direct impact on the consumer pocketbook, consumer surplus in economic terms, receives little attention.
- **Super-Profit Protectionism:** The possibility that the profit margins the music labels were trying to defend in their war against digital distribution were excessive never enters the analysis.
- **Efficiency Gains to Industry:** The efficiency gains in the industry also do not receive the attention they deserve.

Since it is the job of Wall Street analysts to advise investors about the prospect for (preferably supra-normal) profits, these blind spots in their analysis are understandable, but policymakers must have a broader and more complete view. The consumer and public interest impact of technological change, market structure, and alternative business models must be taken into account by policymakers. The investor view must be balanced against the consumer view to ensure a market structure that is efficient, stable and equitable.

4. Avoiding the Nightmare on Elm Street

The juxtaposition of the music and video industry approaches to digital distribution provides the launching point for one recent study entitled *Internet Video: Field of Dreams or Nightmare on Elm Street?*. Needless to say, the music sector is seen as the nightmare on Elm Street. The music industry's fate is depicted as follows:⁸³ Faced with a consumer rebellion, the music labels tried to lock down content and slow alternative distribution. Finally realizing that they needed a digital distribution model, they ended up the captives of a high tech company

available at <http://fjallfoss.fcc.gov/ecfs/comment/view?id=6015188856>.

83. JAFFRAY, *supra* note 79, at 4; see also Ronald Grover et al., *Revenge of the Cable Guys*, BUSINESSWEEK, Mar. 11, 2010, at 38 ("Jeff Bewkes and Brian Roberts, the CEOs of Time Warner and Comcast . . . took a lesson from the music labels, which looked up one day to find that Steve Jobs and Apple had taken control of their inventory.").

(Apple), whose primary interest was in selling hardware and other peripherals. Pricing content to promote penetration, a strategy well-known and effective in the Internet space, meant usage charges were kept low and margins for the record labels were squeezed. An industry that was focused on high margins driven by the “value” of the product had difficulty viewing the world through a low margin, penetration-promoting lens.

The analysts’ buzzwords for what must be avoided by the incumbents in the video industry structure are *arbitrage*, *cannibalization*, and *disintermediation*.⁸⁴ As used in this context, each of the terms indicates a shifting in the flow of commerce through a distribution channel that yields high profits to the incumbent to a channel that yields a lower rate of profit or the removal of the flow of commerce from the incumbent’s channel entirely. Each player with leverage in the current supply chain is at risk of having its control over distribution diminished. This is particularly true for the two sectors involved in the Comcast-NBC Universal merger: video content production and multichannel video distribution. For the content owners, the risk is “leakage” of their content into channels that command lower revenues.⁸⁵ For distributors, it is the potential loss of subscribers, who “cut the cord,” reduce their payments for premium content, or resist price increases because they have alternative distributors available to them.⁸⁶

Another motivating factor in reacting to the potential for digital distribution is the potential for piracy. Wall Street analysts are divided on

84. NATHANSON ET AL., *supra* note 80, at 15; UBS INVESTMENT RESEARCH, *supra* note 82, at 3, 10; Dawn C. Chmielewski & Meg James, *Hulu’s Tug of War with TV*, L.A. TIMES, May 11, 2009, at B1 (“We have to be mindful of the fact that we have a good business that works for all the players,’ said Andrew Heller, domestic distribution president for Turner Broadcasting. ‘We have to find ways to advance the business rather than cannibalize it.”); Deborah Yao, *Cable Companies Want a Way to Win with Online TV*, USA TODAY (Feb. 24, 2009, 5:15 PM) http://www.usatoday.com/tech/news/2009-02-24-cable-companies_N.htm (“There’s pressure on all of us,’ [Jeff Gaspin, President of NBC’s Universal Television Group] said, referring to TV networks. ‘We get paid quite a bit of money from cable operators. . . . It’s important we find ways to do business that protects that business model.”).

85. UBS INVESTMENT RESEARCH, *supra* note 82, at 15; *Big Worry*, *supra* note 80 (“Unlike broadcast television, which relies solely on advertising, cable networks have another revenue stream: fees paid by cable operator. . . . That stream is so important to every entertainment company that everybody is looking at that and saying, if we are not careful we could start to harm that model,’[President of Comcast Cable, Stephen P.] Burke said.”).

86. UBS INVESTMENT RESEARCH, *supra* note 82, at 4; Chmielewski & James, *supra* note 85 (“The appetite for full-length TV shows online was larger than anyone thought or expected,’ said Bobby Tulsiani, Forrester Research media analyst. ‘And now people are starting to wonder, do we even need the cable connections?’”); Deborah Yao, *Cable Companies See Customers Cutting Back: ‘The Beginning Of Cord Cutting*,’ HUFF. POST (Feb. 8, 2009, 2:48 PM EST), http://www.huffingtonpost.com/2009/02/09/cable-companies-see-custo_n_165138.html (“[Time Warner Cable CEO Glenn Britt stated in 2009], ‘We are starting to see the beginning of cord cutting.’”).

this question. Some see avoiding piracy of content as a primary motivator for developing business models that allow consumers convenient access to content.⁸⁷ Others think the piracy concern is overblown.⁸⁸

When Wall Street analysts are contemplating the array of concerns for the participants in the video product space, they see diversity among the players in the traditional Multichannel Video Programming Distributor (“MVPD”) product space: content firms whose interests are defined by primarily ad-supported (over-the-air) networks versus content firms whose interests are primarily defined by fee supported (cable) networks,⁸⁹ incumbent cable operators versus new entrants,⁹⁰ and cable MSO/broadband ISPs versus content companies,⁹¹ as well as several other sets of players who have small roles in the traditional MVPD market.⁹² The different attitudes toward Internet TV among the various players, and the likely longer-term strategies, are evident in the availability of content online:

Complete episodes of about 90% of prime-time network television shows and roughly 20% of cable shows are now available online

. . . .

87. JAFFRAY, *supra* note 79, at 12; Chmielewski & James, *supra* note 84 (“Hulu was launched in March 2008 as a way of keeping TV programming safely in the hands of its creators and distributors. And by making it free, it could short-circuit piracy.”).

88. NATHANSON ET AL., *supra* note 80, at 12.

89. NATHANSON ET AL., *supra* note 80, at 9-10; *Big Worry*, *supra* note 80 (“Unlike broadcast television, which relies solely on advertising, cable networks have another revenue stream: fees paid by cable operators.”).

90. UBS INVESTMENT RESEARCH, *supra* note 82, at 15; George Szalai, *Opinion: Online Video’s Impact Remains Unclear*, ADWEEK, July 3, 2009, available at http://www.adweek.com/aw/content_display/news/media/e3if52b9a5b28d70b335ffe8f533c42b814 (“This is a way to stem concern about cable infrastructure being bypassed by free online viewing,” Collins Stewart analyst Thomas Eagan says.); Grover et. al, *supra* note 83 (“The new attack from Silicon Valley was the most serious yet, because it threatened to permanently cut the coaxial connecting the cable companies and their subscribers. ‘We wake up every day and there is some new competitor out there—a Roku or a Boxee,’ says Melinda Witmer, Time Warner Cable’s programming chief.”); Daniel Roth, *Netflix Everywhere: Sorry Cable, You’re History*, WIRED, Sept. 21, 2009, at 102 (“Our goal is to have everyone cancel their cable subscription,” Roku’s Wood says.”).

91. UBS INVESTMENT RESEARCH, *supra* note 82, at 28; *Big Worry*, *supra* note 80 (“Last month, Comcast agreed to pay Disney a monthly fee to offer its Internet subscribers ESPN 360, the sports network’s online channel. One analyst, Richard Greenfield of Pali Research, has called that deal ‘a watershed event for content owners in a broadband world, albeit that event occurred with little to no fanfare.”); see also Comments of the American Cable Association in A National Broadband Plan for Our Future, GN Dkt. No. 09-51, 5-6 (June 8, 2009) available at <http://fjallfoss.fcc.gov/ecfs/comment/view?id=5515364588>.

92. Most notably the technology sector and device vendors, where massive amounts of storage open up prospects for a new form of distribution of content. UBS INVESTMENT RESEARCH, *supra* note 82, at 10; JAFFRAY, *supra* note 79, at 24.

. . . The online selection of live sports games is spotty as well. This season for example, the National Football League will make Sunday night games available live on the Net, but those amount to only 7% of all regular-season NFL match-ups. Cable and broadcast news shows typically aren't streamed live on the Internet, unless there's breaking news even like Hurricane Katrina.⁹³

Each of the parties is likely to leverage its strategic assets to defend its current share of revenues and rents in video distribution, as well as try to capture part of the efficiency gains flowing from digital distribution. Accordingly, the compromise is to replicate the traditional relations in the new product space. Note the distinction between broadcasters, who are more likely to make content available than cable, with the exception of sports and news content, which are marquee must-have categories that provide leverage to attract audiences.

The potential efficiency gains from digital distribution deserve attention because a new technological approach to distribution has a powerful effect on a business in which distribution has been a substantial part of the cost. There are supply-side and demand-side gains.⁹⁴ Advertising can become more efficient.⁹⁵ Physical costs are reduced as redundancy of devices⁹⁶ is eliminated and economies of scale and scope combine with technological progress to dramatically lower costs.⁹⁷

Music labels certainly had an economic interest in preventing the disintermediation that eroded their rents. They reacted slowly and lacked the market power to prevent it. In the video business, content owners and cable operators are reacting more quickly. Content producers can leverage their libraries and "must have" content in a sector that is highly concentrated,⁹⁸ a situation that is not unlike the one that existed in the

93. Nick Wingfield, *Turn On, Tune Out, Click Here*, WALL ST. J., Oct. 3, 2008, at W1.

94. Various efficiency gains are mentioned primarily from the point of view of increasing profit. JAFFRAY, *supra* note 79, at 12, identifies two classical opportunities—expanding supply in the long-tail and increasing demand through greater convenience.

95. UBS INVESTMENT RESEARCH, *supra* note 82, at 10; *see, e.g.*, Mike Shields, *Servin' It Up MTVN, Quantcast to Laser-Target Web Video Ads*, Mediaweek, Feb. 15, 2010, at 6.

96. NATHANSON ET AL., *supra* note 80, at 17. Declining technology costs run the gamut from bandwidth and multicasting to caching and routers, optical systems and storage.

97. *Id.*; *see also* Saul Hansell, *The Cost of Downloading All Those Videos*, N.Y. TIMES (Apr. 20, 2009, 3:55 PM), <http://bits.blogs.nytimes.com/2009/04/20/the-cost-of-downloading-all-those-videos> ("The Comcast presentation said that the effect of this is that Docsis 3 will reduce the cost of the C.M.T.S. hardware, which had been about \$20 per home passed, by 70 percent, for customers at current speeds. And it will allow 100-Mbps service at a lower hardware cost than the company had been paying for its then current 6-Mbps service.").

98. JAFFRAY, *supra* note 79, at 10, 31; NATHANSON ET AL., *supra* note 80, at 12; *see also* Jason Kilar, *Doing Hard Things*, HULU BLOG (Feb. 18, 2009), <http://blog.hulu.com/2009/02/18/doing-hard-things>; Jim O'Neill, *Hillcrest Confirms Hulu Blocking Kylo Web TV Browser From Its Online Video Content*, FIERCE ONLINE VIDEO, Mar. 22, 2010, <http://www.fierceonlinevideo.com/story/hillcrest-confirms-hulu-barring-kylo-web->

music sector in the late 1990s. However, the real difference is in the market power of the cable operators, because these entities are also the dominant broadband Internet access providers. This is the fundamental difference between the music and video industries. In the latter, the owners of the dominant distribution network have a direct interest in preventing the disintermediation and have powerful tools to prevent it.

Analysts expect cable operators to leverage their market power in other ways.⁹⁹ Cable operators can capture a significant part of the efficiency gains that make larger rents available by increasing prices for Internet access and reducing the opportunity for Internet TV to undermine traditional MVPD market power.¹⁰⁰ They will use tools such as usage based pricing,¹⁰¹ tying traditional video to Internet video,¹⁰² and locking down content.¹⁰³

Estimates of how fast the competitive threat will grow vary from a few years to more than a decade,¹⁰⁴ as do estimates of the magnitude of the threat, which reach as high as one in eight subscribers cutting the cord within a year.¹⁰⁵ However, there is unanimity on one proposition:

tv-browser-online-video-content/2010-03-22.

99. NATHANSON ET AL., *supra* note 80, at 15 (“Cable operators won’t just stand by and watch – they’ll take actions that affect this evolution.”); Andrew Hampp, *MSOs Fight to Keep TV on the TV, Not the Net*, AD AGE (June 16, 2008), http://adage.com/mediaworks/article?article_id=127772 (“Alexander Dudley, a spokesperson for Time Warner Cable, told Ad Age the company is prepared to go as far as withholding some of the subscriber revenue upon which networks like Comedy Central have built the bulk of their business model.”).

100. Ironically, Apple, which is the central player in digital disintermediation in the music space, sees the stranglehold on the set-top box as a barrier to entry. Will Richmond, VIDEO NUZE (June 7, 2010, 9:58 AM ET), <http://videonuze.com/blogs/?2010-06-07/Why-Apple-Still-Doesn-t-Have-a-TV-Strategy/&id=2591>.

101. See NATHANSON ET AL., *supra* note 80, at 15 (“Wachovia Analysts Marci Ryvicker stated, ‘We view usage-based billing, or bandwidth consumption caps, as a significant impediment to not only ZillionTV but also to true over-the-top video providers’”); see also *Add Another Voice to the Chorus of Those Saying Online Video’s...*, COMM. DAILY, Apr. 15, 2009, at CABLE section; *Firestorm Over Time Warner Caps*, DSL PRIME, Jan. 21, 2008 (“I believe Time Warner’s interest in bandwidth caps has little to do with its own costs and a lot to do with the emergence of movie downloads and streaming television programs over the Internet. The smart people at Time Warner are scared of people watching TV directly over the Internet.”).

102. NATHANSON ET AL., *supra* note 80, at 15; see also Grover et al., *supra* note 83, at 38; Szalai, *supra* note 90 (“The lack of focus on such offers proves that TV Everywhere is mainly defensive for now. ‘This is a way to stem concern about cable infrastructure being bypassed by free online viewing,’ Collins Stewart analyst Thomas Eagan says.”).

103. NATHANSON ET AL., *supra* note 80, at 12; see also Hampp, *supra* note 99; Chmielewski & James, *supra* note 84.

104. Compare JAFFRAY, *supra* note 79, at 4, with Richard Morgan, *Why Hulu Matters*, THE DEAL MAG., Dec. 14, 2009, at 40.

105. Compare Press Release, Yankee Group, Yankee Group Says 1 in 8 Consumers Will Ax Their Coax This Year (Apr. 27, 2010) (http://www.yankeegroup.com/about_us/press_releases/2010-04-27.html), with CONVERGENCE CONSULTING GROUP, THE BATTLE FOR THE CANADIAN COUCH

cable operators will actively resist and seek to undermine that competition.

Of course, if they didn't create obstacles to this sort of disintermediation, cabling wouldn't be cabling. Some easy ways to forestall IP video's ascendancy include charging consumers for their Hulu use and increasing the number of commercials embedded in each Hulu episode. Only by taking control of NBCU can Comcast influence such decisions. Comcast's embracing "TV Everywhere," which allows paying subscribers to receive IP video as well as cable video, can be seen as another means to impede the same inexorable end. So, too, is the concept of usage-based pricing—the objective of which would be to price broadband consumption for downloading IP video in ways that make both the cable company and its customers indifferent to disintermediation.¹⁰⁶

The Wall Street analysts identify the combination of the Comcast-NBC Universal merger and Comcast's Fancast Xfinity-branded "TV Everywhere" initiative as perfect examples of the key strategies in action.¹⁰⁷ Vertical integration becomes pivotal to block the effects of digital disintermediation, and the emergence of a large firm straddling the production and distribution stages is a critical step in achieving the necessary spirit of collaboration.

With Comcast and Time-Warner now moving forward with video

POTATO: BUNDLING, TELEVISION, INTERNET, TELEPHONE, WIRELESS 8-9 (2010) (which puts the number at 1 in 30 by year-end 2011); see also Mike Robuck, *Report: OTT eating into video market share pie*, CED MAGAZINE (Oct. 9, 2010), <http://www.cedmagazine.com/News-OTT-video-market-share-100909.aspx> ("SNL Kagan's latest report forecasts that over-the-top providers, such as Hulu, will account for 7.1 million homes by 2013, and for more than twice that number in 10 years."); Tim Arango, *Cable TV's Big Goal: Web Profits*, N.Y. TIMES, June 24, 2009, at B1 (For his part, Comcast's Stephen Burke, President of Comcast cable, states "We don't think that it's a problem now, but we do feel a sense of urgency[.]").

106. Morgan, *supra* note 104.

107. See NATHANSON ET AL., *supra* note 80, at 9; Yinka Adegoke, *Web TV Could Come With a Price Tag After Comcast-NBC*, REUTERS (Oct. 4, 2009, 9:48 AM EDT), <http://www.reuters.com/article/idUSTRE5942UI20091005> ("We suspect Comcast believes it needs content to protect its landline distribution platform,' Richard Greenfield, analyst at Pali Research, wrote in a note to investors on Friday. 'It wants to mitigate the risk of becoming that scary 'dumb' pipe'. . . . Hulu was started by NBC and Fox so they could compete with Comcast. So this is a defensive move to some extent by Comcast,' said Kaufman Bros. analyst Todd Mitchell. 'Hulu will just become another choice of Comcast's pay-TV buffet.'"); see also Comments of Netflix, Inc, in Preserving the Open Internet, Broadband Industry Practices, GN Dkt. No. 09-191, WC Dkt. No. 07-52 (Jan 14, 2010), available at <https://prodnet.www.neca.org/publicationsdocs/wwpdf/0114netflix.pdf> ("[T]he recent announcement of the proposed merger of Comcast and NBC Universal serves to exacerbate the growing concern that MVPDs will use their control over programming networks to stifle competition, including the growing competition from online video providers like Netflix.").

paywalls, are the cable companies doing what Hollywood and the music industry couldn't do? . . . That reality is coming sooner than you think.

. . . .

. . . This isn't the music business, apparently . . . there's still life in old dinosaur methods of content delivery when it comes to movies and teevee [sic] shows, and the conglomerates and CEO's that control them aren't too keen on giving up their domination of content delivery services just yet.

. . . .

. . . It's simply a browser bound way of locking you out of live streamed or stored content based on a verification ID . . . namely your cable account's user name and password.

. . . .

. . . [I]t's almost impossible to stop the Comcast juggernaut from taking over NBC and removing content from Hulu and other currently free broadband streaming services or aggregators.

. . . .

. . . TV Everywhere, which has been tested for over a year, can be seen as simply a way for cable companies to continue with the old model of doing business.¹⁰⁸

The most direct and obvious way to prevent disintermediation is to maintain the flow of content in channels that can be controlled, which is the obvious intent of TV Everywhere: "While a lot is happening on the convergence front (e.g. Google TV, Roku, etc.), with the advent of TV Everywhere, the likelihood that cable programs will not leak out onto the open Internet is lower than ever."¹⁰⁹

III. POLITICAL ACTION AND THE OBAMA CAMPAIGN ORGANIZATION

In a sense, politics is about the creation of a unique, non-

108. Christian Hokenson, *TV Everywhere Leave VOD Nowhere*, HD REPORT (May 18, 2010), <http://www.hd-report.com/2010/05/18/tveverywhere-vod/#more-5941>.

109. Will Richmond, VIDEO NUZE (May 27, 2010, 10:42 AM ET), <http://www.videonuze.com/blogs/?2010-05-27/VideoNuze-Report-Podcast-63-Yankee-Group-Cord-Cutting-Research-Download-Available/&id=2581>.

commercial audience. This section examines the Obama campaign as an example of structured viral communications that harnessed the forces of digital disintermediation for political purposes.

A political party in an election campaign is a quintessential task oriented organization. Communications are central both to its internal organizational coherence and its external goal. The management and manipulation of information are primary tools of success with the ultimate goal of creating an active audience—engaging members and mobilizing them for the electoral effort. The sporadic nature of elections may have masked the impact, but the Obama campaign of 2008 makes it clear that the use of the Internet will transform every aspect of the electoral process.

The Internet and traditional political institutions should be seen as two intersecting planes of action moving down a central path. The ability to conduct political activity is suddenly enhanced (see Figure IV- 1). There are two thrusts to this new dynamic of organization. On one path, Web tools are used to make physical space activities work better. On the other path, technology is used to enrich large-scale cyberspace activities. Given the nature of the environment and the key characteristic for success—openness and viral communications—the lines between internal and external begin to blur.

A. The Magnitude of Change

The magnitude of the organization that was achieved by the Obama campaign, with its combination of both cyberspace and physical space organizing, is staggering compared to prior presidential campaigns. Keep in mind that Obama got 68 million votes (see Figure III-2). Obama collected over 13 million e-mail addresses and attracted nearly 5 million friends on social websites (two million profiles, 1.5 million volunteers and one million texters).¹¹⁰ At the core of the organization were 2,500 paid staff and 150,000 activists who attended Camp Obama for training.¹¹¹ This huge number of contacts produced massive amounts of political action. By the end of the cycle, the Obama campaign raised something on the order of three quarters of a billion dollars from well over three million donors.¹¹² Online donors totaled 3 million and gave half a billion dollars.¹¹³ There were over half a million Obama videos

110. MONTE LUTZ, THE SOCIAL PULPIT: BARACK OBAMA'S SOCIAL MEDIA TOOLKIT 5 (Edelman 2009); Jose Antonio Vargas, *Obama Raised Half a Billion Online*, WASHINGTONPOST.COM (Nov. 20, 2008, 8:00 PM ET) <http://voices.washingtonpost.com/44/2008/11/obama-raised-half-a-billion-on.html>.

111. LUTZ, *supra* note 110, at 12.

112. Vargas, *supra* note 110.

113. *Id.*

posted (most independent of the campaign) that were viewed over 100 million times.¹¹⁴ There were 400,000 blogs and 35,000 self-formed groups that staged 200,000 events.¹¹⁵

The magnitude of the transformation cannot be underestimated. The change in organization reflects a shift in the terrain of politics.

The changes go beyond what Mr. Obama did and reflect a cultural shift in voters, producing an audience that is at once better informed, more skeptical and, from reading blogs, sometimes trafficking in rumors or suspect information. As a result, this new electorate tends to be more questioning of what it is told by campaigns and often uses the Web to do its own fact-checking.

“You do focus groups and people say, ‘I saw that ad and I went to this Web site to check it,’” said David Plouffe, the Obama campaign manager. “They are policing the campaigns.”

[Steve] Schmidt [John McCain’s chief campaign strategist] said the speed and diversity of the news cycle had broken down the traditional way that voters received information and had given campaigns opportunities, and challenges, in trying to manage the news.

“The news cycle is hyper accelerated and driven by new players on the landscape, like Politico and Huffington Post, which cause competition for organizations like The A.P. where there is a high premium on being first,” he said. “This hyper accelerates a cable-news cycle driven to conflict and drama and trivia.”¹¹⁶

B. The Internal Structure of the Structured Viral Organization Model

The exploitation of the opportunity was not accidental. In the political organization, structured viral communication should be conceptualized as a two-way flow of information and resources between the organization and its members (see Figure III-3). The organization must array roles and functions to meet member needs, giving them reason to commit time, effort and resources to the organization. It can

114. *Id.*

115. *Id.*

116. Adam Nagourney, *The '08 Campaign: Sea Change for Politics as We Know It*, N.Y. TIMES, Nov. 4, 2008, at A1.

then use the financial and human resources made available to it to accomplish shared goals.

1. Recruitment and Training

If this were not a goal-oriented, institution-building effort, it would be okay to let the virus spread wherever and whenever it pleased. But, if this is to be an effective political organization, the energy must also be available at specific times for specific purposes. A light hand of hierarchic direction is needed amid the chaos of viral democracy. The key is to build norms that facilitate self-directed activity. Therefore, structure is still vital.

An 80-plus page training manual provided to campaign field organizers illustrates the organizational side of the campaign. Members of leadership teams are assigned specific roles, such as team coordinator, data coordinator, volunteer coordinator, voter-registration and voter-contact coordinator, and house-meeting coordinator. Each of these positions has a clearly defined role outlined in bullet points. Those teams of people and their cadres of volunteers are ultimately assigned to get out the vote in specific geographic regions.

....

. . . So the campaign swelled field operations to 19,000 “neighborhood teams” as of late October, focused on 1,400 neighborhoods across the state, according to a recent report from the *St. Petersburg Times*. The teams are directed by about 500 paid campaign field organizers, and are replicated nationally. In all, the Obama campaign estimates that 1.5 million volunteers are helping it to get out the vote in the battleground states.¹¹⁷

A key challenge to building a model for engagement in political activity based primarily on the Internet is to provide a rhetoric and structure that assures potential members that they will be able to constructively promote their ideas and target their energy in an organized, reliable environment that shares reputational similarities to the world outside of cyberspace.

The model also uses personal storytelling during workshops as a way to motivate peers and potential recruits to action.

117. Sarah Lai Stirland, *Obama's Secret Weapons: Internet, Databases and Psychology*, WIRED (Oct. 29, 2008, 6:01 PM) <http://www.wired.com/threatlevel/2008/10/obamas-secret-w/>.

....

. . . Obama organizers, and some volunteers, enter the campaign machine through weekend training sessions called “Camp Obama.”

....

. . . The sessions vary in size from groups of 40 to more than 300, held variously at the campaign’s Chicago headquarters, in rented office spaces, union halls, churches or on college campuses. In addition to leadership and motivation training, the camp features storytelling sessions, where the volunteers are broken up into small teams organized by congressional district. Each member of these groups is asked to tell personal stories in two minutes, in the same format Obama used in his 2004 speech at the Democratic National Convention.

“Ultimately, your story should move people to specific action by painting a detailed picture of how things might be different if we act, giving us hope that if we act now we can make real that different future,” explains the training manual.

The stories are an exercise in relationship building, says [Marshall] Ganz [a public policy lecturer at Harvard who designed the field-organizer and volunteer training system].

“What we’ve been doing is trying to teach people to do what Obama does during his speeches — to tell their own stories to motivate others,” he says. “You’re building this sense of commitment to both the values and people, but you’re structuring it purposefully to achieve goals like, ‘In this district, we need 2,000 votes.’”

The Obama campaign first experimented with the Ganz-Wageman system during the primaries, trying it out in Iowa and South Carolina. It won in both states, while in New Hampshire, where it ran a more-traditional marketing campaign, Obama lost. The campaign began phasing in the system nationwide in June. More than 23,000 people have participated in at least eight or more hours of leadership training provided by Camp Obama, according to Ganz.¹¹⁸

2. Motivation and Monitoring

Diversifying the nature of the results and defining early on what members will experience in terms of both information and collaboration promotes initial commitment. Updating goals based on the developing interests of members and the changing political climate around them, while also taking feedback to heart about what members want to do, engenders continued commitment.

But the campaign also seems to recognize that some volunteers won't cotton to a top-down system, and its web tools accommodate independent efforts. [Florida resident Jeanette] Scanlon started her work for Obama with the South Tampa team, but felt the campaign wasn't sending enough volunteers to canvas her hometown Plant City, a working-class suburb that voted for Bush in the last two presidential elections. Obama's organizers insisted that they needed to focus their efforts on more densely populated surrounding areas.

....

. . . So Scanlon took matters in her own hands by tapping into the campaign's online Neighbor-to-Neighbor tool on myBo. In two days last September, she knocked on 50 doors to sniff out support for Obama, entering her neighbors' responses into the campaign's databases through myBo.¹¹⁹

This means members must experience frequent results, no matter what form or medium they are delivered in. "MoveOn has figured out how to give its members continuous opportunities to take small, simple steps and see the results in a matter of days, if not hours. Help pay for this ad to go in that newspaper. Go to this vigil and bring a candle."¹²⁰

The main structural objective for satisfying and inspiring members is to ensure "differentiated levels of entry," providing the ability to "participate at various levels in conversations and to contribute to the community's knowledge repository" in myriad ways, whether it be *passive participation* (newsletters, interview transcripts, items that they mainly receive) or *active participation* (discussion group notification, chat announcements, physical-world opportunities).¹²¹

The empirical evidence on group formation and persistence on the Internet shows that networks become groups through communications

119. *Id.*

120. MICHAEL CORNFIELD, POLITICS MOVES ONLINE: CAMPAIGNING AND THE INTERNET 79 (2004).

121. HUBERT SAINT-ONGE & DEBRA WALLACE, LEVERAGING COMMUNITIES OF PRACTICE FOR STRATEGIC ADVANTAGE 88 (2003).

processes that also support the political activities of the organizations.

Online social network sites – socnets, community blogs to YouTube – are changing how the members of this class get their news, whom they trust to provide it and how they act on it. Whatever the source, they comfortably and routinely comment on the news, reproduce it, then forward it to relatives, friends, co-workers and, yes, strangers.

The relationship between the candidates and their supporters has shifted, too. Supporters see themselves less as agents of campaigns but as independent of them.

....

. . . What's surprised [Katie Stoenoff, founder of online group Akron for Obama] most about all the blogging and networking, she says, was her ability to reach out to people whom she did not know, especially Clinton supporters who were reluctant to back Obama.¹²²

Members and participants become more deeply engaged through collateral communications, which expand on the messages that are sent to stimulate specific actions. Insurgent media (blogging) has become a new form of collective action. Collaboration supports both the organization, qua organization, and the specific political activities. Collaboration is an interactive process in which values, norms and boundaries are defined through a fundamentally deliberative democratic process of communications among peers.

“A campaign used to be the big gear trying to get you, the smaller gear, to turn around, to line up with their agenda and what they represent,” [political blogger Chris] Myers says. “Now, through blogging, through only donations, whatever, the voter is now the big gear.”

....

. . . And with the Internet making it easier than ever for voters to fund a candidate, act as their own publishers and search for information (and misinformation), the Washington political establishment – candidates, strategists and journalists – has been forced to loosen its hold on setting the narrative of the campaign. For voters such as Myers and Stoenoff, this is a sign of how the electoral process has been democratized and individualized. It's neither

122. Jose Antonio Vargas, *Politics and Social Networks: Voters Make the Connection*, WASH. POST, Nov. 3, 2008, at C1.

McCain's nor Obama's campaign. It's their campaign.¹²³

Thus, collaboration is fundamental in setting the structured viral model apart from past online endeavors and for priming potential members for confidence in their new information ecology. The "local" environment can be virtual most of the time, but it is beneficial as far as the bonding of members to the organization if it is also physical from time to time.

Things heated up after the Democratic convention in August. Now, about three to four nights a week, she's doing something campaign-related, such as organizing phone banks at Panera Bread, where Obama supporters gather with their cell phones to call neighbors, and helping plan canvassing walks around summit County, where she grew up.

....

. . . Four years ago, participating in a campaign online meant sending e-mail chains and planning e-mail campaigns. Now it can be much more, from live-blogging an event for others who can't be there to creating YouTube videos.

This transformation is not controlled by the campaigns. Sure, McCain and Obama have their own socnets – McCainSpace and MyBarackObama – but that doesn't guarantee that supporters will sign up. You don't need permission – or any affiliation with the campaign – to get involved.¹²⁴

Members customize their involvement by partaking in as much online and physical-world activity as they desire and suggest new discussion groups, physical-world opportunities, and points of interest/emphasis. Members build buzz and carry the hum of activity, informing friends, colleagues, and family.

During a sweltering Friday evening rush hour in early October, Jeanette Scanlon spent two-and-a-half hours with 20 other people waving a homemade Barack Obama sign at the cars flowing through a busy intersection in Plant City, Florida.

....

123. *Id.*

124. *Id.*

. . . Scanlon is one of an estimated 230,000 volunteers who are powering Obama's get-out-the-vote campaign in the swing state of Florida. And while sign-waving is a decidedly low-tech appeal to voters' hearts and minds, make no mistake: The Obama campaign's technology is represented here. Scanlon organized the gathering — and 24 others since September — through Obama's social networking site, my.BarackObama.com. Similarly, she used the site's Neighbor-to-Neighbor tool in September to find registered voters in her own neighborhood, so she could canvass them for Obama. And this weekend, Scanlon and another 75 or so Plant City volunteers will be phoning thousands of Floridians to urge them to vote, using a sophisticated database provided by the Obama campaign to ensure they don't call McCain supporters by mistake.

. . . .

. . . Though she's volunteered on presidential campaigns before, it was the first time that she had ever made the effort to canvas for a presidential candidate by visiting neighbors' houses.¹²⁵

An organization must use both technology and community to serve the needs of the members, a very different role from the typically self-centered campaign that sees its volunteers as serving *its* needs. Members must be able to grasp the information and opportunities they want, without tiring themselves out as a result of “drinking from the fire hose.”¹²⁶ This drowning effect is the fiercest threat to real commitment and prolonged involvement in the community. Personal control over the online environment creates the ability to shape and reshape the production and digestion of the valuable human and social capital that the Internet Engagement Model provides.

The researchers discovered that the kind of volunteers that the Sierra

125. Stirland, *supra* note 117.

In early August, the group was called together again . . . by Kathryn Witzke. The University of South Carolina sophomore is taking a semester off to run five counties in the area as a field organizer.

Ms. Witzke asked each person to explain to the group why they were there. Coordinators were selected for different responsibilities, such as data management and voter registration. Relationships began to form.

. . . .

. . . “The volunteers know their communities better than we do, so we just give them the basic structure and a schedule,” says Chris Lewis, the 29-year-old field director for North Carolina. “But we can also see if something isn't working and make adjustments.”

Christopher Rhoads, *Campaigns Try New Web Tactics In Battle to Tap Fresh Supporters*, WALL ST. J., Oct. 29, 2008, at A1.

126. SAINT-ONAGE & WALLACE, *supra* 121, at 45.

Club attracted were “lone ranger” types who focused on accomplishing goals on their own, rather than effectively working with others with “shared purpose.”

The danger of this approach, Ganz says, is that individuals burn out easily. They try to do everything themselves rather than breaking the goals out into specific tasks that members of interdependent teams can accomplish in pieces. That’s why relationships are so important, they found. Ganz and Wageman’s model gets members of teams to find out more about one another’s experiences, and draw on each member’s expertise.¹²⁷

These Interactions in a political campaign are a good example of what is known as weak ties.

In mathematical sociology, **interpersonal ties** are defined as information-carrying connections between people. Interpersonal ties, generally, come in three varieties: *strong*, *weak*, or *absent*. Weak social ties, it is argued, are responsible for the majority of the embeddedness and structure of social networks in society as well as the transmission of information through these networks. Specifically, more novel information flows to individuals through weak rather than strong ties. Because our close friends tend to move in the same circles that we do, the information they receive overlaps considerably with what we already know. Acquaintances, by contrast, know people that we do not, and thus receive more novel information.¹²⁸

“Sharing thoughts” on the Internet with large numbers of people is another form of weak tie noted in the discussion of file sharing. The interaction is richer than the simple swapping of files.

Over at Swamp Bubbles, the community blog that Myers created in January 2007, liberal voices often challenge Myers, a conservative Republican. The site is a free for all, open to anyone who wants to blog about northwest Ohio politics.

It’s a mixed bunch, “with some people leaning to the right, some to the left, and some just plain nuts”

. . . .

127. Stirland, *supra* note 117.

128. *Interpersonal Ties*, WIKIPEDIA, http://en.wikipedia.org/wiki/Interpersonal_ties (last visited Nov. 28, 2010).

. . . Myers welcomes the tit for tat.

“Look, I may not agree with Pink Slip – I don’t know what his or her real name is – but sometimes Pink Slip makes comments that are good counterpoints that I haven’t considered,” he says. “In my everyday life – my offline life – I’m not in conversation with way far left people. On my site I am.”¹²⁹

The self-correction in the above quote is most revealing in its recognition that the “online life” and the “offline life” are part of “everyday life.” Such recognition evidences the influence of the Internet on the nature of social relations. These anonymous conversations involve a richer exchange than the sharing of files in that they engage the intellect and cause self-reflection in the receiver of the message. However, they still lack the affect of face-to-face interpersonal relations. This type of relationship has become ubiquitous in cyberspace. Benkler’s observation on the important function of these weak ties seems affirmed.¹³⁰

In 1995, Robert Putnam, a political scientist at Harvard, wrote the controversial essay “Bowling Alone,” in which he argued that membership in civic organizations is declining and that this trend weakens our democracy. But the Internet, particularly social network, has redefined networking, says Rory O’Connor, a fellow at Harvard’s Shorenstein Center on the Press, Politics and Public Policy. “Online, what we have are looser but more extensive networks. I’m 50 years old and I’m on Facebook with people I went to grade school with. Online, you have more people in your social network, and to a certain extent, you trust them. You get exposed to more points of view.”¹³¹

3. Management and Coordination

The campaign was structured so that the actions of volunteers were charted and the more active the volunteer, the more access to data and tools they were given. Thus, there was a great deal of self-organizing and autonomous action that was facilitated, not dictated, by the center. The structured viral organization and communication introduced earlier was essential to run and sustain this required level of activity.

“I think what was recovered in this campaign is the sense of what

129. Vargas, *supra* note 122.

130. YOCHAI BENKLER, WEALTH OF NETWORKS 361-72 (2006).

131. Vargas, *supra* note 122.

leadership is, and what the role of the technology is, so that you get the best out of both,” says Marshall Ganz, a public policy lecturer at Harvard who designed the field-organizer and volunteer training system used by the Obama campaign. “The Dean campaign understood how to use the Internet for the fund-raising, but not for the organizing.”¹³²

Face-to-face contact is the life-blood of politics, a highly labor intensive and decentralized activity. It remains at the core of the political. The Internet as a coordinating tool allows the administration of this local activity to be shifted away from local volunteers, whose time is much better spent in face-to-face contact with each other and voters. It facilitates promotion, scheduling, enrollment and gathering/targeting of local data, where centralized messages can be branded locally and delivered to specific areas. The key is to get local members to use the tools to deliver the messages.

The nuts and bolts of what types of face-to-face opportunities will be available and the specifics of who discusses what topics with whom over the phone, via e-mail or in collaborative projects will vary according to developing interests. However, it is important to create organizational opportunities across media with multi-lateral purpose.

“The integration of technology into the process of field organizing. . . is the success of the Obama campaign,” says [Stanford] Dickert, who worked as John Kerry’s chief technology officer for the 2004 campaign. “But the use of technology was not the end-all and be-all in this cycle. Technology has been a partner, an enabler for the Obama campaign, bringing the efficiencies of the [I]nternet into the real-world problems of organizing people in a distributed, trusted fashion. . . .”

. . . .

. . . These neighborhood teams have both phone-banked and physically knocked on doors to make sure that voters are registered and know where to vote — an effort that will continue all the way

132. Stirland, *supra* note 117;

[‘This] year the paradigm got turned upside down and truly became bottom up instead of top down.’ To a considerable extent, Republicans and Democrats say, this is a result of the way that the Obama campaign sought to understand and harness the Internet (and other forms of so-called new media) to organize supporters and to reach voters who no longer rely primarily on information from newspapers and television. The platforms included YouTube, which did not exist in 2004, and the cellphone text messages that the campaign was sending out to supporters on Monday to remind them to vote.

Nagourney, *supra* note 116.

through Election Day.

But the calling won't be a completely random affair. The Obama campaign will give volunteers access to databases that have been constantly updated throughout the summer through its field-office computers, and through myBo — Obama supporters' nickname for myBarackObama.com — with information about potential voters' political leanings. The information in the database has accumulated over time from previous election campaigns, and is constantly updated with information gathered at people's doorsteps by canvassers like Scanlon, and through phone calls.¹³³

The real pay-off to the Internet may reside in the cross-space impacts. Cyberspace dramatically enhances the ability to conduct political activities.

For many viewers, the 2008 election has become a kind of hybrid in which the dividing line between online and off, broadcast and cable, pop culture and civic culture, has been all but obliterated.

Many of the media outlets influencing the 2008 election simply were not around in 2004. YouTube did not exist, and Facebook barely reached beyond the Ivy League. There was no Huffington Post to encourage citizen reporters. . . . These sites and countless others have redefined how many Americans get their political news.

When viewers settle in Tuesday night to watch the election returns, they will also check text messages for alerts, browse the Web for exit poll results and watch videos distributed by the campaigns.

. . . .

. . . “The role of gatekeepers and archivists have been dispersed to everyone with Internet access.”¹³⁴

Nearly a third of all household Internet activity in North America takes place while the user watches television, suggesting new and old media often share rather than compete for attention, the Nielsen

133. Stirland, *supra* note 117.

134. David Carr & Brian Stelter, *Campaigns in a Web 2.0 World*, N.Y. TIMES, Nov. 3, 2008, at B01.

Company said in a report on Friday.¹³⁵

The key role is a volunteer with access to institutional resources – a facilitator. In the viral model of biological infection, she is analogous to a carrier. In the marketing space, she is the maven. In the viral model of Internet communications, she facilitates communications between members. She is wedged in the middle as the liaison between the suggestion box and the leaders, the difference between posting a blog and expecting a reply.

Two days before Super Tuesday and more than a month before the Ohio primary, Stoyloff made a two-minute YouTube video and e-mailed it to her Akron for Obama online group. “Please feel free to forward this link to those who you might need a bit of encouragement to make their primary decision,” she wrote in the e-mail.¹³⁶

The amplification of the power of the organization through viral communications lies in the ability to forge new discussion groups, chats and subcommunities, which strengthen the shared sense of purpose and ownership. Facilitators communicate with each other to learn more about the usage and tendencies of their members, and they thus feel comfortable and confident in managing the commons and ensuring that the members know where the most promising opportunities for collaborative action develop. They are the core of the reputation system that must be established in order for authentic, trustworthy, many-to-many communication to exist.

Discipline is based on social norms, not authority relations of power. “Ostrom found that some system to monitor and sanction members’ actions was a common feature of every successful community . . . [,] not simply a way of punishing rule-breakers but also a way of assuring people that others are doing their part. Many people are contingent cooperators, willing to cooperate as long as most others do.”¹³⁷

Scanlon logs her activities on myBo, which awards points for various volunteer activities. The point system helps other would-be supporters figure out who they can hook up with locally if they want to get more involved in the campaign, says [Chris] Hughes, [a co-founder of Facebook, who left that company to help Obama with his

135. Steve Gorman, *Nielsen Finds Strong TV-Internet Usage Overlap*, REUTERS (Oct. 31, 2008, 6:51 PM EDT), <http://www.reuters.com/article/idUSTRE49U7SC20081031>.

136. Vargas, *supra* note 122.

137. HOWARD RHEINGOLD, SMART MOBS: THE NEXT SOCIAL REVOLUTION 45 (2002).

online organizational efforts].

“If you go to your local group in your small town, you can immediately find out who’s the most active person and who just joined the group for the sake of joining the group,” Hughes says. “And that gives you, the individual Obama supporter, much more information. You can measure your own activity against others, and you can contact the most active people within the groups.”¹³⁸

A variety of crucial external activities are enhanced in the new environment. The obvious ones are funding and outreach. The funding aspect attracted the greatest attention and was already apparent in 2004.

Even more crucial to the way this campaign has transformed politics has been Mr. Obama’s success at using the Internet to build a huge network of contributors that permitted him to raise enough money — after declining to participate in the public financing system — to expand the map and compete in traditionally Republican states.¹³⁹

....

... When Senator Obama’s campaign sought to make one last push with a 30-minute infomercial, it bought time on three major networks, using money harvested on one platform – the Web – to buy time on another – broadcast television.¹⁴⁰

Raising resources is a central organizational challenge. Members customize contributions (method, frequency, direction/cause). They must be supplied with a simple, confidential way of adjusting the amount and direction of their contributions so as to generate the full feeling of efficacy at the funding level.

Stoyloff, on the other hand, has been working for Obama’s campaign for nearly two years. She has also donated about \$150 to Obama. “I feel like I own a piece of this campaign. Like, I’ve bought and paid a piece of it, with work and heart and effort,” she says.¹⁴¹

The magnitude of the Internet small-donor fundraising is staggering. Obama raised substantially more in donations under \$200 than McCain raised in total, indeed more than any presidential candidate

138. Stirland, *supra* note 117.

139. Nagourney, *supra* note 116.

140. Carr & Stelter, *supra* note 134.

141. Vargas, *supra* note 122.

had ever raised.

The system for financing campaigns in place for a generation has been shattered as a result of this year's race and will have to be replaced.

....

... "Internet small-donor fund raising is the most positive thing I have seen in 36 years of working on this," says Fred Wertheimer, head of Democracy 21, a nonpartisan group that studies campaign financing. "If we can make that work in a systematic way instead of just for one or two candidates, then you really have revolutionized the funding of American politics."¹⁴²

C. Exploiting the Communications Resource

Another important area of traditional political activity impacted by the new environment and organization is outreach.

National campaigns have rarely bothered with places like Avery, put off by small populations, low fund-raising potential and a perception of entrenched support for one party. The Internet is making it worth trying by connecting powerful databases of detailed information on millions of voters with trained teams of local volunteers.

"Ironically, it took the Internet to get us back to the old-fashioned way of doing politics," says Mark Sullivan, the founder of a start-up called Voter Activation Network. . . .

....

... In the 1980s, presidential campaigns became increasingly top-down efforts run by well-paid professionals who focused on marketing and direct mail. The growing efficiency of computers, telemarketing and advanced polling rendered grass-roots campaigning and political organizing largely obsolete

....

... Two decades later, presidential candidates proved the strength of the Internet in fund raising

142. Gerald F. Seib, *Campaigns are Where the Real 'Change' Will Take Place*, WALL ST. J., Nov. 2, 2008, at A6.

....

. . . The Obama and McCain campaigns are now onto the next challenge: harnessing the Internet to turn online support into well-organized offline activity.¹⁴³

Just as the explosion of autonomous behavior dramatically loosened the control of the dominant firms in the music sector, the democratization of production and ease of distribution transforms the role of the media in the political sector. “Perhaps drawing on Mr. Obama’s background as a community organizer, his campaign decided early on to build a social network that would flank, and in some case outflank, traditional news media.”¹⁴⁴

This year’s campaign also has marked a change in the role the press plays. The prominence, readership and influence of online political sites has mushroomed, taking away some of the prominence of the mainstream media – traditional television networks, newspapers and news services. Campaigns have taken to getting out word of pending shifts in strategy by leaking them to political web sites, and both parties catered to bloggers at their conventions.

....

. . . The Web also may have diminished to some extent the power of campaign attack ads, because the targets of such attacks can use the Internet to instantly blast out rejoinders and rebuttals. That limits the time charges may linger unanswered.¹⁴⁵

143. Rhoads, *supra* note 125.

144. Carr & Stelter, *supra* note 134.

145. Seib, *supra* note 142;

Last week alone, the campaign uploaded 70 videos, many of them tailored to battleground states – the campaign used peer-to-peer communications to build a juggernaut that did not depend on the whims and choices of the media’s collective brain trust.

....

. . . In fact, the most popular videos on BarackObama.com weren’t TV ads; they were biographical and Web-only spots.

....

“I think that this time around, campaigns got used to the fact that anything that they put out there could be pirated, remixed, mashed-up and recirculated,” said Henry Jenkins, a professor at the Massachusetts Institute of Technology. “It is a much more rapid environment.”

....

. . . With 5 million views since March, Mr. Obama’s 37-minute speech about race is the most popular video on his YouTube Channel.

Carr & Stelter, *supra* note 134.

The traditional mass and local media are left scrambling to adapt, forced to rework their practices to accommodate the new interactive, two-way nature of the media environment.

The networks and their newspaper counterpart[s] have not simply waited to be overtaken. Instead, they have made specific efforts to engage audiences with interactive features, allowing their content to be used in unanticipated ways, and in many efforts, breaking out of the morning paper and the evening newscast.

“Old media outlets – the networks and newspapers – learned a lot of lessons from the last cycle and did not allow others to win the online space this time,” said Rick Klein, the senior political reporter for ABC News.

....

... But network news divisions are expensive operations based on a television business model. They can't run the relatively small money that online advertising draws but they can't compete for audiences if they ignore the Web.¹⁴⁶

Major media organizations expect record-breaking traffic on their Web sites as they follow results in the race between Republican John McCain and his Democratic opponent Barack Obama.

Cable network Current TV is taking its coverage a step further, relying entirely on Web users to provide its news content.

TV networks' plans for heightened Web coverage would seem to serve their audiences well.

....

... The New York Times is asking its Web site visitors to take pictures of their polling places and upload them, providing an election day snapshot of the nation. The news sites will also have up-to-the-minute election maps.

....

146. Carr & Stelter, *supra* note 134.

. . . On a smaller scale, political Web sites Town Hall and The Huffington Post will follow the election from conservative and liberal viewpoints, respectively. Nonprofit group Video the Vote plans to post up to 1,000 video reports, focusing on any problems at the polls in a form of "citizen journalism."¹⁴⁷

Given the history of negative campaigning, the impact that new media have had on that type of campaigning is dramatic. The speed and transparency of the decentralized and highly interconnected media alters the environment. The crowd sourcing aspect of rapid response is indicative of a major impact that structured viral communications can have on the role of the media.¹⁴⁸

As with the other elements of the viral model at the core of the new organization, the viral response to the flow of information mixes the chaos of the Internet with directed activities of the organization. "Bubbling up" is not entirely random. There are triggers that stimulate the flow.

Meanwhile, the Obama campaign has run a sophisticated pushback of its own, tapping a large volunteer corps through its "action wire" to

147. Alex Dobuzinski, *Media Groups Turn on Web for Election Cover*, REUTERS (Nov. 3, 2008, 3:27 PM EST), <http://www.reuters.com/article/idUSTRE4A262V20081103>.

148. Ari Melber, *Web puts Dog-Whistle Politics on a Leash*, THE NATION, Nov. 17, 2008, available at <http://www.thenation.com/article/web-puts-dog-whistle-politics-leash>.

Everyone can hear it now. This Internet-driven, hyperactive presidential race is forcing accountability on two of the oldest tricks in politics: dog whistles and secret smears.

With a "dog whistle," politicians use code words to signal unpopular stances to one target audience, while avoiding a backlash because the reference is lost on others Secret smears run on a similar axis, enabling politicians to undermine an opponent without taking responsibility for the attack. But the times are changing.

. . . .

. . . Partisan and muckraking bloggers now fight political operatives' efforts to keep unseemly attacks below the radar. Take automated "robo" phone calls, which often deploy the sharp attacks that campaigns don't want exposed in the mass media. Previously, the calls were obscure, rarely drawing major media coverage, let alone sustained criticism. Now they can be recorded, uploaded and dissected in a single news cycle. Sites like TalkingPointsMemo and Daily Kos use crowd-sourcing by readers to track the attacks and pin them squarely on John McCain. Insider political sites, like Ben Smith's *Politico* blog, also disseminate the audio recordings to media and political elites, converting a "targeted" message into a mass broadcast. And organized campaigns like the National Political Do Not Call Registry use the web, Twitter and e-mail to track and map every call.

As a hub for intelligence, the web can enlist people in "bubbling up reports" of everything from robo-calls to US attorney firings, explains TechPresident co-founder Micah Sifry, a web activism expert who heralds the trend as a new era of "crowd-scouring" the presidency. He argues that information can whip around online with or without a political agenda. "Even without central direction, the crowd is scouring the world for interesting news and sharing tidbits constantly."

expose smears and contact local media about unfair attacks. The campaign launched two portals, FighttheSmears and BelowtheRadar, to fight what it calls a stealth Republican operation “to quietly poison voters’ information with lies and fear tactics.”

All this online activity has been amplified by the rapidly shifting landscape of political television. The increasingly opinionated cable news programs, always in search of conflict and fresh content, now treat debates over these tactics as a major campaign issue. This emphasis is bleeding into the broader campaign discourse, which includes minute dissection of attacks that were once considered unmentionable.

....

... Run the tape back to 2000, and Bush was never forced to fully answer for one of his most vile political attacks, the racist smear against John McCain’s family in the South Carolina primary. Today, it is hard to imagine a candidate in either party sliding through a presidential primary without a huge backlash for deploying that kind of attack.

This cycle, in fact, even faint dog whistles are called out in real time

....

... “Thanks to YouTube— and blogging and instant fact-checking and viral emails—it is getting harder and harder to get away with repeating brazen lies without paying a price, or to run under-the-radar smear campaigns without being exposed,” contends Arianna Huffington whose website pulses with a constant, two-way debate of news and opinion.

....

... This new media environment undermines political attacks that turn on coded meanings and hidden messages, because now anything can be exposed and cheaply disseminated. Observers used to worry that the web would fragment our media consumption into private little silos—that famous “Daily Me.” Yet in presidential politics, an inverse dynamic is emerging. Small groups of people are using the web to expose the targeted appeals of the analog world, and then injecting them into the mass media for the whole nation to assess.

And many voters do not like what they see.¹⁴⁹

CONCLUSION

This analysis has emphasized four broad points.

First, that the basic economics of production and transaction cost have been dramatically lowered. In the music space, \$15 albums were replaced by \$1 singles as the highest volume units delivered. In the book publishing space, the cost of a digital book is less than half that of a physical book. In politics, the cost to get a vote is the key output. A study by the University of Michigan estimated that the cost to get a vote with a phone bank, the classic late 20th century approach, was \$20 per voter, whereas text messaging cost per voter was only about \$1.56.¹⁵⁰ This drop is of roughly the same order of magnitude as in music (see Figure III-4).

Second, the relations of production change as well. A blog in the Harvard Business Review summarized the fundamental difference between the Obama campaign and the Hillary Clinton campaign as the difference between treating supporters as members versus customers.¹⁵¹

Third, the economic efficiency and effectiveness of communications are the cornerstone of the transformation, but the outcome is not inevitable. The incumbent can delay and distort the development of institutions to favor its interests at the expense of consumers.

Finally, and most importantly, I have argued that it is the social

149. *Id.*

150. Allison Dale & Aaron Strauss, Mobilizing the Mobiles: How Text Messaging Can Boost Youth Voter Turnout (Sept. 6, 2007) (unpublished doctoral study, Princeton University & University of Michigan), *available at* http://www.mindlessphilosopher.net/princeton/Youth%20Vote%20and%20Text%20Messagin_g_9.6.07.pdf.

151. John Sviokla, *Members v. Customers: How the Obama and Clinton Online Campaigns Differ*, HARV. BUSINESS REVIEW BLOGS (Jan. 7, 2008, 3:47 PM), http://blogs.hbr.org/cs/2008/01/members_vs_customers_how_the_o.html.

On Tuesday, January 8, the giants of the presidential battle knocked heads in the always important New Hampshire primary, and far beneath the froth of issues and image is a fascinating difference between how two of the Democratic presidential candidates compete online: Hillary Clinton treats her supporters as “customers” and Barack Obama, as “members.”

When you give money to Clinton's campaign, you get a confirmation. When you give money to Obama's, they automatically create a personalized membership location for you which looks a lot like a Facebook page. Thereafter you log in at my.barackobama.com. Mass customization is not the new thing here - Joe Pine nailed that idea many years back. What Barack's online team understands and Hillary's does not, is that engagement - not just money - is how you win in this new peer-to-peer, attention-scarce, content-overloaded media melee of the Web - and money follows. With the race heating up, the candidates' online customer relationship management (CRM) strategies will play an important role.

organization that uses these technologies that ultimately matters most. Light handed-hierarchy allowed viral communications to take place in a task-oriented organization and came together to bring unprecedented resources to bear.¹⁵²

152. Benjamin Boer, *The Obama Campaign: A Programmer's Perspective*, 7 QUEUE 1, 36 (Jan. 2009).

A computer programmer who worked one Obama campaign made the point. "Obviously, social networking played a huge part in organizing people, but other models that are important to look at are the open source development . . . models. Additionally, the campaign made extensive use of data analysis . . .

....

. . . [B]ecause the people were in sync with the concept of grassroots experimentation, when a concept was successful, it was nurtured and the resources were provided to expand it . . .

....

Open source development, with its focus on distributing the ability of developers to add to an existing code base in a controlled but expansive manner, reflected the campaign's dependence on a far-flung set of leaders and volunteers. People in both universes brought their unique talents to the project. Equally as important, when a set of tasks was not accomplished as planned, resources could be moved to the problem at hand. In the same way that volunteers flowed from making calls in Pennsylvania to making them in Indiana, developers were able to flow from data exchange to the call tool.

....

. . . Each state organization had been given great leeway in designing how it was going to use the available systems, and ad hoc development of scripts and extensions of the systems were necessary as different teams attempted to stretch the data systems. For each primary, however, the relevant team was reconfigured, bringing best practices in from many locations and refactoring and consolidating processes that had been developed for targeting and scoring voters. This willingness to experiment with data analysis and then expand its use is indicative of how the campaign operated.

. . . Ideas could be tried, tested, and changed. Once an idea proved successful, it could be expanded and rolled out to thousands or hundreds of thousands of people with incredible speed.

....

. . . Platforms that could be easily configured allowed operations quickly to move processes, such as hiring and procurement, from headquarters to the hundreds of offices that were eventually established, yet allowed for centralized control of these processes. In other instances, programs such as Precinct Captain were designed in the state offices using simple platform tools and then extended to other programs with more concerted development efforts. *Id.*

Figure I-1

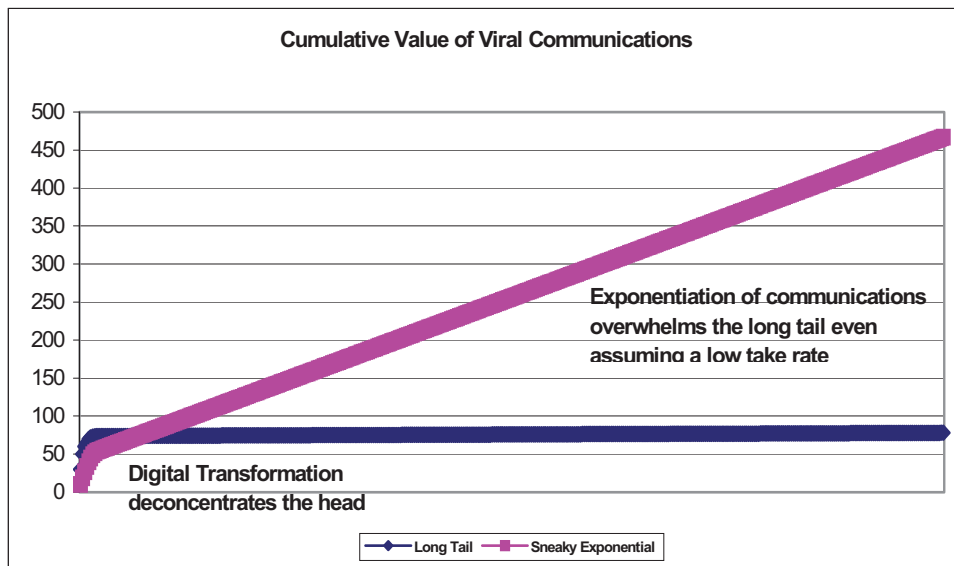
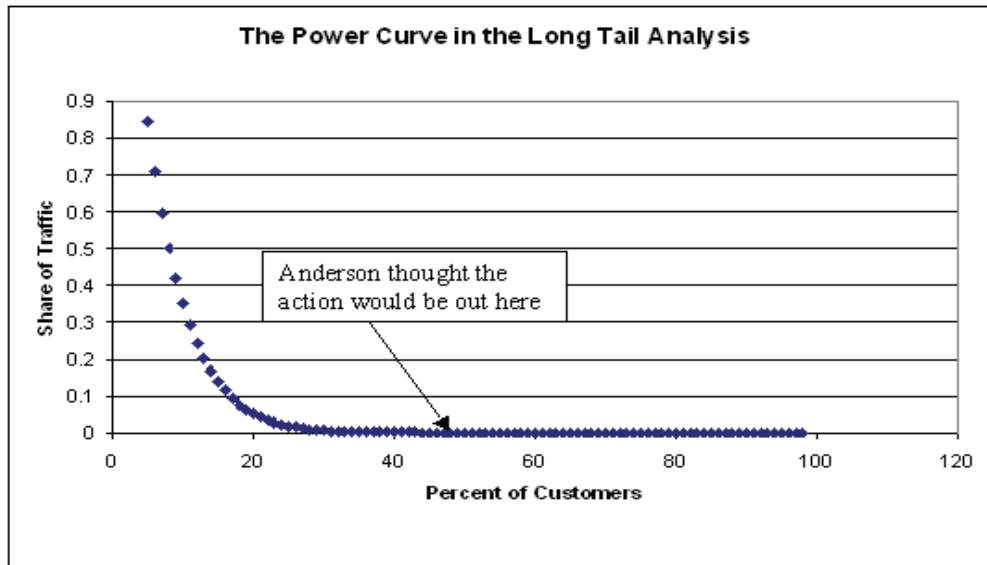


Figure I-2: *Network Architectures*¹⁵³

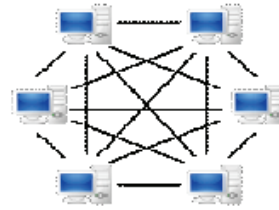
Metcalfe Network

(One-to-One)

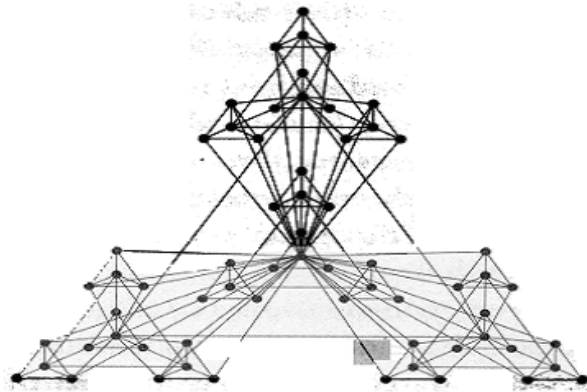


Groups Forming

(Many-to-Many)



Decentralized, Distributed, Hierarchical Communications Creates
Creates An Ultra-Robust Multi-scale Network that Facilitates
Structured Viral Communications



MODULES ORGANIZED IN A DECENTRALIZED
AND DISTRIBUTED HIERARCHICAL NETWORK
(E)

153. See David P. Reed, *That Sneaky Exponential – Beyond Metcalfe’s Law to the Power of Community Building*, <http://www.reed.com/dpr/locus/gfn/reedslaw.html> (last visited Dec. 21, 2010); ALBERT-LASZLO BARABASI, LINKED 145, 233 (2003).

Table I-1: Sources of Organizational Advantage

Resource Base			
Focal point of Activity	Resource Exploited	Process	Benefit
Autonomous transactions	Local Knowledge	Consumer as producer	Better Fit Between needs & output
Demand side value creation	Network	Self-organizing	Increased option value
Supply-side			
Mesh Networks	Spectrum	Embedded Coordination	Dynamic Occupation
Open Source	Software Code	Embedded Knowledge	Exploit rich information
Peer-to-Peer (music, video)	Content, Storage, Bandwidth	Torrenting, Collaboration	Cost Reduction
Party/campaign	Engagement	Texting, shared lists	Resources, Time

Table I-2:
*Structured Viral Organization Resolution of Organizational Challenges*¹⁵⁴

Why do people choose to cooperate? In each case there is a key resource that is exploited more effectively by the new organizational form (smart radios: spectrum; open source: rich information; digital music: content and bandwidth; political organization: engagement), rewarding the participants with a higher level of performance.

Who gets to participate according to the rules of entry? Entry into the organization is easy and open – permission is not needed.

Where are the positions located? The organization is horizontal, socially and geographically. This does not mean there is no hierarchy and rules of order – shallow hierarchy exists (the ratio of members to managers is very high), as do rules of how the participants in the network interrelate.

What are members allowed to do in those positions? In all cases, the importance of centralized control is reduced and local action and autonomy is important. Allowing and encouraging collateral and viral communications between members through shared tools and protocols are a key strength of the new organization. Communications become multi-purpose.

How are they motivated? Task-specific rewards are enjoyed (e.g. use of the resource, victory in the election) and involvement is pleasing, as is reputational gain).

How are they disciplined? Norms of peer-to-peer relations of equality are the central disciplining force, not relations of power.

How are they monitored to comply with the rules? Communications intensive organization lowers monitoring costs and facilitates collective action.

154. OSTROM ET AL., *supra* note 6, summarized tersely at 41-42.

Table I-3: Organizational Challenges of Cost Shifting¹⁵⁵

Full Cost Recovery (fixed, variable, transaction),
 Commitment (Monitoring & Enforcement. Default & Report),
 Price Discrimination (Cost allocation rules inverse elasticity, equal burden, equal benefit)

Social Challenges of Cost Shifting

Tethering, Competition, Free Riding, Waste, Predation,

Strategies for Shifting Cost Recovery

<u>Different Time</u>	<u>Different Product</u>	<u>Different people</u>
Pre-payment (lay away plans)	Strong Complements	Buyers
Post-use payments (subscription)	Bundling of weak complements	Sellers
	Tied Products	Advertiser
<u>Tapping Traffic Flows</u>	Enhanced Versions	
Loss leaders		
Trial Subscription		
Training		

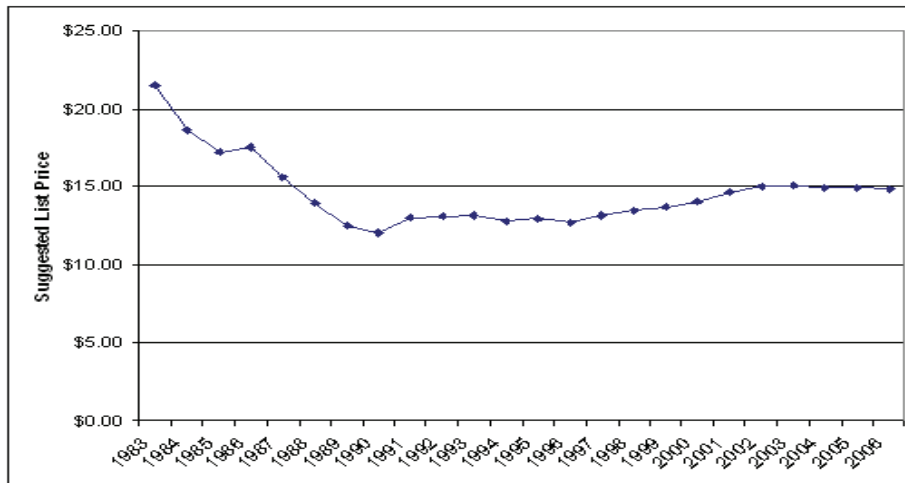
Table I-4.¹⁵⁶**ANDERSON'S SCARCITY/ABUNDANCE PARADIGM HAS GOTTEN IT HALF RIGHT****SCARCITY IS THE WRONG MODEL; FREE, CHAOS IS NOT THE RIGHT MODEL**

PRESTON PADDEN	CHRIS ANDERSON	NEW INSTITUTIONAL ECONOMICS
IMPOSE SCARCITY	IMAGINE ABUNDANCE	CREATE PLENTY
Everything is forbidden unless permitted	Everything is permitted unless forbidden	Struggle to solve the problems of cooperation to reap the advantages not only of technology but also all of the other facets of human endeavor that constitute civilization
Paternalism	Egalitarianism	Collaboration
Business Model Profit	We'll figure it out	People are encouraged to do useful things because of expansion of shared resources
Top down	Bottom-up	Mild-hierarchy, Central support
Command and Control	Out of control	Norms of peer relations

155. *See id.*

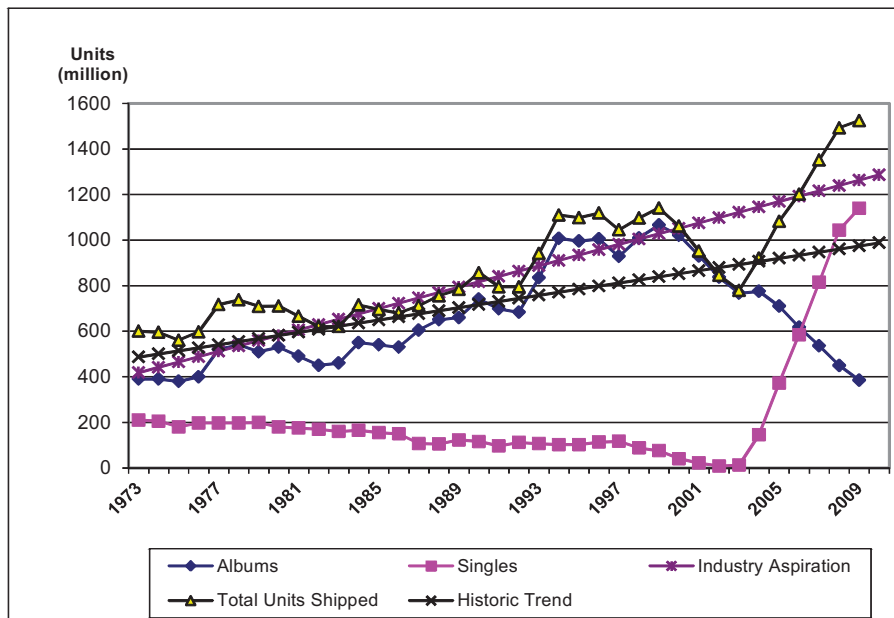
156. *See id.*

Figure II-1: CD List Prices



Source: RIAA, *The CD: A Better Value Than Ever*, August 2007

Figure II-2: U.S. Sales of Albums and Singles 1973-2009¹⁵⁷



157. RECORDING INDUSTRY ASS'N OF AMERICA, ANNUAL STATISTICS (various years); Boorstin, *supra* note 19 (Growth trends are linear projections described in text).

Figure II-3: RIAA Claimed Shipments of Singles¹⁵⁸

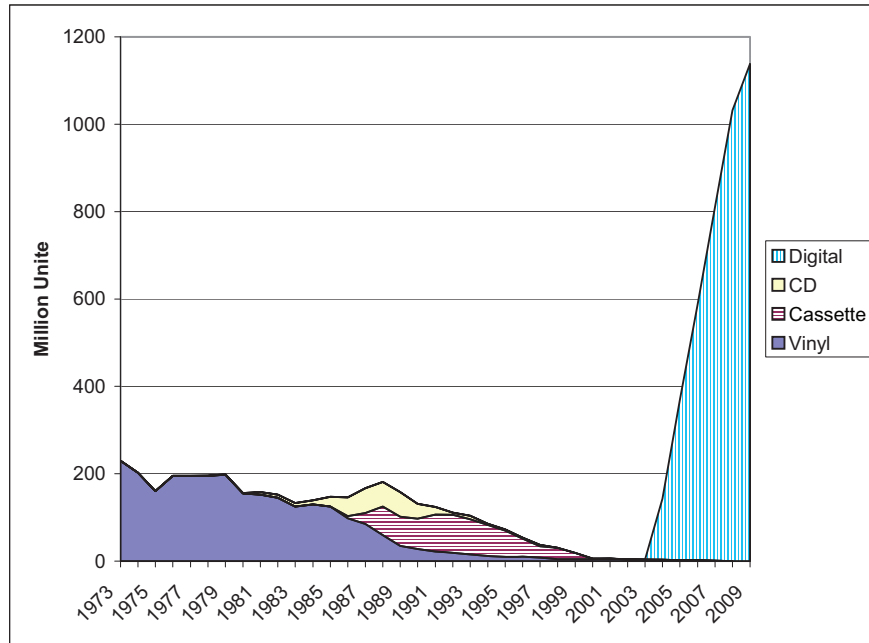
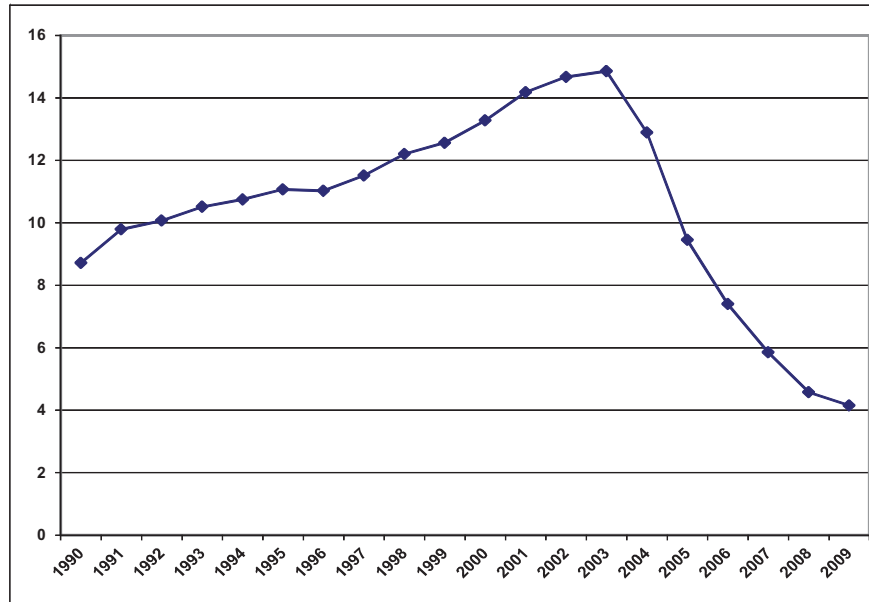


Figure II-4: RIAA Revenue Per Unit Shipped¹⁵⁹



158. RECORDING INDUSTRY ASS'N OF AMERICA, *supra* note 157.

159. *Id.*

Figure II-5: *Who Get What from the Music Consumer Dollar*¹⁶⁰

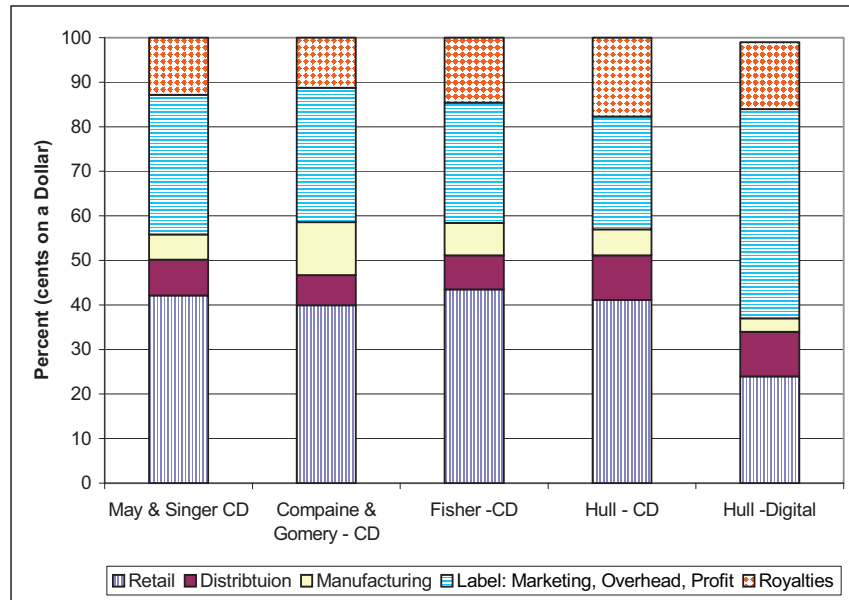
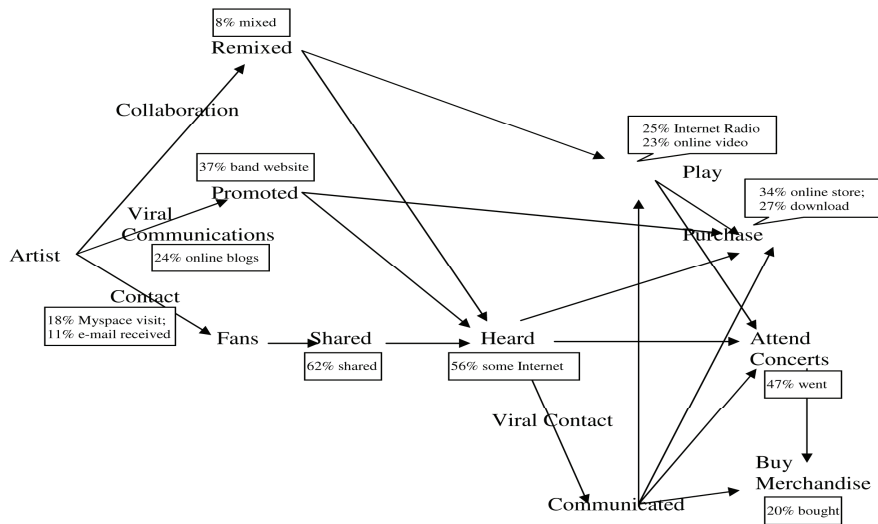


Figure II-6: *Digital Production and Distribution Enhances the Artist's value Proposition*



160. WILLIAM W. FISHER III, PROMISES TO KEEP 259-64 (2004); HULL, *supra* note 40, at 259.

Figure II-7: *Enhancing the Artist's Value Proposition in the Digital Age*¹⁶¹

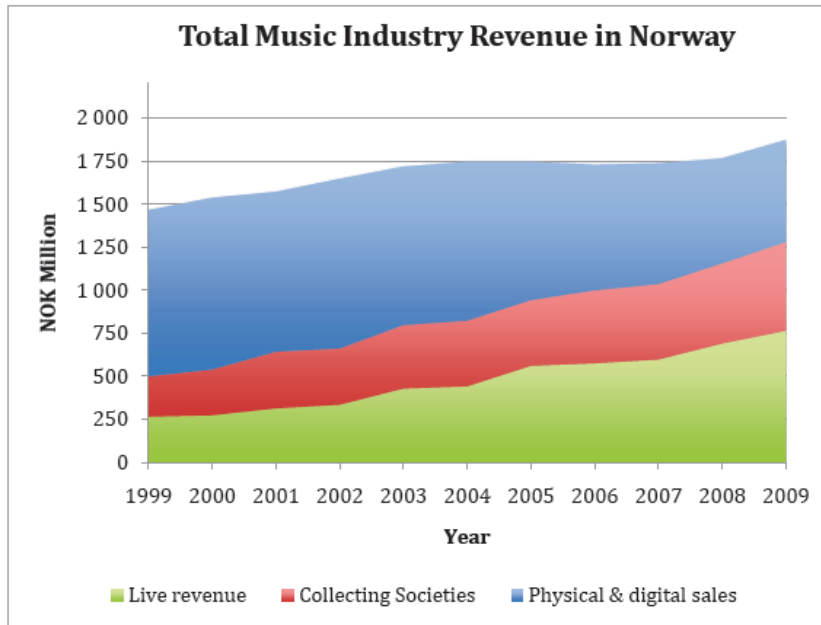
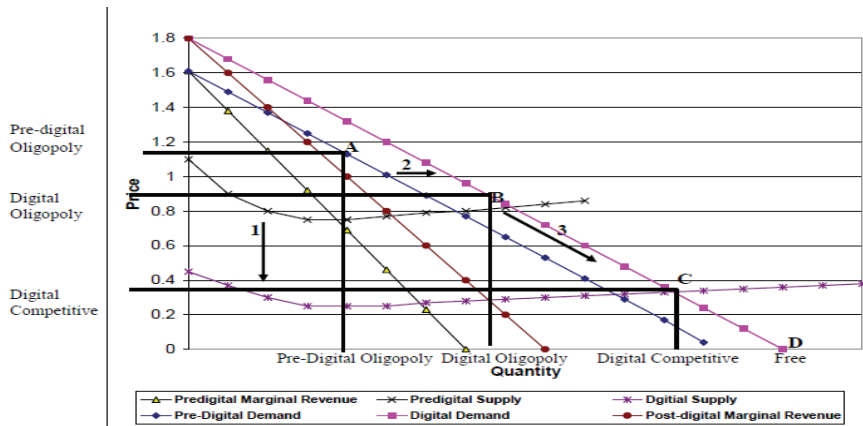


Figure II-8: *Recording Industry Supply, Demand and Marginal Revenue*



161. Richard Bjerko & Anders Sorbo, Then Norwegian Music Industry in the Age of Digitalization 62 (Jan. 9, 2010) (unpublished thesis, Norwegian School of Management), available at <http://www.scribd.com/doc/37406039/Thesis-Bjerko-Sorbo>.

Figure II-9: Newspaper Revenues¹⁶²

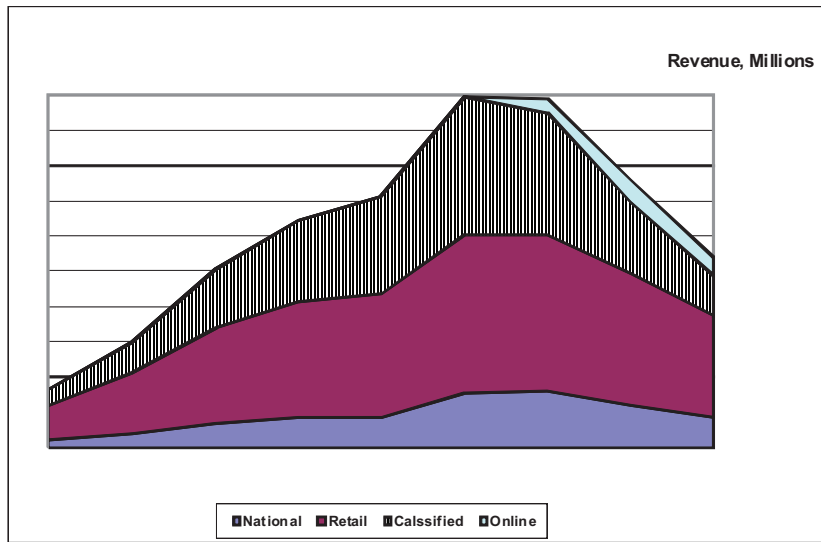
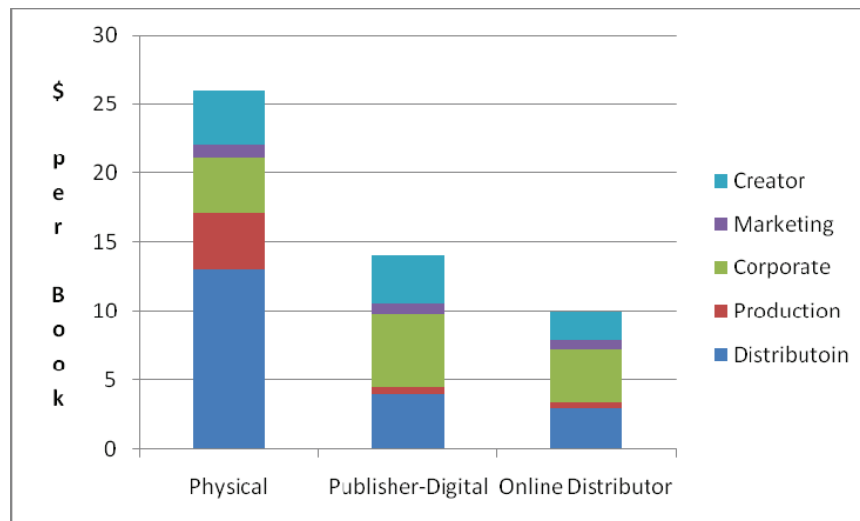


Figure II-10: Differing Views of Digital Book Economics



162. *Trends & Numbers*, NEWSPAPER ASS'N OF AM.
<http://www.naa.org/trendsandnumbers.aspx> (last viewed Dec. 21, 2010).

Figure III-1: PHYSICAL SPACE AND CYBERSPACE INTERSECT ON THE AXIS OF POLITICAL ACTION¹⁶³

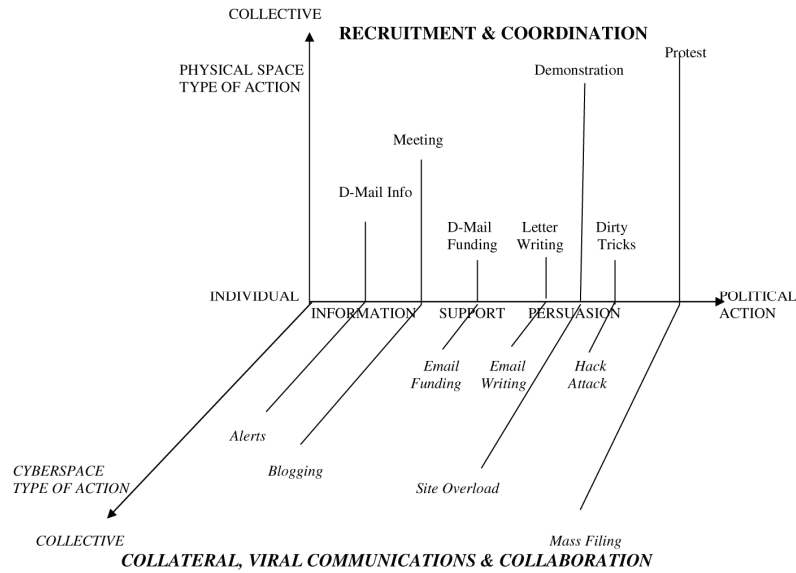
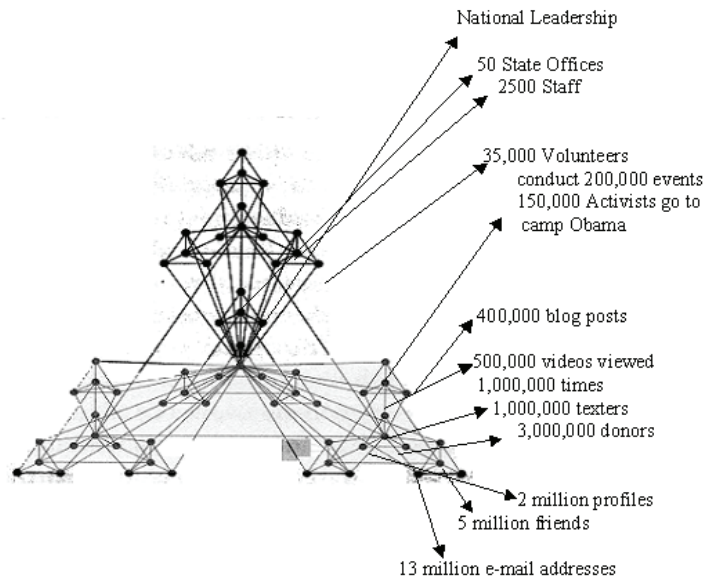


FIGURE III-2: Structured Viral Communications in the Obama Campaign



163. Mark Cooper, *Political Action and Organization Building: An Internet-based Engagement Model*, in *ONLINE DELIBERATION: DESIGN, RESEARCH, AND PRACTICE* 194 (Todd Davies & Seeta Pena Gangadharan eds., 2009).

FIGURE III-3: ROLES, FUNCTIONS AND ACTIVITIES

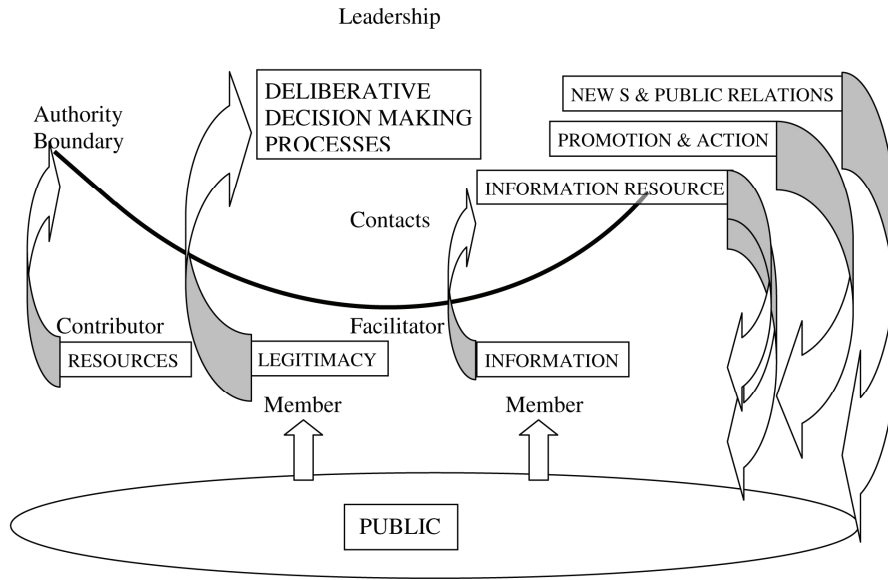
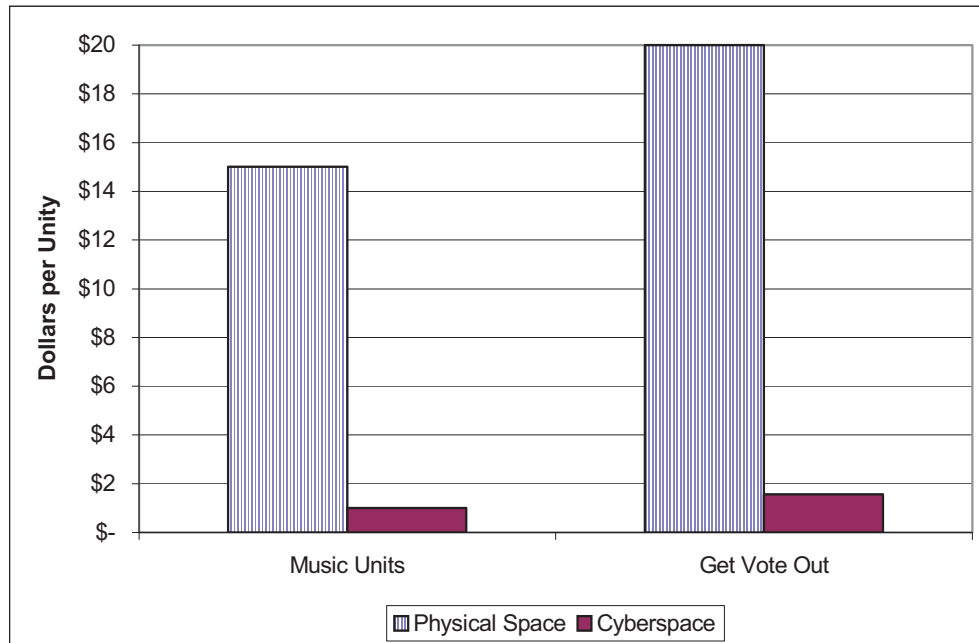


Figure III-4: Declining Cost of Production: Dominant Technology¹⁶⁴



164. Cooper, *supra* note 23; Alex Dobuzinski, Media Groups Turn on Web for Election Cover, Reuters (Nov. 3 2008, 3:27 PM EST) <http://www.reuters.com/article/idUSTRE4A262V20081103>.