Microsoft Courts Hollywood Allies

Humbled by Apple's success in music, the tech giant mends fences with the film world as it tries to conquer the home entertainment market.

By Joseph Menn, Times Staff Writer

REDMOND, Wash. — When Apple Computer Inc. transformed the digital music scene in April 2003 by selling songs over the Internet, the richest man in the world was not amused.

Microsoft Corp. Chairman Bill Gates had struggled for a decade to get his software into consumers' home entertainment systems. Now the digital media party was finally starting, and he wasn't invited.

But the blow gave Gates new insight, motivation and some needed humility — and it intensified work on what might prove the turning point in his quest to extend Microsoft's supremacy from the office into the living room.

Just weeks after Apple's seismic announcement, Gates and new AOL Time Warner Inc. Chairman Richard Parsons settled America Online's claim that Microsoft had crushed its Netscape software subsidiary with illegal monopolistic behavior.

More important, Gates and others said in recent interviews, the settlement led to a new relationship that has changed the course of Microsoft's fractious dealings with Hollywood.

The alliance with what is now Time Warner Inc. "is quite an amazing thing, given that they had a lawsuit against us and we were really mostly in conflict," Gates said in a recent interview. "We have a great, ongoing dialogue with them, including them guiding us on the concerns of other content companies."

Gates' battle to succeed in video where he failed in music is far from over. For one thing, the movie studios and television broadcasters are more prone to internal disagreement than were the record companies when Apple signed them up. That makes it trickier for Microsoft to forge content deals.

What's more, movie producers are under less financial pressure to rush to a download world: Unlike music sales, which have been declining, DVD revenue is still growing, although more slowly than it once did.

Even if they stick together, the content creators may stand pat, place their bets with multiple technology partners or choose someone other than Gates. In particular, few in Hollywood would be shocked to see Apple founder Steve Jobs pull another rabbit out of his hat, unveiling a perfectly thought-out system for moving paid video to computers and portable devices.

Meanwhile, Google Inc. and Yahoo Inc. already are getting users to contribute video to their sites for others to watch. And Time Warner's AOL is finally taking advantage of its parent's premium content, this month promising online video from Warner Bros., HBO and other Time Warner sources.

Yet after investing billions of dollars and working doggedly behind the scenes, Microsoft executives are predicting visible results within a year.

"We'll see a broader range of movies available for both rental and ownership" via the Internet, Gates said from his corner office. And he said those movies would become available much sooner in their life cycle, "closer to the pay-per-view-type release date."

The pact with Time Warner called for Microsoft to pay $750 million in compensation for its misdeeds and for the two companies — until then mainly rivals in selling Internet access — to collaborate on ways to keep video from being copied indiscriminately. Parsons later directed Time Warner to join with Microsoft in buying a combined majority stake in ContentGuard, which holds patents on anti-copying techniques.
Walt Disney Co. was so concerned about missing out that it called Microsoft and asked for a similar alliance in writing, minus the cash. And the other studios are coming along, spurred by Gates’ chats with News Corp. Chairman Rupert Murdoch and other industry captains, many of them at the annual media conference held by investment bank Allen & Co.

Hollywood negotiators say the key has been Microsoft's realization that it can't dictate terms the way it has with computer makers. After it was left in the dust by Apple's iTunes, they say, Microsoft's arrogance evaporated.

"They get it better than they used to," said one studio's new-media executive, who like others declined to be identified because of the sensitivity of negotiations. "They're trying to learn lessons from their failure on the music side, where Apple blew them out of the water."

Perhaps the most significant fruit emerged a year ago with the formation of a group that is close to finishing a rights-management system for high-definition video. Backers of the Advanced Access Content System, known as AACS, include tech firms Microsoft, Intel Corp. and IBM Corp.; media companies Warner Bros. and Disney; and consumer electronics companies Panasonic, Toshiba and Sony, which also makes movies.

Microsoft digital media chief Amir Majidimehr said AACS, which uses pieces of technology from Microsoft and other companies, would allow some content to be moved around within a home network, such as from a computer to a television.

But such control may alienate customers, analysts warn. Indeed, some consumer advocates complain that Microsoft is giving veto power over new technology to the risk-averse entertainment industry. Especially disturbing, they say, is the idea of buying a device that does something, only to have a piece of restricted content disable that feature later with a forced software "upgrade."

"The warning I'd like to see is: 'Here are all the things that can be removed from this device if someone somewhere does something naughty, and the studios decide to punish the innocent,' " said Cory Doctorow of the Electronic Frontier Foundation. "Microsoft and other technology companies are saying that the person who makes the record should be able to design the record players, and we have never given that power to copyright holders."

Gates said that such compromises were essential for drawing more content into the digital realm and that standard practices would emerge.

"Can I use it, can I lend it to my friend, can I use it in my summer home, what can I do with it? That's got to be clear," he said.

Controversy or no, AACS will be included in HD DVD, one of the two high-definition successor formats to DVDs. The competing format, Blu-ray, may follow suit.

For the negotiations with Hollywood, Microsoft last summer hired Blair Westlake, a longtime home video and television executive at Universal. Westlake advocated for some of the studios' concerns within Microsoft, said Disney Executive Vice President Salil Mehta, which made the people in Redmond "more cooperative."

Microsoft has even agreed to make architecture changes in its next-generation Windows operating system and is modifying its policy positions in Washington. Although the company previously opposed laws that would require anti-copying technology, for example, Westlake now says some might be appropriate.

Microsoft has reason to play nice. Its future depends on developing new uses for computers. As more PC users see their current machines as good enough for everyday computing needs, they delay buying new ones, which depresses Microsoft's sales. But if PCs could become true family entertainment centers, that would kick-start sales.

"It's important to us to get the content available," Gates said. Without the studios' work, "our platforms aren't very interesting."

Taking studios' copyright concerns seriously by working on AACS was one step to reassure Hollywood skeptics. Another came after Microsoft developed a technique for compressing large video files for easy transmission.

Facing suspicion that its VC-1 technology might give it too much control, Microsoft turned over the authority to license VC-1 to the same group that administers licenses for the industry-standard MPEG digital video format. That move won it enough backing from consumer electronics companies that makers of both HD DVD and Blu-ray players will support Microsoft's technology.

Another sign that Microsoft is loosening its tight control over technology has been its willingness to negotiate where consumers can move their content within the home and even how they move it within their computers.

"They can feel a sense of ownership of how it got pulled together," Gates said of the studios and broadcasters.
"When we say to them, 'Hey, please make more content available,' obviously we need to be able to listen to what their concerns are."

Among the trickier remaining goals for Microsoft is making it easy for people to watch cable television on Media Center PCs, or computers based on a special edition of Windows that are designed to be used in living rooms as home entertainment centers. Some cable companies see Microsoft as an emerging competitor and aren't cooperating, instead offering their subscribers advanced recording functions in an effort to make cable-equipped TVs a more compelling choice than Media Center PCs.

Gates' longer-term plan involves a technology known as IPTV, or Internet protocol television. With that, Microsoft can circumvent the cable firms and deal with their rivals, the phone companies.

Some studios say they will be reluctant to give the phone companies much IPTV content if it will be locked into Microsoft's format and can't be transferred to devices relying on other protection schemes.

"I don't want my customers to have to pick a technology before they can pick content," said Mitch Singer, a Sony Pictures executive vice president and key negotiator.

Although Microsoft is seen as having a more complete technology for IPTV than rivals, the first large phone company trials of its system have been delayed because of quality issues.

But the content owners are watching IPTV's progress closely, Gates said. "They'll often say to us, 'Well, how many households, and in what year?,' and at this point nobody knows the exact number. But over the next five years, it will be definitely many tens of millions."

In the best case for Microsoft, Gates said, the phone companies will invest so much that the cable companies get nervous and invest in IPTV as well.

Whichever way it shakes out, Gates vows not to play the victim in "Son of iPod."

After learning a hard lesson in the digital music business, "we're really having to work more closely with partners in the hardware industry and content industry, to really think through the whole end-to-end experience and make it better," Gates said. "That's where we've done our mea culpa. We are fixing that."

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